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# Monitoring of Corporate Groups by Independent Directors

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**Abstract**

*Both the United States and Korea have reformed their corporate governance in recent years to put increasing responsibilities on independent directors. Independent directors have been found to be an important force protecting the interests of shareholders when it comes time to make certain highly salient decisions, such as firing a CEO or selling the company. This article compares the role of independent directors in the US and Korean systems. I argue that the US may have placed regulatory burdens on independent directors that they are unlikely to be able to satisfy, given their part-time status. By contrast, in the* chaebol *system of Korea, independent directors may have a critical role to play in limiting self dealing by controlling shareholders. Given the dominance of these controlling shareholders in the Korean economy, independent directors will need strong backing to be effective in protecting the interests of public shareholders.*

Independent directors have become a popular "cure-all" in the United States for whatever the latest malady ailing the modern corporation happens to be. Whenever a corporation has found its way into the headlines as the subject of the scandal *du jour*, it is overwhelmingly the case that it is the managers who are caught with their fingers in the till, having manipulated the numbers, rolling the dice with the shareholders' money, or otherwise abusing the trust of shareholders and other corporate constituencies. They are, after all, the ones in charge of the day-to-day operations of the company. All too frequently the managers, who have charged some outrageous perk to the corporation's bill, or who have relabeled an expense as a capital expenditure, are at the very top levels of the corporate hierarchy, perhaps even serving on

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the board. Immunity from greed, fear, and other weaknesses of character are apparently not required to advance to the top of the corporate hierarchy.

It is the venality at the very top that most offends. Given the lofty levels of compensation that CEOs in the United States typically receive, it is hard for the average person (or more importantly, the average politician) to understand the desire for further aggrandizement and reluctance to accept responsibility for poor performance. One suspects that sense of outrage at the abuse of trust is mirrored, and perhaps magnified, inside the boardrooms of the corporations caught up in the wrongdoing. The directors who have placed their confidence, and to some extent their reputations, in the hands of the CEO (who generally will also serve as chairman of the board) are likely to feel a sense of betrayal as well as outrage. The outside directors are probably not the last to know, but they may take the most personal offense at the abuse.

How natural, then, is the instinct of policymakers confronted by corporate wrongdoing to want to harness that sense of betrayal and outrage inside the boardroom to make better citizens out of corporations and their officers. If only we could shift power from the inside directors to the outside directors, all would be well. The insiders, most offensively the CEO/Chair, may have been complicit in the wrongdoing. But as for the outside directors, generally the worst that can be said is that they did not know of the accounting shenanigans or outsized bet. Perhaps shifting power to the latter, relatively innocent group, we could thwart the wrongdoing before it even gets started, or at least root it out before it begins to snowball into a major scandal. Conflict of interest is the problem, goes the story, so shifting authority to individuals whose judgment is unclouded by conflict will greatly reduce the embarrassing problems that keep appearing in the headlines. Agency costs will be kept in check by recruiting faithful agents as independent directors to monitor the insiders; politicians and bureaucrats will avoid the awkward questions that inevitably arise out of corporate scandal: "Why didn't you catch this sooner? Why wasn't there a law to prevent this? What are you going to do to help these investors who have lost all this money?"

The American faith in independent directors appears to have attracted adherents globally — the long-term trend has been toward greater director independence around the world. I will focus here, however, on two countries: Korea and the United States. Both countries have turned to corporate governance reform in the wake of crises. For Korea, the impetus was an

economy-wide financial crisis that led to the intervention of the IMF in 1998. Weaknesses of corporate governance were widely perceived as exacerbating the financial shock to the Korean economy.[1)]

In this regard, the recent Korean experience echoed the American experience with the market crash of October 1929, which was popularly blamed for the subsequent widespread economic hardship that accompanied the Great Depression. That episode led to the first federal securities laws in the United States, the Securities Act of 1933 and the Securities Exchange Act of 1934. Those laws created the essential framework of the securities regime that still governs in the U.S. In adopting those laws, however, the 1930's Congress generally avoided wholesale incursions into the internal governance of corporations, leaving that area generally for the states (with the limited exception of disclosure relating to proxies). For the United States, the impetus to corporate governance reform was the collapse of high-tech bubble, which saw the tech-laden Nasdaq index plunge from nearly 5000 to 2000 in a year's time.[2)] That collapse was accompanied by a salient scandal which fueled the drive to reform. A series of high-profile accounting imbroglios (e.g., Enron, Worldcom, Healthsouth, etc.), reflected any number of violations of existing disclosure and anti-fraud requirements. As a result, the U.S. has witnessed a number of criminal indictments and convictions for those disclosure violations. Prosecution, however, was not deemed a sufficient response (except perhaps by those indicted), so the accounting scandals have also produced a number of governance reforms which apply to the guilty and innocent alike. None of these reforms seem to have helped with the next crisis, which stemmed from inadequate risk management, perhaps fueled by poorly structured incentive compensation that rewarded executives of financial institutions for placing enormous wagers on the direction of the housing market.

Korea is further along from its motivating financial crisis. It has made great strides during the intervening period in bringing its corporate governance requirements up to international standards. Korea, infected like other

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1) Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERKELEY J. INT'L L. 61, 69 (1999).

2) The Nasdaq closed at 5,048.62 on March 10, 2000 and 1,923.38 on March 12, 2001, *available at* http://finance.yahoo.com.

countries by the crisis in the U.S., must now face the question of whether it has renewed its appetite for governance reform. Are further reforms needed? If the answer is yes, does Korea have the political will to finish the job of reforming its governance standards? Has Korea done enough to prevent the fraud next time?

The United States by contrast, already boasted governance standards — arising from a combination of state corporate law, exchange listing standards, and best practices — that were among the most stringent in the world when it faced its spate of the accounting scandals. Nonetheless, those governance controls proved inadequate to prevent the sort of attention-getting frauds that typically lead to corporate and securities fraud reform. The regulatory backlash in the United States has led to the enactment of best practices as a matter of federal law in the hope that doing so will help prevent fraud in the future. Were those toughened standards needed, or were they overkill? Will the United States' rigorous new standards prevent the fraud next time?

Obviously these two countries' reform drives have significantly raised governance standards in both countries. More interesting, perhaps, is the fact that the gap between the two has narrowed. Korean governance standards — at least on paper — have many similarities to the standards now in place in the United States. This facial similarity between the governance regimes in the two countries overlooks one critical fact — the corporate environment varies dramatically between Korea and the United States. Although the Korean economy continues to be dominated by the *chaebol* groups of affiliated companies, the American economy is dominated by publicly-held companies with widely dispersed shareholders. One question raised by Korea's move to upgrade to international best practices is whether the practices appropriate for a country like the United States, which has very few controlling shareholders, can be translated into Korea's complex web of corporate groups. What implication does this wide divergence in the two countries' corporate environments have for determining the appropriate standards for corporate governance? Most importantly for purpose of looking at the role of outside directors, does independence have the same meaning and purpose in the context of a corporate group? Does the notion of independence need to be adjusted to fit into a group context? Should directors' independence be measured with respect to the group as a whole, or only with respect to the individual affiliated company within the group?

In Parts 1 and 2 of this paper, I discuss the current state of corporate governance in Korea and the United States and the recent changes to the two regimes. In Part 3, I compare the very different governance problems faced in those two countries and analyze whether the independent director is the answer to the problems faced in either country. I conclude that the independent director is unlikely to eliminate fraud and self-dealing from the American capital markets, as it proponents may have hoped. I also conclude, however, that the use of independent directors, if properly bolstered by other governance measures, could help mitigate the problems fostered by the *chaebol* system in Korea.

## Part 1: Corporate Governance in Korea

### *1. The Dominance of the* Chaebol

The defining characteristic of corporate governance in Korea is the predominance of *chaebols*, a group of affiliated firms, which although they are legally independent, are nonetheless tied together by cross shareholdings.[3] The group is commonly dominated by a controlling shareholder or family. Although common shares carry one vote per share in Korea (dual class shares are prohibited for now[4]), the strategic use of cross ownership results in the controlling shareholder exercising voting power over the affiliated companies substantially greater than the controller's economic rights. Kim, Lim and Sung report a startling gap of median voting rights of 74.59 percent for controlling shareholders of *chaebol* firms, but only 12.95 percent median cash flow rights for those shareholders.[5]

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3) Cross shareholding is not permitted between two firms, but this restriction is readily circumvented through the use of three or more firms. Sea Jin Chang, *Ownership Structure, Expropriation, and Performance of Group-Affiliated Companies in Korea*, 48 ACAD. MGMT. J. 238, 238 (2003).

4) SANGBEOP [KOREAN COMMERCIAL CODE] art. 369-1. The Ministry of Justice has drafted legislation that would allow dual-class stock.

5) Woochan Kim et al., *What Determines the Ownership Structure of Business Conglomerates?: On the Cash Flow Rights of Korea's Chaebol*, ECGI — FINANCE WORKING PAPER NO. 51/2004; KDI SCHOOL OF PUB POLICY & MANAGEMENT PAPER NO. 04-20 (2004), at 22, *available at* http://ssrn.com/abstract=594741.

In part to maintain this control, *chaebol* firms rely heavily on debt.[6] Indeed, this is the principal benefit afforded by affiliation with the *chaebol* group: affiliated firms have greater access to financing than non-*chaebol* firms, the result of cross-debt guarantees among *chaebol* member firms.[7] Moreover, the importance of the *chaebol* to the Korean economy means that they were historically "too big to fail," enjoying the implicit guarantee of a bailout from the government.[8] That guarantee now appears to have been withdrawn, as evidenced by the demise of the Daewoo group. Perhaps the recently enacted prohibition of loans and guarantees to specially-related persons will put pressure on the *chaebol* to reduce their debt levels.[9] The available evidence suggests that substantial improvement has been made already, with the debt load of the *chaebol* substantially reduced from where it stood at the time of the IMF crisis.[10]

### 2. Evidence on the Effect on Minority Shareholders

Unfortunately, the benefits afforded by greater access to debt carries with it substantial costs for equity holders. The "separation of ownership and control" enjoyed by the controlling shareholders of the *chaebol* has important implications for minority shareholders in Korean firms. Although this separation of cash flow rights from control rights may reduce the cost of debt (perhaps because it aligns the interests of default-averse creditors with the interests of under-diversified controlling shareholders), it may also leave

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6) Jae-Seung Baek et al., *Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis*, 71 J. FIN. ECON. 265, 267 (2004) (the average debt to total assets ratio in the top 30 *chaebol* firms was 77.18% in 1993-1998).

7) Hyun-Han Shin & Young S. Park, *Financing Constraints and Internal Capital Markets: Evidence from Korean 'Chaebols'*, 5 J. CORP. FIN. 169, 172-73, 190 (1999).

8) Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 J. CORP. L. 199, 207 (2000).

9) Cross-debt guarantees of *chaebol* group companies are tightly regulated by law. DOKJEOMGYUJE MIT GONGJEONGGEORAE E GWANHAN BEOPNYUL [KOREAN MONOPOLY REGULATION AND FAIR TRADE ACT], art. 10-2. I am indebted to Joon Park for this point.

10) According to the analysis of the Financial Supervisory Service, the largest five *chaebol* groups reduced their average total liabilities-to-equity ratio from 352% (December 31, 1998) to 125% (December 31, 2002); other *chaebol* groups reduced their average ratio from 427% (December 31, 1998) to 172% (December 31, 2002).

minority shareholders vulnerable to expropriation by controlling shareholders. The directors charged with protecting those minority shareholders are scant protection: "*chaebol* affiliates' boards of directors are generally filled with insiders and friends of *chaebol* families."[11] Thus, the discretion of the controlling shareholder is largely unchecked by the formal authority supposedly held by the board.

There is considerable evidence of that controlling shareholders use that discretion to appropriate wealth from the minority. For example, minority shareholders in *chaebol* firms typically lose out when the firm makes an acquisition, but the controlling shareholder benefits.[12] Controlling shareholders also appear to manipulate their ownership interests in group firms to concentrate their economic rights in the most profitable members of the group.[13] Conversely, controlling shareholders may reduce their equity exposure in group members firms that have provided debt guarantees to more risky firms within the group.[14] So the greater access to debt that *chaebol* firms enjoy may again come at the expense of minority shareholders.

This divergence between control and economic rights may also manifest itself in diminished profitability. Controlling shareholders in *chaebol* groups may be more concerned with avoiding losses to their under-diversified wealth than they are with maximizing the profits of the firms affiliated with the group. Minority shareholders, by contrast, are more likely to be fully diversified (and therefore effectively risk-neutral) and less likely to have equity holding in each of the members of the group. There is evidence that the ownership structure of the *chaebol* may hurt profitability. For example, Joh shows that *chaebol* firms experienced lower operating profits during the pre-crisis period.[15] Monitoring by the controlling shareholder appears to promote the interests of the group as a whole, not the firm for which the individual works. So top executive turnover in *chaebol* firms appears to be unrelated to

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11) Chang, *supra* note 3, at 241.

12) Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695, 2737 (2002).

13) Kim et al., *supra* note 5, at 30; Chang, *supra* note 3, at 250.

14) Chang, *supra* note 3, at. 242.

15) Sung Wook Joh, *Corporate Governance and Firm Profitability: Evidence from Korea before the Economic Crisis*, 68 J. FIN. ECON. 287, 318-19 (2003); Terry L. Campbell & Phyllis Y. Keys, *Corporate Governance in South Korea: The Chaebol Experience*, 8 J. CORP. FIN. 373, 389 (2002).

firm-level performance, whereas it is significantly related for non-*chaebol* firms.[16] In addition, executive compensation correlates with stock-market returns and return on assets for non-*chaebol* firms, but there is no significant relation between these performance measures and executive compensation for *chaebol* firms, despite the fact that *chaebol* firms pay their executives more.[17]

Not surprisingly, the stock market appears to recognize this risk of abuse by the controlling shareholders of *chaebol* firms: Baek, Kang & Park find that firms in which the controlling shareholders' voting rights exceed his economic rights had significantly lower returns during Korea's financial crisis.[18] By contrast, firms with the largest non-managerial blockholder concentration experience significantly greater stock returns during the crisis.[19] These findings suggest that concentrated ownership is not the problem; it is the separation of control from cash flow entitlements. In addition, transparency helps mitigate the problem; firms with cross-listed ADRs (thereby subject to more stringent disclosure regimes) and firms with substantial foreign institutional investment also enjoyed significantly less negative returns.[20] Monitoring of management by large investors — without the risk of expropriation by the controlling shareholder — benefits *all* of the investors.

### 3. *Reforming the* Chaebols

Reforming the corporate governance of the *chaebol*s to discourage misappropriation from minority shareholders has been a principal focus of the government since the financial crisis of 1997-1998. The IMF and World Bank identified weak corporate governance as an important cause of the crisis.[21]

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16) Campbell & Keys, *supra* note 15, at 390.

17) Takao Kato, Woochan Kim & Ju Ho Lee, *Executive Compensation, Firm Performance and Chaebols in Korea: Evidence from New Panel Data*, 15 PACIFIC-BASIN FIN. J. 36 (2007).

18) Baek et al., *supra* note 6, at 310. Interestingly, the lower stock market returns of the *chaebol* firms were not matched by lower accounting profitability during the crisis — *chaebol* firms had greater profits (although the difference is not statistically significant) than their non-*chaebol* counterparts. *Id.* at 307.

19) *Id.* at 302.

20) *Id.* This fact is noteworthy in light of the fact that the flight of foreign capital played an important role in exacerbating the effects of the financial crisis. Milhaupt, *supra* note 8, at 295, 297.

21) Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on*

Prior to these reforms,

> Principal shareholders commanded all facets of corporate affairs, including board decisions, the selection of directors or auditors, and shareholder meetings. Principal shareholders single-handedly appointed directors and auditors. Candidates were selected from company employees, with one of the most important criteria being personal loyalty to the principal shareholders.[22]

Now, directors owe an explicit fiduciary duty to the corporation.[23] In addition, thresholds have been lowered for the bringing of derivative suits and removing directors.[24] The former change has resulted in a significant increase in the number of derivative actions.[25]

Large firms (i.e., those with assets greater than 2 trillion won) are singled out for especially stringent corporate governance requirements. Large firms must draw at least half of their directors from outside the firm, have an audit committee with at least two-thirds outside directors, and have a nominating committee for outside directors.[26] Chaebol firms have also received special attention. Principal shareholders who act as de facto directors or otherwise influence company management now owe a fiduciary duty to the corporation, whether or not they serve formally as directors.[27] Moreover, conflict of interest transactions involving the firms in the groups with more than 5 trillion of total assets must be approved by the board of directors.[28] There is evidence that a similar provision adopted by the SK Group in its articles of incorporation has been effective in preventing at least some overreaching by the controlling shareholder.[29] It is worth noting that the provision in question may have been adopted as a result of pressure from foreign investors.[30]

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*International Competition*, 21 U. PA. J. INT'L ECON. L. 273, 275(2000).

22) *Id.* at 279-80.

23) KOREAN COMMERCIAL CODE, art. 382-3.

24) *Id.*, art. 385 & 403.

25) Kim, *supra* note 21, at 295.

26) KOREAN COMMERCIAL CODE, art. 542-8 & 542-1.

27) *Id.*, art. 401-2.

28) KOREAN MONOPOLY REGULATION AND FAIR TRADE ACT, art. 11-2.

29) Kim, *supra* note 21, at 325.

30) *Id.*, at 324-25.

These requirements appear to have had some effect, as *chaebol* firms do not have significantly worse governance than other Korean firms.[31] There is evidence that improvements in corporate governance have a real payoff — Black, Jang, and Kim find that better corporate governance correlates with significantly greater market valuation.[32] For example, having a majority of outside directors correlates with a roughly 40% greater share price.[33]

To summarize, the main challenge facing the Korean system of corporate governance is the predominance of the *chaebol* system. Korea has made great strides over the last few years to try and bolster the protections afforded to minority shareholders, but more must be done. I will turn to that topic in Part 3.

## Part 2: Corporate Governance in the United States

### *1. Dispersed Public Ownership*

The pattern of corporate ownership in the United States differs substantially from the one found in Korea. Controlling shareholders, while not unheard of, are the exception rather than the rule. The typical ownership pattern in the United States is one of dispersed public ownership, with no single shareholder holding more than a small percentage of the company's shares. The need for diversification and certain regulatory restrictions ensure that even institutional investors will not ordinarily hold more than a small bloc of shares in any one company. Moreover, cross-ownership is relatively rare. American companies own shares in other companies, but they are typically a joint venture between companies. More typically, a parent corporation will own 100% of the shares of a subsidiary, essentially obviating conflict of interest concerns, or different businesses within a corporation will simply be operated as separate operating divisions, without the formality of separate incorporation. (The downside of

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31) Bernard S. Black, Hasung Jang & Woochan Kim, *Predicting Firms' Corporate Governance Choices: Evidence from Korea*, 12 J. CORP. FIN. 660, 677 (2006).

32) Bernard S. Black, Hasung Jang & Woochan Kim, *Does Corporate Governance Predict Firms Market Values? Evidence from Korea*, 22 J. L. ECON. & ORG. 366 (2006).

33) *Id.*

the latter arrangement, of course, is that all of the company's assets will be placed at risk if one of the operating divisions sustains liabilities that it cannot satisfy on its own.)

In this system of dispersed public ownership, the principal concern for abuse of power by those in control is not the risk posed by controlling shareholders, but rather, the potential for overreaching by managers. Given the dispersion of ownership, the voting mechanism will only be a weak check on managerial abuse and incompetence. Managers (particularly CEOs) in practice have a great deal of say over who will be named to the company's board, so the ability of the shareholders to affect the company's direction through their power to elect directors will be diffuse at best. Recognizing these weaknesses in direct accountability to widely dispersed shareholders, the corporate governance regime in the United States aims to protect the interests of largely powerless shareholders from overreaching by managers. Controlling shareholders are a concern, but a secondary one. The principal role of independent directors in the corporate regime of the United States is to restrain the CEO and other managers.

### *2. Evidence on the Effect of Independent Directors*

What does the available evidence from the United States show about the success of independent directors in restraining managers? Most notably, on the subject presumably of greatest interest to shareholders, there is no evidence to show that more independent boards correlate with better firm performance.[34] So shareholders cannot rely on independent directors to bolster the bottom line. This should hardly be surprising — if outside directors were a magic elixir, somehow boosting corporate performance, we would hardly need governance mandates to encourage greater board independence. Companies would bring more independent directors on board purely out of self-interest.

Independent directors do appear to have an effect, however, at certain critical junctures for the corporation. Those junctures arise when the board is

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34) Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 259 (2001).

asked to make certain high stakes decisions. Being an outside director has historically been a part-time job, but at times it can capture the director's full-time attention. More independent boards are more likely to replace the CEO after a period of poor performance.[35)] This finding suggests that independent directors take this paramount monitoring task seriously. Turning to other salient situations likely to capture the focus of independent directors, more independent boards generally extract higher takeover premia in takeovers.[36)] Companies adopting "poison pill" shareholder rights plan experience a positive stock price reaction if their board is majority independent, but a negative reaction otherwise.[37)] What explains these findings relating to takeovers? Perhaps more independent boards limit the ability of target company managers to extract side payments from potential acquirers, which the pill may facilitate. On the other side of the fence, acquiring companies announcing takeovers experience *less* of a drop in their stock price if they have a majority of independent directors.[38)] Independent directors may check excessive managerial optimism and a penchant for empire building.

These findings that independent directors guide salient decisions are promising. The evidence on whether more independent directors contribute to more accurate financial reporting, however, is mixed. On the one hand, board independence does not appear to have any significant effect on a company's exposure to securities fraud class actions, one of the principal unfortunate consequences stemming from inaccurate financial reporting in the United States.[39)] On the other, there is evidence that weak governance, including a lack of board independence, is associated with enforcement actions by the Securities and Exchange Commission.[40)] This finding is

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35) Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 458 (1988).

36) James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195, 216 (1997).

37) James A. Brickley et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371, 388 (1994).

38) John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 219 (1992).

39) Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J. L. ECON. & ORG. 627, 642 n.14 (2007).

40) Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC,* 13 CONTEMP. ACCT. RES. 1, 21-22 (1996); Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and*

confirmed in a study looking at a broader range of fraudulent behavior.[41] These studies, however, rely on data that may have little bearing on current practice because governance practices in the United States have considerably less variation today than they did ten to twenty years ago. Virtually all of the boards of American public companies are now "above average," at least when compared with the governance practices of a generation ago.

### 3. *Reforming the Role of Independent Directors*

The corporate governance reforms in the United States have not been directed toward areas in which independent directors have been shown to have a positive influence on shareholder returns. Instead, the reforms are pinned to the hope that independent directors can encourage more accurate financial reporting. That focus reflects the scandals that give rise to the impetus for reform. The reforms came in response to a series of accounting scandals at large public companies, most notably Enron, Worldcom, Adelphia and Tyco. Unlike Korean crisis of 1997-1998, the stock market decline that accompanied these headlines of scandal did not have any appreciable effect on the overall economy. Notwithstanding the limited economic impact of these scandals, the widespread wrongdoing at those prominent firms raised concerns that it might reflect a broader pattern of misleading financial statements and self-dealing. Among the concerns raised were: (1) the perception that managers focused too narrowly on showing earnings growth from quarter to quarter, which may have created a temptation to shade the numbers in order to show that growth; (2) the closely-related concern that incentive-based compensation, which was supposed to align managers' interests with those of shareholders, again may have tempted managers to play fast-and-loose with accounting-based measures of performance; and (3) a limited form of self-dealing involving not related-party transactions of the sort seen in the *chaebol*, but instead enormous pay packages to managers, seemingly unchecked by too quiescent independent directors.

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*Financial Statement Fraud*, 71 THE ACCT. REV. 443, 463 (1996).

41) Hatice Uzun et al., *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33, 41 (2004).

Politicians quickly stepped in to exploit the opportunity created by this very public airing of corporate dirty laundry. The Sarbanes-Oxley Act of 2002 was the political response to the accounting crisis in the United States.[42] Not surprisingly, given that the impetus for legislation arose out of accounting problems, the governance reforms adopted in response to the accounting scandals revolve around the relation of public companies to their external auditors. Those external auditors were perceived to be lacking in the independence. A variety of restrictions were adopted to foster auditor independence; the reform involving the board was to make the external auditors solely accountable to independent directors.

Although anxious to be seen "doing something" about corporate misbehavior, Congress took pains to avoid responsibility for the details of the reforms to be adopted. Instead of requiring that audit committees be made up solely of independent directors, Congress instead directed national securities exchanges to adopt listing standards requiring wholly-independent audit committees.[43] The distinction between laws and listing standards is largely cosmetic, given that changes in listing standards are subject to approval by the Securities and Exchange Commission. In effect, the delegation of this task to the exchanges was a *de facto* takeover of an important aspect of corporate governance from state corporate law (its traditional domain in the American system). The takeover was done, however, with a self-regulatory veneer, useful because the exchanges have imposed governance standards, of varying degrees of intrusiveness, for decades.[44] Those listing standards now require not only that all members of the audit committee be independent (as directed by Congress), but also require that those members be "financially literate" or possess "financial sophistication."[45] Sarbanes-Oxley also requires that the independent audit committee have exclusive authority over the retention and compensation of auditors.[46] Auditors also must report to the audit committee material accounting decisions.[47] Finally, the law establishes "whistle-

42) Pub. L. No. 107-204, 116 Stat. 745 (2002).

43) Sarbanes-Oxley Act, Pub. L. No. 107-204, § 301, 116 Stat. 745 (2002).

44) Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 34-47654 (April 25, 2003).

45) NYSE Listed Company Manual § 303A.07; Nasdaq Rule 4350(d)(2).

46) Sarbanes-Oxley Act, § 301, *supra* note 43.

blowing" procedures for employees to report concerns about accounting to the audit committee.[48]

The requirement of the independent audit committee supplements the requirement that the board of directors have a majority of independent directors. Both the New York Stock Exchange and Nasdaq listing standards now mandate that independent directors predominate.[49] In and of itself this requirement is uncontroversial, but the definition of independence is circumscribed by a number of relationships with the companies which are specified as inconsistent with independence.[50]

A more direct challenge to the power of the CEO is reflected in changes in the selection of directors. Nomination of directors is placed in the hands of independent directors: the NYSE requires a nominating committee consisting solely of independent directors, while the Nasdaq allows a choice between such a committee and nomination by a majority of the independent directors serving on the board as a whole.[51] The exchanges split similarly on the question of CEO compensation: the NYSE requires a compensation committee consisting solely of independent directors, while the Nasdaq again gives a choice between such a committee and allowing a majority of independent directors to determine compensation.[52] The division between the NYSE and Nasdaq reflects the difficulty that some smaller companies, largely concentrated on the Nasdaq, may have in finding enough qualified independent directors to serve all the mandated committees. The requirements relating to CEO compensation probably codify, in large part, existing practice: CEO compensation would be subject to entire fairness review by the courts if not ratified by the independent directors.

All of these committee requirements have put substantial new responsibilities on independent directors; compliance with all of these new requirements has forced independent directors to work more. Not surprisingly, companies have been forced to pay correspondingly more for

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47) *Id.*, § 204.

48) *Id.*, § 301.

49) NYSE Listed Company Manual § 303A.01; Nasdaq Rule 4350(c)(1).

50) NYSE Listed Company Manual § 303A.02(a); Nasdaq Rule 4200(a)(15).

51) NYSE Listed Company Manual § 303A.04(a); Nasdaq Rule 4350(c)(4)(a).

52) NYSE Listed Company Manual § 303A.05(a); Nasdaq Rule 4350(c)(3)(a).

independent directors' services.[53] The trend is unlikely to abate; the recent subprime crisis has brought calls for a greater role by independent directors in risk management.[54] Given these greater responsibilities, boards may have to expand to accommodate the greater work load. Expansion of the board, however, may be bad news for investors, as larger boards correlate with weaker firm performance.[55]

## Part 3: The Role of Independent Director in Korea and the United States

### *1. Korean and United States' Independent Directors Compared*

The table below summarizes the recent reforms relating to independent

| | Korea | United States |
|---|---|---|
| Board | > 50% independent[56] | > 50% independent[57] |
| Audit Committee | Required<br>67% outside directors and non-outside director member must satisfy statutory independence test[58]<br>Must have at least one finance or accounting expert[59] | Required<br>100% independent directors[60]<br>Must possess "financial sophistication" or "financial literacy"[61]<br>Auditors must report to audit committee[62] |

53) Towers Perrin, *Compensation for Corporate Directors Rose Modestly in 2008*, *available at* http://www.towersperrin.com/tp/showdctmdoc.jsp?country=global&url=Master_Brand_2/USA/News/Monitor/2009/200910/mon_article_200910c.htm (reporting decline in director compensation in 2008 after yearly increases of 10%).

54) Press Release, National Association of Corporate Directors Launches Campaign to Strengthen Corporate Governance (Mar. 24, 2009), *available at* www.nacdonline.org/DirectorChallenge.

55) David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185, 209 (1996).

56) KOREAN COMMERCIAL CODE, art. 542-8.

57) NYSE Listed Company Manual § 303A.01; Nasdaq Rule 4350(c)(1).

58) KOREAN COMMERCIAL CODE, art. 542-11 & 415-2.

59) *Id.*, art. 542-11.

| | Korea | United States |
|---|---|---|
| Nominating committee | Required for outside directors<br>≥ 50% independent[63] | Required<br>100% independent directors on committee or majority of independent directors[64] |
| Compensation committee | Not required | Required<br>100% independent directors or majority of independent directors[65] |
| Related-party transactions | Board approval required[66]<br>Loans and guarantees prohibited (except for certain limited circumstances) | Independent directors' approval required (otherwise subject to legal challenge)[67]<br>Loans to officers prohibited[68] |
| Cumulative voting | Required absent opt out in charter; many firms have opted out[69] | Permissible, but not required and not common[70] |

directors for large, public firms in Korea and the United States discussed above.

Placing the two countries reforms side-by-side in the chart highlights the fact that Korea's corporate governance provisions, by and large, have more in common with the requirements in the United States than differences. One might conclude from this overall similarity, and given their relative states of capital market development, that both countries have adopted roughly appropriate models of corporate governance. I would argue, however, that the opposite conclusion is warranted: given their relative states of capital

60) NYSE Listed Company Manual § 303A.07(b); Nasdaq Rule 4350(d)(2).

61) *Id.*

62) NYSE Listed Company Manual § 303A.07(a).

63) KOREAN COMMERCIAL CODE, art. 542-8.

64) NYSE Listed Company Manual § 303A.04(a); Nasdaq Rule 4350(c)(4)(a).

65) NYSE Listed Company Manual § 303A.05(a); Nasdaq Rule 4350(c)(3)(a).

66) KOREAN COMMERCIAL CODE, art. 542-9.

67) NYSE Listed Company Manual § 307.00; DEL. CODE ANN. tit. 8, § 144; N. Y. BUS. CORP. LAW § 713; CAL. CORP. CODE § 310.

68) Sarbanes-Oxley Act § 402, *supra* note 43.

69) KOREAN COMMERCIAL CODE, art. 542-7.

70) See MODEL BUS. CORP. ACT § 7.28 comt. Statutory comparison (2008).

market development, Korea requires more stringent corporate governance mandates than does the United States. Korea cannot be content to follow the American lead in corporate governance if it hopes to attain the depth and liquidity of the American capital.

### *1. The Path Forward for Independent Directors in Korea*

Korea's public companies continue to be dominated by the *chaebol*; that dominance is unlikely to end any time soon. As a result, the *chaebol* are the face of Korean companies for many potential investors. As the research discussed in Part 1 demonstrates minority shareholders in those firms face very substantial risks of expropriation by the controlling shareholder. They face an even more substantial risk that the *chaebol* group will be managed to minimize the losses to the controlling shareholder. Potential investors have good grounds to be wary of placing their money in the hands of the controlling shareholders.

The combination of *chaebol* dominance and controlling shareholder abuses means that the *chaebol* present a difficult "chicken-and-egg" problem for Korean reformers. On the one hand, the available evidence suggests that the shareholders of the *chaebol* companies would benefit the most from improvements in corporate governance. Korea cannot encourage a culture of investor confidence in Korean companies (with the attendant benefits that this would create for economic growth) without taming the power of the controlling shareholders of the *chaebol* and protecting minority shareholders from their overreaching. *Chaebol* shareholders, as a group, would be better off if governance were improved, but the benefits would accrue primarily to minority shareholders at the expense of controlling shareholders. Thus, controlling shareholders, anxious to preserve their substantial discretion, are likely to pose a substantial obstacle to further reform. As a result of their wealth and central role of their businesses in the Korean economy, the controlling shareholders exercise tremendous influence in policy discussions. Slicing this Gordian knot to promote a system that facilitates the confidence of minority investors is the central challenge facing Korean regulators today.

Can the knot be cut? Unfortunately, the answer to this critical question is: "Not overnight." Moreover, the task will take considerable political will. The hope is that independent directors may be the "camel's nose under the tent"

that eventually brings true transparency and accountability in Korea's corporate boardrooms. The power of independent directors will need to be bolstered, however, to achieve this end. But any increase in the power of independent directors is likely to draw opposition from the controlling shareholders of the *chaebol*. To overcome that opposition, Korean reformers must strategically take advantage of the periodic opportunities for reform — created by financial crisis and scandal — to press for further power in the hands of boards dominated by independent directors. Every incident in which a controlling shareholder is publicly disgraced is an opportunity for further reform.

The governance reforms already adopted in Korea are critical first steps. Much reliance is placed, however, on independent directors to ensure that these reforms translate into actual protection for minority shareholders. To achieve this goal, independent directors need to be independent in more than just name. At a minimum, independent directors need to be independent of other members of the *chaebol* group, in addition to independent of the company on whose board they serve. The current rule is that independent directors cannot be employees of affiliated companies of the *chaebol* group.[71] They are not barred, however, from service as directors for *chaebol* affiliates.[72] Service as a director might not be thought to be sufficient to compromise independence. The fees paid to directors are, after all, relatively modest when compared to the typical directors' wealth and income. So one might perhaps conclude that service as a director of an affiliated company should not be deemed to compromise independence. On the other hand, directors owe a duty to each of the companies on whose boards they serve, and in the *chaebol*, these duties are likely to come into conflict.

The problem, however, may go deeper than a conflict of interest or legal duty, either perceived or real. What is needed is a counter to controlling shareholders' manipulation of transactions among the *chaebol* affiliated companies. From this perspective, an independent director loyal to the group, rather than the individual company, is not likely to help. The independent director must be independent from the group in order to be fully independent

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71) KOREAN COMMERCIAL CODE, art. 382.

72) *Id.*

from the controlling shareholder. To be sure, this will impose costs on group cohesiveness, but that is the point. If the controlling shareholder wants a free hand to transfer assets among affiliated companies, the companies should be merged, or the minority shareholders should be bought out and the structure changed to a parent/subsidiary one with 100% ownership. Requiring independent directors for all members of the group imposes a tax on an interlocking corporate structure that has been shown to harm minority shareholders. Controlling shareholders can avoid this tax by moving to a holding company structure, which would carry with it substantially improved transparency.[73)]

Finding enough independent directors for all group companies will not be easy. A more daunting challenge for reformers, however, is cultural rather than legal. It will take time for Korea to develop a culture of independence necessary for outside directors to have the desired effect on management. The institution of independent directors is starting from a very low level:

> Korea has no tradition of active discussion within the Board of Directors, and experience with independent directors has been limited. Most have been lawyers, accountants, academics and retired government officials. Concerns have been expressed about the effective independence of many independent directors and about their lack of business experience. Newly-appointed directors often complain about lack of access to the information they consider necessary for informed decision-making.[74)]

This cultural weakness suggests that reformers must take stronger formal steps to ensure that independent directors are tough-minded defenders of the interests of *all* shareholders. It is worth considering whether the roles of CEO and Chairman should be separated to provide a stronger voice for the independent directors in the boardroom.

Another mechanism to bolster independent directors as monitors is to

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73) Hwa-Jin Kim, *The Case for Market for Corporate Control in Korea*, 8 J. KOREAN L. 227, 248 (2009) (discussing reorganization of SK Corporation in response to a hostile takeover attempt).

74) Bernard S. Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 537, 557 (2001).

strengthen the role of institutional investors. The role of independent directors could be greatly enhanced if shareholders were to take advantage of the provision allowing shareholders holding at least one percent of the company's shares to nominate candidates for director.[75] Unfortunately, one weakness currently limiting the effectiveness of institutional investors in Korean corporate governance is that many Korean institutions are affiliated with the *chaebol* and as a result provide little in the way of independent monitoring.[76] One avenue for overcoming this problem is to encourage foreign institutions to take larger positions in Korean companies. Such institutions are accustomed to standards of corporate transparency substantially greater than those currently practiced in most Korean companies. To be effective in demanding transparency, however, these institutions will want some assurance of representation in the boardroom. For this reason, restrictions on share ownership for outside directors should be repealed.[77] Ownership of shares — if less than a controlling stake — is a powerful incentive to work hard on behalf of minority shareholders. In addition, the provision of the Korean Commercial Code [Sangbeop] allowing companies to remove cumulative voting through their charter provision should be repealed.[78] Many companies have taken advantage of this position to eliminate the threat posed to the controlling shareholder's power by institutional investors, thus rendering the cumulative voting provision ineffective.[79] There are now limits on controlling shareholders voting their shares to remove cumulative voting.[80] These limits also apply to undoing the charter provisions that already restrict cumulative voting.[81] But who will initiate such a change? For outside investors to have an effective voice in the direction of the company, cumulative voting should be mandatory for the foreseeable future.

Cumulative voting would give institutions real clout in determining *who*

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75) KOREAN COMMERCIAL CODE, art. 542-6.

76) Black et al., *supra* note 74, at 552.

77) KOREAN COMMERCIAL CODE, art. 542-8; SANGBEOP SIHAENGRYUNG [KOREAN COMMERCIAL CODE PRESIDENTIAL DECREE], art. 13.

78) KOREAN COMMERCIAL CODE, art. 382-2.

79) Bernard S. Black, *The Role of Self-Regulation in Supporting Korea's Securities Markets*, 3 J. KOREAN L. 17, 27 n.9 (2003).

80) KOREAN COMMERCIAL CODE, art. 542-7.

81) *Id.*

the independent directors will be. Setting the agenda for voting is also important. Although (as I discuss below) it is difficult to justify the inclusion of any inside directors on the audit committee, the inclusion of inside directors on the nominating committee raises a more problematic question. Including inside directors on this committee may help ensure that the outside directors chosen are a good "fit." But if insiders choose the outsiders, how closely will the board scrutinize the conduct of the insiders? Here the conflict between the board's role as a team decision-maker and its role as a monitor is particularly acute. I think, however, that in the context of Korea's controlling shareholder dominated corporate governance, the incremental independence that might result is worth the loss in board solidarity. As transparency and accountability increase, this question might need to be rethought.

The role of the audit committee also should be broadened and its independence bolstered. The requirement that boards approve related-party transactions over a certain size threshold is a step in the right direction.[82] The dynamics of the board room, however, and the desire to get along with one's fellow board members, make this provision less effective than is needed. Given the pervasiveness of related-party transactions among *chaebol* members and the evidence that such transactions are manipulated to benefit controlling shareholders, stronger medicine is needed. Related-party transactions should require approval of the company's audit committee, not the board. Moreover, the audit committee should be made up exclusively of independent directors. (Some firms have already taken an essentially equivalent step by creating related party transaction review committees consisting exclusively of outside directors.[83] This approach may be preferable if there are concerns with demanding too great a time commitment from outside directors.) The audit committee, if properly empowered and staffed by the right people, is potentially the single most effective mechanism for protecting the rights of minority shareholders against overreaching by controlling shareholders and managers. The internal auditor, as an employee of the firm, should report to the audit committee, but should not be part of that committee, particularly if the audit committee's responsibilities are expanded. Putting insiders in the

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82) *Id.*, art. 542-9.
83) Kim, *supra* note 21, at 275.

audit committee's meeting room, even if they meet statutory tests for independence, can only dampen the vigorous independence that is needed there. Giving the independent directors the separate space afforded by a relatively autonomous audit committee may well encourage a certain solidarity among them, and corresponding willingness to stand together to make tough decisions in the face of demands from strong-willed controlling shareholders. This monitoring role could be further enhanced by requiring that the company pay the reasonable expenses of advisors — accountants, lawyers, etc. — for the audit committee.[84)]

### *3. Independent Directors in the United States: The Path Forward?*

If Korea would be well served by giving independent directors more power, does it necessarily follow that the United States is equally well served? The new independence requirements for boards that have been adopted in the United States put the tension between the two roles of corporate boards in stark contrast. One vision of the role of the board — call it the "cooperative" model — sees independent directors as part of a team that helps devise business strategy, offer the CEO and other managers useful advice based on extensive business experience, and provides useful business contacts that help promote the firm's profitability. The cooperative model sees outside directors as useful because they broaden the range of expertise and experience available to firm decision-making. The other vision of the role of the board — call it the "adversarial" model — sees directors, particularly those independent of management, as monitors of management, charged with uncovering self-dealing, fraud, other forms of malfeasance, and now, excessive risk taking. The adversarial model sees outside directors as useful because they bring vigilant suspicion to bear on management's activities. One suspects that the vigilant "monitor" is not much of a "team" player. Moreover, one can have doubts about who is benefiting from the monitoring. Is it the shareholders of the firm, disabled by collective action problems from monitoring on their own? Or is it the regulators, attempting to leverage their enforcement resources by conscripting agents inside the firm to ensure that the corporation

84) Black et al., *supra* note 74, at 563.

lives up to its social responsibilities? If shareholder voting does not suffice to ensure that directors will monitor on behalf of shareholders in the way that government regulators believe that they should, the theory goes, perhaps other (more intrusive) mechanisms can help ensure that directors do their job.

The tension between the independent director's twin roles — advisor and monitor — is inevitable. In the fervor of reform frenzy, it is easy to lose sight of the important role that independent directors can play in making the business more profitable. No one expects the board of directors to actively manage the company, but the directors may have an important (non-monitoring) role to play in developing an overall strategy and vision for the corporation. Despite the emphasis that regulators put on the role of directors in ensuring the corporation's managers comply with the law, independent directors typically are chosen on the basis of their business expertise, not their monitoring capabilities. So CEOs of other companies are several times more likely than lawyers to serve on the boards of public companies.[85] One assumes that it is not because the CEOs are more vigilant monitors. The experience of top-level management is apparently more valuable in devising business strategy than the instruction provided in law school. Deputizing independent directors as corporate cops inside the boardroom may have very real costs in the ability of the board to help guide the business. The United States needs to worry about how it may be undermining board effectiveness by fostering too much of an adversarial relationship between independent directors and management; Korea has far to go before this will be a concern.

These costs might be worth paying in the United States if enhanced independence was likely to substantially reduce the incidence of fraud and self-dealing, as it may do in Korea. But the United States is starting from a much lower incidence of fraud and self-dealing than Korea (and most other countries in which controlling shareholders dominate public companies). Dispersed share ownership — and the corporate disclosure that promotes such ownership — is the norm in the United States. There is a culture of accountability by corporate managers to the market, as well as the board, that serves as the background for policy efforts to discourage fraud and self-dealing. Fraud and greed will always be with us; closing off one avenue

85) Stephen P. Ferris et al., *Too Busy To Mind the Business? Monitoring by Directors with Multiple Board Appointments*, 58 J. Fin. 1087, 1094 (2003).

simply pushes the fraudsters and the greedy to find another weakness in the system. The quest for regulatory perfection is illusory, but the costs of that quest — which ultimately will be paid by the shareholders who are supposed to benefit from regulation — will be all too real.

## Part 4: Conclusion

My focus in this paper has been on the convergence between Korea and the United States on the role of independent directors in corporate governance. Korea has come a long way toward the United States model in the last few years as it responded to a devastating financial crisis, even as the United States raised the bar still higher in response to a corporate crisis of its own. For this effort, Korean reformers are to be congratulated.

Unfortunately, there is still work to be done in Korea. The self-dealing and lack of transparency of the *chaebol* are the principal impediments to a culture of investor confidence in Korea. Independent directors — preferably selected by institutional investors — can play an important role in making the changes that are needed. To do so, however, their independence must be further strengthened.

The United States, by contrast, now risks overdosing on independence. Independence facilitates monitoring, but it discourages the trust and candor that are essential to building an effective team. Independence, therefore, should be deployed with caution, and not as the cure-all for the latest scandal to catch the attention of politicians. Time will tell whether the United States has used the appropriate caution in adopting its latest governance reforms.

KEY WORDS: corporate governance

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