

**WHO WILL CONTROL *FRANKENSTEIN*?**  
**: THE KOREAN *CHAEBOL*'S CORPORATE GOVERNANCE**

A THESIS

SUBMITTED TO THE

STANFORD PROGRAM IN INTERNATIONAL LEGAL STUDIES

AT THE STANFORD LAW SCHOOL,

STANFORD UNIVERSITY

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS

FOR THE DEGREE OF

MASTER OF THE SCIENCE OF LAW

By

**Jeong Seo**

May 2005

## **Abstract**

In a *chaebol*, since a dominant family exercises control with only a small equity-holding, a sharp disparity exists between cash-flow rights and voting rights. The controller reduces managerial agency costs but creates his own agency costs. Furthermore, the disparity exacerbates the controller's agency costs. Meanwhile, outsider shareholders' voting rights are ineffectual in eradicating this problem. Therefore, external monitoring devices over the *chaebol* controller are required.

Korea has relied on government regulation—including attempts to change *chaebols'* ownership structures—to address this problem. Unfortunately, however, without well-functioning capital markets, the regulation has proved to be ineffective. As observed in the *SK* scandal, a market for corporate control could be helpful in policing the *chaebol* controller's mismanagement or tunneling. In this changing environment, regulators should focus on facilitating capital markets and monitoring interested party transactions in the *chaebol*, instead of attempting to change the *chaebols'* ownership structure.

## Table of Contents

Abstract.....	ii
Acknowledgments .....	iii
Table of Contents .....	iv
Table of Figures .....	vi
Introduction.....	1
<b>I. The Controlling Minority Structure .....</b>	<b>13</b>
<i>A. General Features of the Chaebol's Ownership Structure .....</i>	<i>14</i>
1. The small equity shares of the chaebol family .....	14
2. The disparity between cash-flow rights and voting rights .....	19
<i>B. The Development of the Chaebol's Ownership Structure.....</i>	<i>22</i>
1. Diversification.....	23
2. Ownership diffusion policy .....	30
3. Legal barriers to alternative methods .....	32
<b>II. Agency Costs in the Chaebol System.....</b>	<b>35</b>
<i>A. The Dynamics among Constituencies within the Chaebol.....</i>	<i>36</i>
<i>B. Reduction in Managerial Agency Costs in the Chaebol .....</i>	<i>38</i>
<i>C. Agency Cost Problems of Controlling Shareholders .....</i>	<i>43</i>
1. Mismanagement .....	45
2. Tunneling.....	50
3. Limits on a controlling shareholder's agency costs .....	55
<b>III. The Government's Monitoring Activities.....</b>	<b>57</b>
<i>A. Background .....</i>	<i>58</i>
<i>B. Legal Rules: A Restriction on Intra-Group Shareholding.....</i>	<i>60</i>

<i>C. The Outcome of Regulation</i> .....	64
1. The increasing gap between ownership and control .....	64
2. Unnecessary inefficiency .....	65
3. Lenient exceptions.....	66
4. Summary .....	67
<b>IV. Market Intrusion and Conflict of Interest Law</b> .....	<b>68</b>
<i>A. The Need for Market Pressure</i> .....	69
<i>B. The Feasibility of Market Discipline in Korea</i> .....	72
<i>C. The Outcome of Market Intrusion</i> .....	76
<i>D. The Role of Good Legal Rules</i> .....	81
1. Different attitudes toward tunneling .....	82
2. The Samsung Electronics case .....	83
3. The need for sophisticated legal rules regarding self-dealing.....	85
<b>V. Conclusion</b> .....	<b>89</b>
<b>REFERENCES</b> .....	<b>92</b>