Developments in Corporate Governance in Asia—The Case of Korea's LG Group

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*Once devastated by the Asian crisis and criticized for flawed corporate governance practices, Korea's leading business groups (*chaebol*) have staged an impressive recovery amid the global recession. This paper examines the hypothesis that their success stems partly from the government's leadership and initiatives to radically reform the corporate governance system, and from the decisive and diligent actions of firms, and presents a case study of one of the most progressive and successful* chaebol*, the LG Group.*

* *This is an English translation of the original Japanese report* (click here) released in November 2009.

1. Introduction

Amid the worldwide recession, leading Korean firms have managed to achieve an impressive business recovery. This contrasts sharply with their dismal condition following the Asian currency crisis of 1997 and 1998, which revealed the inadequate state of corporate governance particularly at large conglomerates (*chaebol*). However, firms subsequently transformed their actions and behavior through extensive reforms and aggressively sought new global markets, in the process enhancing both their business performance and organizational structure. Today, Korean firms such as Samsung Electronics, LG Electronics, and Hyundai Motor are highly regarded as world class competitors.

This paper examines the hypothesis that the resurgence of Korean firms after the Asian crisis was in part the result of the government's leadership and initiatives in corporate governance reforms and other areas, as well as the decisive and diligent actions of firms who endured the painful process of consolidation and restructuring.

To test my hypothesis, I present a case study of the LG Group, a leading conglomerate whose innovative governance reform initiatives have received high acclaim. The LG Group's experience offers important implications for Japanese firms.

2. Corporate Governance in Asia

While countries around the world are striving to improve their corporate governance regime, the U.S. is regarded as being the most advanced as a result of the strong legal provisions on monitoring and penalties under the Sarbanes Oxley Act of 2002 (SOX). Amid the globalization of business and investment activity, the U.S. style of corporate governance has influenced corporate governance regimes in Asia and the rest of the world, although local differences may exist.

At the time of the Asian currency crisis, the failure of corporate governance was seen as an important cause of the crisis. The World Bank (2000) points out the following corporate governance problems that widely prevailed among East Asian firms at the time of the crisis:

- ineffective board of directors, inadequate internal oversight and external monitoring
- weak internal control
- unreliable financial reporting
- weak compliance
- poor auditing

In the Asian crisis, the IMF-led financial bailout of crisis countries required that countries address and remedy these problems. As a result, recipient countries became more sensitive to these issues and diligently undertook necessary reforms and improvements.

3. Corporate Sector and Corporate Governance Trends in Korea

1. Situation Before the Asian Crisis

Exhibit 1 Korea's 10 Largest Business Groups by Total Assets (KRW trillion; includes public sector)

	1997			2009	
1	Hyundai	53.6	1	Samsung	174.9
2	Samsung	51.7	2	Korea Electric Power Corporation	117.2
3	LG	38.4	3	Hyundai Motor	86.9
4	Daewoo	35.5	4	SK	85.9
5	SK	22.9	5	LG	68.3
6	SsangYong	16.5	6	Korea National Housing Corporation	64.3
7	Hanjin	14.3	7	POSCO	49.1
8	Kia	14.3	8	Lotte	48.9
9	Hanwha	11	9	Korea Expressway Commission	42.3
10	Lotte	7.8	10	Korea Land Corporation	41.4

Source: Korea Fair Trade Commission

Korea's export-led industrialization began in the 1960s, initially focusing on labor-intensive industries, and later followed by the rise of heavy and chemical industries in the 1970s. The government played a lead role from 1962 by drafting five-year plans which identified key industries and set economic goals, while financial assistance (low-interest rate loans and tax incentives) was offered to selected firms. Part of the government's policy was to nurture the rapid growth of conglomerates known as *chaebols*. Most were family-run enterprises led by insiders or subsidiaries with a controlling interest, with control of the corporate group maintained through a pyramid-shaped structure and circular type of cross-shareholding structure among group companies. Based on their intimate ties with the government, *chaebols* received priority bank loans based on government policy to help grow and diversify (under the so called "intra-group one-set policy," each group owned a complete complement of companies spanning many industries). Furthermore, since groups were prohibited from owning banks, as financial liberalization progressed, many *chaebols* came to own a non-bank financial institution whose purpose was to provide financing.

In this way, the *chaebol* grew to become a major force in the economy. At the time of the Asian crisis, the 30 largest corporate groups by total assets were designated as large-scale corporate groups. As of April 1998, they comprised a 45% share of the corporate sector by total assets, and 44% share by revenue. In addition, insiders played a major role as controlling shareholders—the insider shareholding ratio was 43.0% (in April 1997), consisting of 8.5% by owners and special associates (family and relations), and 34.5% by group companies.

This type of governance framework characterized by insider control has been criticized for the following problems: (1) difficulty of securing and executing voting power in proportion to shareholdings; (2) inadequate legal protection of minority shareholders' rights; (3) dividends are downplayed; (4) little attention is given to annual shareholders' meetings; (5) management is not subject to discipline from hostile M&A activity; (6) owners and other insiders tend to interfere in the decision making process; (7) disclosure is inadequate in depth and scope, and financial statements lack transparency. Furthermore, since large creditor banks basically respect and follow the government's intentions, they lack the ability to assess the creditworthiness of businesses. Thus they would find it difficult to control the actions and intentions of a *chaebol* leader who pursues independent initiatives and neglects management efficiency.

As a result, many problems arose, including ambitious business diversification by the leader (a characteristic *chaebol* behavior), mounting debt from rampant capital spending and real estate investment without regard to efficiency (the average debt ratio of the *chaebol* reached approximately 400%), mutual debt guarantees among group companies, government-directed bank loans, and financing by non-bank companies within the group.

2. Adaptation and Change After the Asian Crisis

Along with Thailand and Indonesia, Korea suffered the worst economic damage from the Asian crisis, with GDP plummeting -6.9% in 1998. However, when the three countries sought financial aid from the IMF and World Bank, only Korea was presented with a conditionality agreement that explicitly included corporate governance reform. This indicates the severity of problems with regard to the *chaebol*.

3. Key Points of Korea's Corporate Reforms

Under President Kim Dae Jung, corporate reforms were initiated based on the so-called "5 + 3 principles" (the first five principles of *chaebol* reform were released in January 1998, followed by the other three in August).

Of these, the most important issues regarding corporate governance were the clarification of management responsibility and strengthening of the external monitoring function. The following measures were implemented alongside reform of the Commercial Code and Securities and Exchange Law, and establishment of listing rules of stock exchanges.

Protection of shareholders' rights: Liability of controlling shareholders was strengthened (under the "shadow director" system, when owners or controlling shareholders without legal managerial power exercise influence over the directors of group companies, or else directly exercise managerial power, they can be held liable for acting in the capacity of directors). Rights of minority shareholders and institutional investors were strengthened (minimum shareholding requirement was reduced for bringing legal actions against directors and presenting proposals for annual shareholders' meetings).

Corporate board reform: All listed companies are required to appoint outside directors, and auditors were replaced by an audit committee (at least two-thirds of members must be outside directors, and large listed companies are required to establish an audit committee). The aim is to increase management transparency by enhancing monitoring of management's execution of activities.

Greater management transparency: Corporate accounting standards were revised, external auditing was enhanced, consolidated reporting was adopted for the business group, and disclosure was enhanced with quarterly reporting.

Stronger market discipline: Restrictions were abolished on M&A activity and equity investment by foreigners.

Looking at specific reform actions, in 1998 the government announced the Big Deal policy, which aimed to reduce corporate debt and consolidate and restructure holdings of the top five *chaebol* in seven sectors through the exchange of businesses. Workouts were implemented for the *chaebol* ranked sixth or lower (in which creditor bank groups were

Exhibit 2 "5 + 3 Principles" of the *Chaebol* Reform Agenda (1998)

Original 5 principles

1. Increase management transparency (duty to compile consolidated *chaebol* financial statements, greater disclosure, etc.)
2. Eliminate mutual debt payment guarantees among affiliates
3. Improve financial health (decrease debt-equity ratio, etc.)
4. Focus on core businesses
5. Hold controlling shareholders and managers accountable for managerial performance (protection of minority shareholders' rights, duty to install outside directors, etc.)

Additional 3 Principles

1. Prohibit dominance and separate industrial capital from financial capital
2. Restrict "roundtrip" equity financing and unfair transactions among affiliates
3. Prohibit irregular inheritance practices

Source: Compiled from various sources.

Exhibit 3 Summary of Corporate Governance Reforms

Category	Description
Enhancement of management transparency	･Introduced duty to compile consolidated financial statements ･Adopted IFRS in 2009 ･Strengthened penalties for accounting fraud & poor auditing ･Introduced duty to set up internal accounting & control system
Measures related to internal control & external monitoring	
Independence and accountability of board of directors	･Introduced liabilities of shadow directors and right to demand cumulative voting for directors ･Introduced minimum requirement for outside directors (25% of board in 1999, and 50% in 2000 for large listed companies & financial institutions) ･Introduced duty to set up audit committee
Power limitation and liabilities of leading shareholder	･Guidance to eliminate chairman's office ･Shadow directors are deemed to have same liabilities as properly appointed directors, and are subject to shareholder derivative suit
Disclosure enhancement	･Quarterly reporting requirement ･Electronic disclosure requirement ･Forecast issuing requirement ･Stronger sanctions for disclosure violations
Shareholding requirements for minority shareholder rights	･Reduced requirement for submitting shareholder proposal to 1% (0.5% at large listed companies)for bringing shareholder derivative suit to 0.01% ･Reduced requirement for proposing dismissal of board member or internal auditor to 0.5% (0.25% for large listed companies)
M&A activity	･Eliminated restriction on investment by foreigners ･Simplified tender offer procedure, approved M&A funds

Source: Compiled from *JILPT Research Report* No. 10 (2004).

tasked with assessing the viability of companies with cash flow problems and either liquidating or rescuing them).

In December 1998, President Kim Dae Jung met with the leaders of the five major *chaebol* and creditor bank groups, and negotiated an agreement in which the *chaebol* would reduce the number of affiliates by half (by concentrating on core businesses) and bring the debt-equity ratio below 200% by the end of 1999, and improve the financial structure by eliminating all mutual debt guarantees by March 2003. Meanwhile, due in part to resistance to government intervention in corporate affairs, the Big Deal's only tangible result was the merger of LG Semiconductor into Hyundai Electronics (later renamed Hynix Semiconductor).

Along with corporate reform, the government pursued financial reform by injecting public finds into banks struggling with nonperforming corporate loans, allowing foreign investment in banks, and liquidating deficit-ridden non-banks. In addition, labor market reform entailed comprehensive measures to reduce excess employment by allowing dismissal for reorganization purposes, thereby enhancing the labor market's flexibility.

Korea's response to the Asian crisis was characterized by the boldness and swiftness of the government-led reforms. At the same time, the extent of reforms also reflected the deep damage suffered by the economy and corporate sector. Moreover, the government's strong leadership in industrial guidance and influence over bank lending indicate the government's de facto role as a highly influential stakeholder of the *chaebol*. We should also note the important role of social activism such as the People's Solidarity for Participatory Democracy (PSPD), from the perspective of the numerous class actions and expression of opinions.

When these initiative were rolled out around the time of the Asian crisis, approximately half of the 30 largest *chaebol*—mainly second-tier business groups such as Hanbo, Sammi, and Kia—went bankrupt due to rampant investment spending and debt. Furthermore, Daewoo Group, a key member of the five major *chaebol*, went bankrupt in 1999. The remaining *chaebol* who survived underwent a grueling restructuring effort.

As a result of restructuring, all of the remaining four major *chaebol* managed to improve their debt ratio to below 200%, reduce the number of affiliated companies by half, and eliminate all mutual debt guarantees (legal reforms related to corporate governance are shown in Exhibit 3).

As a result of the ensuing economic recovery, improvement in export markets, and heightened corporate health, the debt ratio and other key financial indicators improved significantly. (For example, according to FTC data released in April 2009, the average debt ratio was 119.9%). Other key developments include the approval of a holding company system, and new rules related to corporate governance and corporate activity such as heightened disclosure with the planned shift to IFRS (full compliance is slated in 2011).

4. *Chaebol* Trends in the Current Recession

As a result of the Lehman shock of September 2008 and ensuing global recession, the Korean economy suffered heavily in October and November 2008. As its currency value and stock market fell and foreign reserves dwindled, the economy seemed on the verge of catastrophic failure. However, the worst was averted by swift fiscal and monetary actions of the government and central bank, along with support in the form of the currency swap arrangement with the U.S. FRB, Japan and China. The economy has subsequently performed well compared to other countries who are still suffering from heavy damage. A large part of Korea's performance can be attributed to the international competitiveness of leading *chaebol* companies such as Samsung Electronics, LG Electronics, and Hyundai Motor. Below are some highlights of their recent performance and market position:

Fortune Global 500 in 2009: Included 14 Korean companies such as Samsung Electronics (ranked 40th), LG (69th), SK Holdings (72nd), Hyundai Motor (87th), and POSCO (199th). For reference, the top ranking Japanese companies were Toyota Motor (10th), Honda (51st), Nissan (52nd), Hitachi (67th), Panasonic (79th), and Sony (81st).

2008 global market share in mobile phones (by sales volume, according to ABI Research): Nokia (38.6%), Samsung (16.2%), LG (8.3%), Motorola (8.3%), Sony Ericsson (8.0%).

2008 global market share in TV shipments (by shipment value, according to DisplaySearch): Samsung (23.0%), LG Electronics (13.7%) Sony (11.8%), Panasonic (8.6%), Sharp (6.4%).

Operating profit growth in Q2 2009 (according to *Nikkei Shimbun* August 19, 2009 morning edition): Samsung Electronics earned 1.06 trillion KRW (7.2 times more than in preceding quarter), LG Electronics earned 710 billion KRW (63% increase from preceding quarter), Hyundai Motor earned 650 billion KRW (4.3 times more than in preceding quarter; 1 KRW = approx. 0.078 JPY).

4. Corporate Governance Reform at the LG Group

1. Business History of LG Group

The LG Group originated in 1947 with the establishment of the Lak-Hui Chemical Industrial Corp. According to FTC data on large-scale business groups released in April 2009, LG ranks fifth in total assets with 68.3 trillion KRW (fourth among private business groups), and comprises 52 affiliates.

Upon his death in 1969, founder Gu In-Hwoe was succeeded by his eldest son Gu Ja-Gyeong. The leadership was then passed down in 1995 to his eldest son Gu Bon-Mu who still leads the group as CEO of the holding company. In the founding family, the founder's younger brother married into the Heo family, who along with the Gu family jointly own and managed the group (until the GS Group separated as explained below). The Gu family is said to have owned 70% of the group, and the Heo family 30%.

Exhibit 4 Holding Structure of the LG Group (the Gu family owns a 48.6% stake)

As of December 31, 2008

Company	Shares Owned	Stake Ratio *	Book Value	Book Value Portion	Net Income
LG Electronics	50,341,430	31.11%	2,559,340	39.91%	482,786
Siltron	3,418,141	51.00%	239,575	3.74%	3,635
Lusem	1,400,000	64.81%	29,375	0.46%	15,026
Electronics Total			2,828,290	44.11%	
LG Chem	25,226,000	30.07%	1,461,822	22.80%	1,002,585
LG Household and Health Care	5,315,500	30.00%	141,608	2.21%	120,575
LG Life Sciences	5,044,114	30.00%	83,295	1.30%	15,164
LG MMA	1,200,000	50.00%	115,350	1.80%	30,192
Chemicals Total			1,802,075	28.10%	
LG TeleCom	103,614,396	37.37%	716,712	11.18%	283,559
LG Dacom	25,018,906	30.04%	433,715	6.76%	120,289
Telecommunications Total			1,150,427	17.94%	
LG CNS	72,072,492	82.67%	309,928	4.83%	115,402
Serveone	5,000,000	100%	223,424	3.48%	75,505
LG Management Development Institute	1,000,000	100%	17,203	0.27%	3,255
LG Sports	600,000	100%	1,097	0.02%	-389
LG Solar Energy	928,000	100%	26,630	0.42%	20
G II R	5,798,593	35.00%	39,496	0.62%	-2,245
Services Total			617,778	9.63%	
LG Hitachi	245,000	49.00%	14,023	0.22%	1,008
Others Total			14,023	0.22%	
Grand Total			6,412,593	100.00%	

* Stake ratios includ preferred stocks.

Source: LG Group web site

The group expanded by diversifying beyond its two core business areas of electronics and chemicals. At present, the group is run by LG Corporation, which is the holding company that controls the group, and 12 listed companies in three business groups—electronics, chemical, and telecommunications & services (2008 consolidated results were total assets of 64.8 trillion KRW, sales revenue of 90.2 trillion KRW, and net profit of 3.0 trillion KRW).

The electronic products group, led by LG Electronics (founded in 1958; has total assets of 17.3 trillion KRW and revenue of 27.6 trillion KRW), encompasses IT products, consumer products, heavy electrical products, and LCD displays. Along with Samsung, LG ranks in the top three in global market share for mobile phones and TV sets. LG has also held the top global market share for home air conditioners for seven straight years.

The chemical products group, led by LG Chem (Korea's largest chemical company, with 2008 total assets of 8.0 trillion KRW, and revenue of 12.6 trillion KRW), manufactures products ranging from petrochemicals to life sciences, and the telecommunications & services group provides services in telecommunications, data, and solar power generation. Like LG Electronics, LG Chem has earned a solid reputation for its aggressive development of new markets and areas and relentless pursuit of customer satisfaction. The LG group's vision is to achieve "No. 1 LG" based on the founding management principle of "respecting human dignity."

In recent years, the LG Group has spun off two friendly business groups: LS Group (24th largest *chaebol* by total assets in 2009), spun off in 2003 and led by the family of the founder's younger brother, manufactures power and communications cables; and GS Group (12th largest *chaebol*), whose businesses include petroleum refining & retailing, distribution, etc., was spun off in 2004.

Even as many Japanese manufacturers struggle to overcome operating losses, the LG Group's core operating company, LG Electronics, has become a global market leader in mobile phones, TV sets, and home appliances. Like other *chaebol*, the company suffered heavy damages in the Asian crisis, and was forced to sell off the semiconductor business under the Big Deal. But by diligently pursuing structural reform and concentrating on core businesses, it managed to ride out the hard times (for example, the debt-equity ratio improved from 505.8% in 1997 to 80.0% in April 2009). In pursuing a globalization strategy, the group changed its name to LG in 1995 as part of a corporate identity and brand recognition campaign. The group's current ownership structure is disclosed on the company website (Exhibit 4).

2. Management Characteristics of the LG Group

Compared to other *chaebol*, the LG Group seems to have concentrated its management resources more efficiently due several notable characteristics: good cooperation among members of the founding family (including the Heo family) to help facilitate management (few disputes have erupted over succession to the leadership position or inheritance of business assets, and wealth; relations are also good with the GS and LS groups); less business diversification and consistent focus on electronics and chemical industries; fewer political ties and less dependence on political power, with emphasis on self-directed business guidelines and strategy.

Since the beginning, the group's management philosophy has emphasized harmony, solidarity, and respect for people. LG was the first *chaebol* to actively recruit and nurture professional managers from the outside. Moreover, in a country marked by turbulent labor relations, LG has not been subjected to a pay raise offensive in the past 20 years (NNA Japan, March 9, 2009). Thus LG is known as the *chaebol* of "harmony," while Samsung is known for "control" and Hyundai for "guts" (*Shukan Toyo Keizai*, 2005).

3. Organizational Structure and Corporate Governance Characteristics

The LG group has undertaken the following initiatives in the areas of corporate governance and organizational structure.

- Since their founding, GoldStar and Lak-hui Chemical have strived to develop their management structure. In 1966, the founder installed the chairman's office, under which the planning and coordination office (later renamed the structural coordination headquarters) controlled the entire group. As a result, much of the actual management of individual companies came to be performed by professional managers. In 1970, the second generation leader installed a collegiate system of group executives called the management committee.

- In 1967, GoldStar was the first company in Korea to introduce a divisional organization system for its communications, electrical cable, and home appliance businesses (Lak-hui Chemical followed suite in 1968), and also established a business administration division separate and independent of the manufacturing division. Thus while being a family controlled *chaebol*, LG was innovative in adopting modern organizational structure (later it began spinning off some business divisions).

- The group pursued board reform in conformance with the government's revised guidelines and laws as described above. As a result, the average board size was reduced from 14.5 members in 1997 to 7.8 members in 2002, with an average of 2.8 outside board members (more recently, LG Corp. and LG Electronics have 7 board members including 4 outside members, while LG Chem has 6 board members including 3 outside members).

- In 2001, the group was reorganized under a holding company structure. The move was well received as the first by a large *chaebol*, and is thought to have the following objectives: (1) to simplify and clarify the complex ownership structure involving the Gu and Heo families and affiliated companies; (2) to reduce the risk of group-wide failure from the bankruptcy of an affiliated company; (3) to make the control structure of the leader (CEO) and founding family transparent as required by law; and (4) to enhance financing capability by upgrading the corporate image and gaining positive acceptance among financial institutions and investors.

5. Conclusion

Below are the main points of Korea's corporate governance reform following the Asian crisis, based on the experience of the LG Group.

- A critical factor in the success of Korea's bold and swift reforms was the government and corporate sector's shared sense of extreme urgency that the Asian crisis could destroy the national economy.
- Although other *chaebol* undertook many of the same reforms, the LG Group was the first to reorganize under a holding company structure and clarify relationships among group companies. Its first mover status can be attributed to a corporate culture of team spirit and harmony, maintenance of good labor relations and relations within the founding families, and a head start in focusing on core businesses (diversification was already limited to electronics and chemicals). LG has already progressed to the third generation of family leadership ahead if Samsung and Hyundai Motor.
- Although improvement of the corporate governance system may not directly boost a company's business results, it can positively impact corporate activity by improving management efficiency and transparency and upgrading the company's image and credibility.
- Despite the severity of the current global recession, LG Electronics and Samsung Electronics have emerged even stronger and more resilient. This can be attributed to favorable macroeconomic conditions such as the weak currency, improvements in manufacturing, product development, marketing, and financial health, and structural reforms in corporate governance and other areas after the Asian crisis.
- As pointed out by social activists, it is necessary to keep a close eye on the considerable influence wielded by founding families and affiliated companies even among *chaebol* with a holding company structure. In addition, while corporate governance has made progress in Korea, systemic issues such as the slow adoption of consolidated disclosure practices still need to be carefully watched, as well as the individual progress of each *chaebol*.
- Compared to their struggling counterparts in Japan, Korea's electronics companies have excelled in global markets due to their strong positioning and competitiveness. One clear difference is that the successful Korean companies can make bold and swift decisions because they have strong leaders with an entrepreneurial spirit. The difficult part, of course, is to strike the right balance between checking a strong leader's arbitrary actions and allowing an entrepreneurial spirit to flourish. Korean companies must spare no effort in tackling this crucial issue if they intend to become even more competitive on the global stage.

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(In English; for references in Japanese, please refer to the original Japanese report.)

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