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# A STUDY ON CORPORATE BOARD MODEL

## - THE CASE OF POSCO -

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## ABSTRACT

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Corporate governance is an important topic in today's global business and a key element of Korean economic reform packages since the IMF crisis The board of directors is an essential system in maintaining in the balance between shareholders and managers and its effectiveness is critical for the competitiveness of a firm in today's era of global competition Today, there is a tendency to adapt the Anglo-Saxon model as a global standard Characteristics of the Anglo-Saxon board model are the *majority outside board*, various committees, active role of the board, and well-established norms of behavior In contrast, the all-executive board, power concentration at the top, and weak role of the board, characterized corporate boards in Korea before the IMF crisis.

In that sense, it is time that the boards in Korea make changes in order to revive and survive under a globally competitive environment Today, Korean companies face the breakdown of the old economic system and face fundamentally changing financial environment. Accordingly, the reform of the board is not a question of choice but one of necessity The reform programs initiated by the Korean government mainly focus on the

introduction of outside directors to enhance transparency and accountability of corporate management through "checks and balances "  The reform direction is in line with the Anglo-Saxon model and OECD principles

Meanwhile, POSCO, one of the most successful Korean corporation since the 1960s, now faces fundamental changes as a result of its anticipated privatization  In order to respond to new challenges such as the increase of foreign investors and institutional investors, POSCO should reform its board in terms of role, operating practices, board composition, and committees

First, the board should redefine its role and redesign its processes for shaping corporate strategy, monitoring corporate performance, ensuring superior management, and establishing and maintaining values and ethics

Second, the board should reform its composition by introducing a *majority outside board,* and reducing the overall size of the board to 10 – 13 members  The majority outside board should be achieved by both increasing the number of outside directors and decreasing the number of standing directors

Third, committees can be better utilized to handle sophisticated issues and leverage directors' time and experience  For this purpose, committees should address three critical areas such as director nomination and board governance, management development and compensation, and corporate policies and controls

These reforms should be implemented by changing the company's objectives from " *contribution to the nation by steel making*" to " *maximization of shareholders' interests.*

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# CHAPTER 1: INTRODUCTION

## 1.1 BACKGROUND OF THE STUDY

Since being hit by a financial crisis in 1997(hereafter IMF crisis), Korea has actively implemented far-reaching economic reforms The issue of corporate governance has been a high priority in those reform packages The corporate governance system in Korea is viewed as one of the major causes for the collapse of the Korean economy The corporate governance of corporations and financial institutions has been so ineffective as it failed to monitor and control excessive investments, which decreased the overall efficiency of the Korean economy In general, the main goal of corporate governance reform in Korea is to adapt, the so called, global standard based on the Anglo-Saxon model, which emphasizes shareholder value and management transparency and accountability.

The significance of corporate governance has increased in the modern economy. Why has it been important? According to OECD[1], good corporate governance is an important step in building market confidence and encouraging more stable, long-term international investment flows

The business-corporation is an increasingly important engine for wealth creation worldwide and how companies are run will influence welfare in society as a whole In order to serve this wealth creating function, companies must operate within a framework that keeps them focused on their objectives and accountable for their actions That is to say, they need to

[1] The OECD Principles of Corporate Governance- Questions & Answers. www.oecd.org

establish adequate and credible corporate governance arrangements Many countries see better corporate governance practices as a way to improve economic dynamism and thus enhance overall economic performance The importance of good corporate governance has also been highlighted by the recent turbulence in financial markets

## 1 2 SCOPE OF THE STUDY

This study focuses mainly on different corporate board models and recommends a better board system for Korean companies. Chapter two reviews general theories on corporate governance The Anglo-Saxon model and OECD principles on corporate boards will be discussed in chapter three In chapter four, the characteristics and problems of Korean boards will be analyzed. In chapter five, POSCO's case will be reviewed as a specific case study on corporate boards The reasons for selecting POSCO for the case study are as follows:

- POSCO is one of the representative Korean companies that has competitive advantage in global markets. In this sense, POSCO can lead the effort to reform corporate governance throughout Korean companies
- POSCO is a globalized company in terms of ownership, as it listed its Depositary Receipts on the New York Stock Exchange and the London Stock Exchange in 1994 and 1995 respectively At the end of 1998, foreign ownership of POSCO shares was 38.1 percent and is increasing rapidly following deregulation of foreign

investment.

- The Korean government is implementing POSCO's privatization program, and one of the objectives is to introduce a new advanced corporate governance model.
- POSCO has operated the "outside director system" since 1996 Recently, POSCO established the Global Professional Management (GPM), an advanced corporate governance structure, which places top priority on shareholders' value

## 1 3 METHOD OF THE STUDY

This study depends largely on literature research and interviews with relevant managers of POSCO for the case study Recent data and information were obtained from Internet sites

## CHAPTER 2: THEORIES OF CORPORATE GOVERNANCE

One of the most significant systems ever created has been the joint-stock limited liability company[2] The concept of the company has enabled vast sums of capital to be tapped by separating ownership and management However, the corporate governance problem arises due to the separation What does the corporate governance mean? It involves a set of relationships among a company's management, board of directors, shareholders, and other stakeholders[3] These relations provide a structure through which the objectives of the company are set, and means of attaining those objectives and monitoring performance

Basically, there are two different theories on corporate governance One is the agency theory that deals with the concept of principal-agent relationship between shareholders and management; the other is the contractual theory that is based upon the concept of multiparty stakeholders

Why is the board important in corporate governance? The board of directors is the core system in corporate governance. It is the main mechanism for monitoring management and providing strategic guidance regardless of different board structures.

In this chapter, two theories of the corporate board will be summarized In addition, the importance of the board in corporate governance will be explained

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[2] Robert I.Tricker, International Corporate Governance, Prentice Hall. 1994, p 1

[3] Ms Joanna R Shelton, Deputy Secretary General OECD, abstracted from her opening address in Seoul Conference on Corporate Governance in Asia, March 3, 1999

## 2.1 AGENCY THEORY

Corporation is a mechanism consisting of various participants such as shareholders, management, employees, customers, suppliers, government, and so on  The primary participants, however, are the shareholders and management  As the corporation grows, shareholders act as a principal who provide the capital whereas the management act as an agent who use that capital to create value on behalf of the shareholders

The agency theory argues that agent problem arises because of conflict of interests between the principal and the agent  With management control, managers can maximize their own welfare, which may not be in the best interest of shareholders  For example, they may seek to benefit from the private consumption of corporate wealth or even make selfish investment decisions to protect their job security while sacrificing the wealth of shareholders  This moral hazard problem can be intensified when there is information asymmetry between the shareholders and managers  The potential conflict of interest between agents (managers) and principal (shareholders) incurs monitoring costs when shareholders set up a monitoring mechanism to prevent such abuse of corporate resources by the managers  Agency costs are defined as the extra costs of having an agent act for a principal  Therefore, it includes not only direct costs such as management fee and contract cost, but also indirect costs such as monitoring costs by audit or board and wealth loss due to the agency problem

In this context, the theory argues that corporate governance should aim at reducing the agency costs  Furthermore, the theory argues that market disciplines imposed by

competition in product market, managerial market, and capital market work effectively as a mechanism in reducing agency costs. For example, corporate takeovers and proxy fights are an effective market mechanism for disciplining managers and reducing problems in the separation of ownership and management In general, it is understood that this theory can explain well the Anglo-Saxon model of corporate governance because it has relied on market discipline to reduce agency problem caused by the separation of ownership and management, and has given priority on maximizing short-term returns to shareholders

## 2.2 CONTRACTUAL THEORY

On the other hand, contractual theory argues that a corporation exists not for the maximization of shareholders' interests, but for all stakeholders' long-term interests Therefore, it regards the corporation as a governance mechanism for a set of contracts between all stakeholders This argument weakens the traditional concept of corporate control solely by shareholders and provides a theoretical base for the stakeholder concept in corporate governance The theory has a rationale in the sense that shareholders are rarely the only residual claimants having residual risk of the corporation in modern corporations In reality, as there are parties such as debtholders and employees other than shareholders who make firm-specific investments, shareholders are no longer the only residual claimants In this context, the theory argues that corporate governance should be aiming at minimizing contracting costs between all stakeholders. However, it is difficult to write contracts that can govern such relationships over an extended period of time and that are flexible enough

to respond to changing circumstances. It becomes advantageous, therefore, for the corporate participants, such as shareholders, creditors, employees, and managers, to maintain long-term relationships with one another in order to extract the full value from their firm-specific investments and to minimize contractual costs In general, it is understood that this theory can explain well the Japanese model and German model of corporate governance because they have relied on organizational control rather than market discipline, and have contributed to the management strategy focusing on stable and long-term growth

## 2.3 BOARD OF DIRECTORS

The board of directors is a crucial part of the corporate governance structure because it is the link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers) This means that the board is the overlap between the small, powerful group that runs the company and a large, diffuse, and relatively powerless group that simply wishes to see the company run well The board's primary role is to monitor management on behalf of the shareholders to add value As the strength and survival of any corporation depend on a balance of two distinct powers - the power of those who own the corporation and the power of those who run it - good boards matter for the success of corporations It was empirically found that good governance practice by the board really does make a difference – a difference that many investors are

willing to pay for[4] According to a survey conducted by McKinsey & Company in 1996, two-third of investors replied that they would, when they were asked whether they would pay more for the stock of the companies having good board governance practices Among those willing to pay more for good governance, the average premium specified was sixteen percent

Moreover, good governance by boards will be more and more important for the success of corporations with the globalization trends of the world economy A 1992 research paper by Oxford Analytica, an English consulting group, identified possible developments in corporate governance The paper concluded that a major force for confluence, or homogenization toward the Anglo-Saxon model, would be the increasing globalization of capital The paper predicted that such a fluid, worldwide capital market would have immense effects on corporate governance. As asset managers seek to invest abroad, they will be attracted to markets that have the most open, shareholder-friendly governance structures. It would be obvious that investors would be likely to favor markets where disclosure of financial and other information is well established and where clear avenues of protest exist should managerial decisions be made that might not be in the shareholders' best interest Thus, good governance by the board will be an important factor in the global capital market. Companies all over the world will offer strong shareholder relations as a way of attracting money. This trend should cause a confluence of different governance practices over the next decade That is the reason why the board of directors

[4] Robert F Felton, "Putting a value on board governance", The McKinsey Quarterly, 1996 No 4,

of the United States is viewed as the global standard

# CHAPTER 3: CORPORATE BOARD MODELS

The governance system in each country is a product of evolutionary processes under given institutional settings In turn, the institutional settings are the reflections of social, political, as well as economic values. Accordingly, the structure of corporate governance differs from country to country. The governance system in Anglo-Saxon countries is decentralized and relies upon market discipline On the other hand, the Japanese and German governance systems are characterized by organizational control. Japanese *keiretsus* often centered on banks, are tied together into long-term relationships through cross-shareholding among member firms. The German system of corporate governance is characterized by a dual board system, proxy voting and close ties between large banks and firms

The roles and responsibilities of the board of directors, operating practices, and composition differ from country to country

In this chapter, board structures by Robert, I Tricker are summarized. Then, the Anglo-Saxon model and OECD principles on corporate governance will be reviewed in detail

## 3.1 BOARD STRUCTURES

The responsibility of the board is to govern the company, while the manager's task is to run its business[5] A useful way of showing the distinction is to depict the board as a circle superimposed on the top of the hierarchical pyramid of management organization (See Figure 3 1

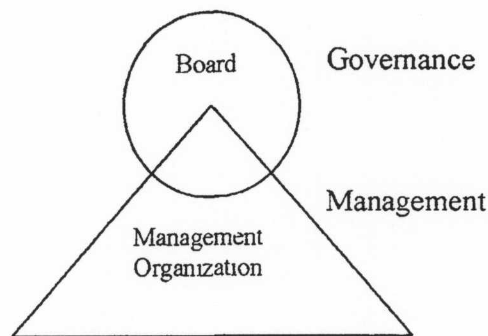


**Figure 3.1 The Board and Management Differentiated**

Basically, there are four alternative board structures

- The *all-executive boards* in which every director is also a managerial employee of the business, which is dominant in small businesses
- The *majority executive board* in which the outside directors are in the minority, which is dominant in Japan and Korea
- The *majority outside board* with non-executive directors, which is dominant in Anglo-Saxon countries

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[5] Robert A G Monks and Nell Minow, Corporate Governance< Blackwell. 1995, p 44-45

- The *two-tier board* in which there are no common members between the board and the executive management team, which is dominant in many continental European countries like Germany.

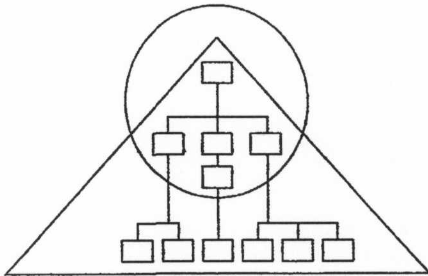

**Figure 3.2 All-Executive Board**

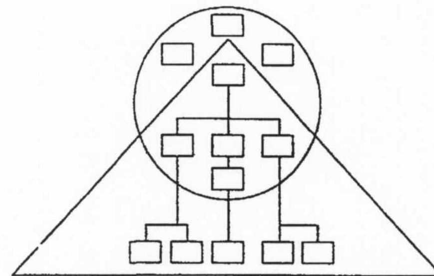

**Figure 3.3 Majority Executive Board**

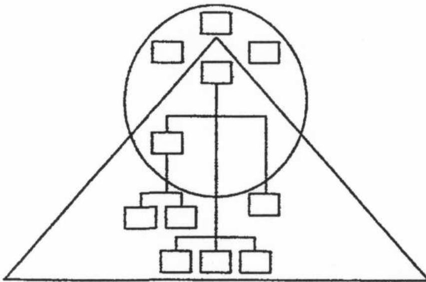

**Figure 3.4 Majority Outside Board**

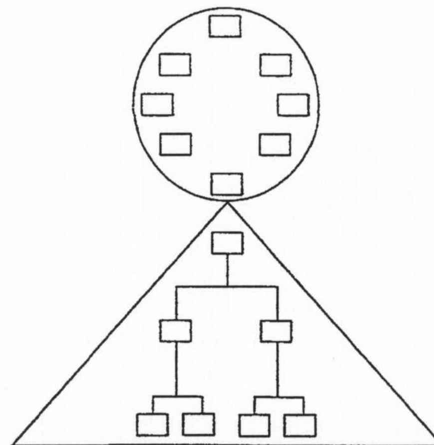

**Figure 3.5 Two-tier Board**

## 3.2 ANGLO-SAXON MODEL

### 3 2 1 Historical Evolution

The boards in Anglo-Saxon countries carried on a tradition that began with the earliest form of corporate organization, the joint stock companies In the British colonies, as in Great Britain itself, the group of people who oversaw the company would meet regularly The group was named "the board " However, the board similar to that of today's largest companies was devised by Alexander Hamilton, the United States' first secretary of the Treasury, in 1791 following the American Revolution He devised both an early board of directors in charge of management and an early audit committee Since then, the structure and composition of the boards have changed surprisingly little in 200 years For over a hundred years, however, the boards in the United States have reflected a power struggle between shareholders and managers

According to Robert Felton, a partner of McKinsey Seoul office, changes in four forces - ownership, economy, government and politics, and innovation – have shaped the characteristics of each corporate governance era. For example, concentrated ownership drove a new focus on the board in the 1990s Securities Exchange Commission (SEC) rules for easier investor coordination, innovations such as junk bonds and shareholder activism, and the generally robust economy Therefore, typical boards in the United States are now characterized by active board participation in the management process, by dominating by external directors, and by overseeing management so that all shareholders' value is maximized The transition has been facilitated by the following factors.

- As takeovers died down, shareholders needed new pressure point to ensure shareholders' value maximization
- Active boards were needed for protecting minority shareholders especially with the dominance of institutional investors
- The institutional investors, instead of sitting on the boards themselves for regulatory and practical reasons, put pressure on directors to oversee management

3.2 2 Legal Obligation of Directors

Generally, the corporate governance system in Anglo-Saxon countries relies on the board of directors as its main organ[6] Elected by shareholders, the board safeguards shareholders' interests by overseeing management and board selection, reviewing financial performance and allocation of funds, and ensuring that the corporation acts in a legally and socially responsible manner

Legally, most jurisdictions describe directors as having two duties, the *duty of care* and the *duty of loyalty*. *Duty of care* means that directors must exercise due diligence in making decisions They must discover as much as possible on the question at issue and be able to show that, in reaching a decision, they have considered all reasonable alternatives[7]

- Directors must participate in board and committee meetings
- Directors are entitled to place matters on the agenda.
- Directors should receive adequate information prior to meeting and must review the

[6] Jay W Lorsh & Elizabeth Macver, Pawns or Potentates, Harvard Business School Press, 1989, p 9

materials supplied

- Directors should make inquiry when alerted by the circumstances [8]

*Duty of loyalty* means that directors must exercise their powers in the interests of the corporation and not in the director's own interest or in the interest of other people

- Conflicts of interest "Interested" directors should disclose their interest and all material facts concerning the matter and should abstain from voting
- Corporate opportunity In some cases, directors should make a business opportunity available to the corporation before they pursue it, disclosing full information and authorization from the board to pursue it

3 2 3 Roles and Responsibilities of the Board

These legal definitions, however, offer only a general guideline of the directors' role Therefore, many scholars and institutions in the United States have tried to step beyond the legal definitions of a board's duties and develop more specific descriptions of the responsibilities of the directors For example, Robert Ticker broadly separated the roles into two categories One is the performance role, in which the board is focusing on strategic and policy issues for the future, setting the corporate direction and contributing to the performance of the business The other role is the conformance role, in which the board is ensuring that the company is conforming to policies, procedures and plans laid down by the board and is being properly accountable for its activities

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[7] Robert A G Monks & Nell Minow, Corporate Governance, Blackwell Publishers Ltd , 1995, p 182

| Outward looking | Conformance Role | Performance Role |
|---|---|---|
| Inward Looking | | |
| | Past and present orientated | Future oriented |

**Figure 3.6 The Two Primary Functions of the Board[9]**

The roles and responsibilities of the board stated in the Corporate Director's Guidebook by the American Bar Association are summarized as follows

- Approve fundamental operating, financial and other corporate plans, strategies and business objectives
- Make M&A and major capital expenditure decisions
- Evaluate performance of corporation and its senior management and take appropriate action, including removal, when warranted
- Approve and implement senior executive succession plans, evaluate, and fix compensation of senior executives.

On the other hand, the Business Roundtable, representing the largest US corporations,

[8] Source McKinsey's report submitted to POSCO
[9] Robert I.Tricker, p245

describes the duties of the board as follows[10]

- Select, regularly evaluate, and, if necessary, replace the chief executive officer
- Determine management compensation Review succession planning
- Review and, where appropriate, approve the financial objectives, major strategies, and plans of the corporation
- Provide advice and counsel to top management.
- Select and recommend to shareholders for election an appropriate slate of candidates for the board of directors, evaluate board processes and performance
- Review the adequacy of the systems to comply with all applicable laws/regulations

3 2 4 The Structure of US Board

According to [11]Spencer Stuart Board Index (hereafter SSBI), the characteristics of U.S boards are summarized as follows

- Board size the average SSBI board comprises 13 directors, while the average S&P 500 board has 12, a figure that has remained constant for the past three years Clearly, boards generally have made great strides in paring back to a more workable size, which in turn allows them to transact necessary business more efficiently
- Board composition Of the directors currently serving on SSBI boards, 79% are outsiders, compared with 74% five years ago It has been found that the continued predominance of outside directors has been a significant factor in the trend toward

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[10] Robert I Tricker, International Corporate Governance, Simon & Schuster. 1994. p 98

[11] SSBI is a historical document in regard to the U S board for 13 years Especially, it tracked the board last year by expanding its survey from 100 leading companies to the S&P 500 companies

increasingly independent board

- Outside director profile The average age of directors is 61(60 for S&P 500 boards) and the median term is three years The top category for newly added outside directors includes active CEOs and professional management of other companies Directly behind, is academic and non-profit, followed by consultants It shows that companies want directors with business operating experience
- Board meetings. The average SSBI board met eight times (the average S&P 500 board, seven times), a figure unchanged from the past years' survey However, the category of "4-7" board meetings a year is now increasing
- Committees The average number of committees is five, a figure unchanged over the last five years In descending order of prevalence, four most common committees except the compulsory audit committee required by law, are human resources/compensation committees (98% of S&P 500 boards), nominating/corporate governance committees (82%), executive committees (71%), and finance committee (58%)
- Director compensation: A widely accepted tenet of corporate governance intended to support greater board independence is that the compensation committee is composed entirely of outside directors The average annual retainer for SSBI is $ 40,836 excluding meeting fees and stocks. Paying certain portion of compensation in stocks is a growing trend

Meanwhile, Dennis C Carey summarized several trends in board structure over the past ten

years, which was reported in the SSBI survey for 1994[12] The trends included board's downsizing, fewer inside directorships, outside director predominance, fewer board meetings, significant committee involvement, formal retirement plans, stock plans for outside directors, formal rules of governance, separation of chairman and CEO and international directorships

| | 1994 Survey | 1989 Survey |
|---|---|---|
| average number of board members | 13 | 14 |
| average number of inside directors | 3 | 4.4 |
| average ratio of outside directors to insiders | 4 1 | 3.1 |
| average number of meetings | 9 | 11 |
| average number of committee | 5.4 | 2 7 |
| average ratio of companies having formal retirement plan | 79% | 18% |
| average ratio of companies having stock plans for outside directors | 51% | 15% |

**Figure 3. 7 Summary of SpencerSuuart Board Index 1994 and 1989**

[12] Dennis C Carey was Co-Managing Director of SpencerStuart, based in Philadelphia

3 2 5 Process of US boards

According to the Corporate Director's Guidebook of the American Bar Association, the process of US boards is summarized as follows

- Directors are elected at shareholders' meeting
- Directors meet on average nine times a year, devote about 120 hours to board service a year nine full days of meeting and six to nine full days of preparation
- Information provided to directors should include
  - Current business and financial performance, the degree of achievement of approved objectives
  - Financial statement, with appropriate segment or divisional break down
  - Material litigation and regulatory matters
- In regard to agenda for directors' meeting, a balance should be sought between management presentation and discussions Management initially sets the agenda but directors are given opportunities to place items on the agenda The board must discuss overall annual agenda of matters that require recurring and focused attention, such as achievement of principle operation or financial objectives and review of the performance of the CEO and other members of the executive management.
- For monitoring management, boards are encouraged to develop tough guidelines and evaluate its effectiveness against these guidelines

## 3.3 OECD PRINCIPLES ON CORPORATE BOARDS

OECD has conducted a number of reviews on corporate governance regimes in specific countries within the process of the annual country surveys The OECD is also working to improve understanding of the implications of corporate governance on economic performance In line with this effort, the OECD established a special Business Sector Advisory Group in 1996. The group presented a report titled "Corporate Governance Improving Competitiveness and Access to Capital in Global Markets", which pointed out some areas where international standards or guidelines may be useful In April 1998, the OECD Council agreed to develop a set of principles on corporate governance In order to fulfil this objective, the OECD established an Ad-Hoc Task Force on Corporate Governance The Task Force presented 'Draft OECD Principles of Corporate Governance' in February 1999, which is to be officially approved by the OECD Council in May 1999

Interest in corporate governance in OECD countries first arose because investors became increasingly concerned that in companies with dispersed ownership – particularly characteristics of the United States and the United Kingdom – management was pursuing objectives other than long term returns to shareholders. However, the Asian financial crisis that began in mid-1997 intensified the need for better corporate governance standards, with increasing emphasis on the problems of non-OECD countries. In particular, prevailing governance mechanisms in Asia have been criticised because they often did not encourage management to use resources efficiently. The OECD principles have been developed because OECD members felt the neccesity to set up minimal guidelines in order

to enhance international comparability of corporate governance

The principles represent a common basis which OECD member countries consider essential for the development of good governance practice They are intended to be concise, understandable and accessible to the international community

3 3 1 Characteristics of the OECD principles

The characteristics of the 'OECD principles' are summarized as follows:

First, while the principles include the perspective from the contractual theory, they mainly adapt the perspective from agent theory that supports the Anglo-Saxon model based on shareholders' capitalism They state that the interest of other stakeholders besides shareholders should be recognized and protected

Second, the principles emphasize that while corporate governance should remain primarily a private sector prerogative, governments have a distinct and important responsibility in providing a regulatory framework that allows investors and enterprises to adapt corporate governance practices to rapidly changing circumstances

Third, the principles indicate that through its impact on corporate competitiveness and access to global capital markets, corporate governance plays an increasingly important role for enterpreneurship, economic growth and employment.

Fourth, the principles recognize that corporate governance practices should constantly evolve to meet changing conditions and vary as a function of ownership structures, business circumstances, competitive condition, corporate life cycle and numerous other factors. Experiment and variety should be expected and encouraged within the limits of

credible regulations emphasizing fairness, transparency, accountability and responsibility

3 3 2 Five Basic Principles of Corporate Governance[13]

The OECD report presents five principles for corporate governance framework These are summarized as follows

First, the corporate governance framework should protect shareholders' rights

Second, the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have equal opportunity to obtain effective redress for violation of their rights.

Third, the corporate governance framework should recognize the rights of shareholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainablility of financially sound enterprises

Fourth, the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company

Fifth, the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders

[13] www oecd org//daf/governance/principles html

3 3.3 Principles on the Role and Function of the Board

The responsibilities of the board are specified in detail as follows

First, board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and shareholders

Second, where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly

Third, the board should ensure compliance with applicable law and take into account the interests of stakeholders

Fourth, the board should fulfill certain key functions, including

- Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance, and overseeing major capital expenditures, acquisitions and divestitures
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning
- Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process
- Monitoring and managing potential conflicts of interest between management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are

in place, in particular, systems for monitoring risk, financial control, and compliance with the law

- Monitoring the effectiveness of the governance practices under which it operates and making changes as needed
- Overseeing the process of disclosure and communications

Fifth, the board should be able to exercise objective judgement on corporate affairs independent, in particular, from management

- Boards should consider assigning a sufficient number of non-executive members capable of exercising independent judgement to tasks where there is a potential for conflict of interest Examples of such key responsibilities are financial reporting, nomination of executives, and board remuneration
- Board members should devote sufficient time to their responsibilities

Finally, in order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information

# CHAPTER 4: CORPORATE BOARDS IN KOREA

It is generally recognized that the failure of corporate governance was one of the critical causes brought about the IMF crisis in Korea In particular, the corporate board has been criticized because it has failed to monitor management and alarm early warnings on behalf of shareholders The failure of corporate board has produced a lot of pitfalls in Korean economic system, over-investment relying on excessive borrowings, fleet-type management of *chaebols* by cross-shareholding, internal transactions between majority shareholders and management sacrificing minority shareholders' interests, delays in development of professional management and succession system, and so on

Why has the board of Korean companies failed? In this chapter, the characteristics and problems of corporate governance, especially corporate board, will be briefly reviewed Then, recent changes of the board in Korea will be introduced

## 4 1 CHARACTERISTICS AND PROBLEMS

In order to explain the characteristics and problems of Korean boards, it is necessary to understand the characteristics of corporate governance system firstly because the corporate board is a core system in corporate governance Compared to the corporate governance system of the United States, the Korean system has the following unique features

First, most Korean companies are owned and managed by a principal shareholder

Second, many Korean companies belong to a conglomerate business group, *chaebols*,

forming corporate networks through extensive cross-shareholdings

Third, decisions at the top tended to be made by autocratic owners Especially, strategic and financial decisions were made in the hands of a single owner or family, although decisions in some other tactical areas were decentralized

Fourth, the owner-manager practice was believed to have enhanced "responsible management" and reduced the agency cost from the separation of ownership and management. However, the Korean system did not have a well-functioning mechanism for moderating agency problems

Under the existing corporate governance system, the boards of the Korean companies could not effectively represent shareholders and other stakeholders Compared to the boards of the United States, the boards of Korean companies prior to the IMF crisis were characterized as follows

First, the *all-executive board* was very typical. Most companies, except several public companies, had an *all-executive board* in which a director was also a member of management.

Second, the chairman played a dominant role in selecting the members of the board although they were formally elected at the shareholders general meeting

Third, the role of the board was very weak for "checks and balances" because of the selection practice Board members did not represent outside shareholders, and minority shareholders were neglected

Fourth, the power of the boards was concentrated to one director-"chairman" The other

directors engaged mostly in management activities and some second-tier strategic decision making

## 4 2 CHANGES IN BOARD REFORM

### 4 2 1 Before the IMF Crisis

Efforts to reform board practice in Korea had already been taking place voluntarily before the IMF crisis because some companies perceived the changes to be necessary under the rapidly changing business environment The changes mainly focused on the introduction of an outside directors system because it has been regarded as a core issue in corporate governance in order to enhance the transparency and accountability of corporate management For example, Hyundai group announced the introduction of an outside directors system in 1996. Actually, the system was introduced in three companies of the group in that year POSCO also introduced the outside directors system in 1997, and became the first company in Korea where outside directors were a majority in the board Moreover, POSCO's board organized three committees – Nomination Committee, Investment Committee, and Public Relations Committee

### 4 2 2 Legal Changes since the IMF Crisis

Formal introduction of the outside directors system in Korea took place from 1998 when the government initiated economic reforms as a result of the IMF crisis

In February 1998, the Korea Stock Exchange (KSE)'s regulation on listing requirements

were amended so that listed corporations were obliged to elect outside independent directors[14] It was required for listed corporations to have at least one outside directors on their board before their Shareholders General Meeting (SGM) was held in 1998, and had one-quarter of the board filled by outside directors starting in 1999

An outside director must meet the set qualification standards, and must process sufficient professional knowledge and experience in management, economics, accounting, law or other related fields. Such a person may not be a majority shareholder, be specially related in any way to the corporation, be a spouse, be blood-related to a director or be a director or an employee of an affiliate The listed corporation without an outside director may be disciplined since such a requirement is one of the delisting criteria Such a corporation will then be assigned to the supervisory listing section and possibly face delisting in two years by the KSE

4 2 3 General Features of the Outside Directors System

According to a survey conducted by the Federation of Korean Industries in April 1998, the following features were found in regard to the outside directors system in Korea[15].

- Board size: The average number of outside directors was 1 3, while the number of elected directors was 9.1. However, companies planned to increase outside directors to 2 6 on average in 1999, which accounted for 28 8 percent, exceeding the 25 percent guideline of KSE regulation.

[14] Woon-Youl Choi, "Special Topics on Capital Market Development" Lectured at KDI School in Nov 1998
[15] FKI, "Introduction of outside directors system and its practices", 1998 4, survey on 646 companies with responses from 486 companies

- Board composition Certified Public Accountants (CPA) or management professionals were dominant with 32 8 %, followed by professors (27 6%), directors of other companies either retired or acting (17 1%), and lawyers (11%)
- Compensation Remuneration to outside directors was 40 4 percent of inside directors' average pay
- Operations Companies usually felt difficulties in finding qualified candidates for outside directors, determining the level of compensation and responsibility, and defining authorities of the outside directors In addition, it was found that companies worried about side effects such as delays in the decision-making process, increases in expenses, and outflow of company information

4.3 4 Criticism of Outside Directors System

The outside directors system has been introduced not by the voluntary decision of companies but by involuntary enforcement of the new government policy As a result, there have been some criticisms such as the following

- The composition ratio of outside directors of the board is insufficient Even 25% as planned in 1999, would not be enough for the board to function effectively for "*checks and balances*"
- Qualified outside directors are relatively few. Most favored occupations from companies are professors, lawyers, retired government officials, and CPAs while other companies' CEOs are mostly favored in the United States Without practical experience in businesses, the role of outside directors would be limited.

- There are no general norms in regard to compensation, authority, and level of responsibility for outside directors although they must share many kinds of legal obligations as a member of the board Some outside directors have already resigned their position because they felt high risks under the increasing power of minority shareholders

These problems may be due to the fact that the outside directors system is in the early stage of implementation. However, it is recommended that these problems should be addressed as soon as possible in order to establish an effective outside directors system

# CHAPTER 5: CASE STUDY OF POSCO's BOARD

While POSCO was under government control, the Korean government influenced and oversaw decision-making and the board's role was limited Prior to 1998, the government held more than a 30% stake in POSCO. POSCO had few non-Korean shareholders and domestic law restricted foreign stock ownership. Moreover, merger and acquisition activity was heavily regulated Under the existing ownership structure, government not only appointed top managers such as chairman and president, but also consulted on major strategic decisions Accordingly, the board of directors had little or no role in strategy planning, management selection or evaluation Maximization of shareholders' value was not always the top priority POSCO, however, became the world's most efficient and cost competitive steel maker and contributed to the Korean economic growth

Today, POSCO is facing fundamental changes as a result of privatization In July 1998, the government announced the Privatization Plan for state-owned companies and declared that it would dispose of all POSCO shares held by the Korea Development Bank (KDB) and the Ministry of Finance and Economy (MOFE) by 1999 In December 1998, the government sold all of MOFE's 3.14% stake and 2 73% of KDB's stake through the issuance of Depository Receipts. The remaining 21% held by KDB will also be sold by year-end 1999 with a 3% limit on individual holdings

As a result of these reforms, it is expected that foreign investors will hold more than 50% of POSCO's stock before long. Global institutional investors will hold substantial number of shares Moreover, *chaebols* and/or other hostile parties will be permitted to accumulate

more than 3% of POSCO's shares

Management practices will be affected by the changes in ownership structure Government will be less involved in the oversight of POSCO. Global investors will demand more experienced and independent oversight from the board If POSCO's management underperforms, it will be vulnerable to hostile acquisition or proxy fights Therefore, POSCO's performance and independence will depend on competent and objective oversight, which can be provided by an independent and experienced board In order to manage the challenges unleashed by privatization, POSCO should reform its board of directors

In this chapter, the current status of POSCO's board will be introduced, and, recommendations for improvements in the future will be presented

| | End of 1997 | End of 1998 |
|---|---|---|
| Ministry of Finance & Economy | 19 57 | - |
| Korea Development Bank | 14 06 | 21 07 |
| Investment Trust/Insurance Firms | 7 91 | 10 43 |
| Major Four Commercial Banks | 7 73 | 2.51 |
| Employees Stock Ownership Association | 0.64 | 0 22 |
| Industrial Bank of Korea | 0 31 | 6 30 |
| Foreign Holdings | 25 07 | 38 10 |
| Others | 24.71 | 21 37 |
| Total | 100 0 | 100 0 |

**Figure 5.1 POSCO's Shareholder Demographics (Unit: %)[16]**

[16] www posco co kr

## 5 1 CURRENT STATUS OF POSCO's BOARD

POSCO's board of directors convened fourteen times in twelve months since the 30th Annual General Meeting of Shareholders on March 17, 1998 The board discussed and resolved a total of 87 items on the agenda, including borrowings, issuance of depositary receipts, the annual operating plan for 1999, and donations Committees under the board reviewed various issues and provided the board with their opinions and recommendations The Nomination Committee, which consisted entirely of outside Directors, held five meetings It appointed executive officers including the Chairman/CEO and the president/CEO, and recommended candidates for the Board for the 31st Annual General Meeting of Shareholders It also reviewed remuneration for directors and auditors The Investment Committee convened seven times to evaluate the feasibility of investment projects, both domestic and overseas, as well as rights offering plans to subsidiaries The Public Committee also held seven meetings and reviewed donation plans to schools, civic organizations, and research institutes

At the 31st Annual General Meeting of Shareholders on March 16, 1999, the company's Articles of Incorporation were revised towards the introduction of Global Professional Management (GPM), an advanced ownership and governance structure for POSCO to ensure the transparency and accountability of management and to maximize shareholder value. For the efficient decision-making, the number of standing directors has been reduced to seven from not more than nine, while that of outside directors has been reduced to eight

from not more than ten Outside directors form the majority of the board so that management transparency can be enhanced Qualification requirements for outside directors have been stipulated precisely to appoint outside directors among independent professionals with expertise. The procedures for the appointment of directors have also been improved and all candidates for directors will receive the review of the Director Nomination, Management Development and Compensation Committee before being recommended by the board of directors. The special committees of the board were reorganized into the following three committees: the Nomination, Management Development and Compensation Committee, the Board Operation Committee, and the Finance and Public Policy Committee Their purpose is to deliberate on certain matters to be submitted to the meeting of the Board of Directors The Nomination, Development and Compensation Committee consists entirely of three outside directors, the Board Operation Committee consists of one standing director and three outside directors, and the Finance and Public Policy Committee consists of two standing directors and three outside directors The members of the committee out of the outside directors appoint the chairman of each committee

## 5 2 RECOMMENDATIONS FOR IMPROVING POSCO's BOARD

### 5 2 1 Roles and Operating Practices

The role of POSCO's board will need to be expanded to manage forces that are unleashed by privatization Under the expected new ownership structure, the objective of the

company should be redefined from "*contribution to the nation by steel making*" to "*maximization of all shareholders' interests*" The new objective can be achieved through clear separation of roles and responsibilities between the board and management The board should consist of independent and qualified members in order to oversee management and help set corporate directions, whereas the management team should consist of experts in the steel industry in order to run the company's day-to-day operations without intervention from owners

The role of the board should focus on how to achieve the following objective.

First, the board should shape and approve strategic directions because it is responsible for ensuring strategy to maximize shareholder value As the overseers of shareholder interests, the board's clear involvement and awareness of the company's long term strategic planning are vital However, POSCO currently does not involve the board sufficiently in strategic planning As a result, the check-and-balance system is weakened, and potentially significant contributions from the board are forgone In that sense, POSCO's board should take a role of not only approving major strategic and operating decisions of the management, but also being involved in strategy formulation process

Second, the board should monitor performance because it is responsible for overseeing corporate performance Global investors will demand independent oversight of performance. As the overseers of management for the shareholders, the board must monitor the proper execution of the company's strategy and ensure timely response to the changing environment by management However, POSCO's current performance measures are not clearly linked to top-line corporate goals and the board does not review

performance in reference to pre-established goals For this purpose, the board should utilize Key Performance Indicators (KPI) for the company appropriately

Third, the board should ensure that both current and future leadership has the capabilities and proper incentives to manage the company for the goal of maximizing shareholder interests The rationales for this role are as follows

- The board has an "advice and consent" role in ratifying the CEO's choice of a successor
- The board can facilitate a stable leadership transition
- Independent external directors can be more objective
- Institutional investors demand that board should play a more active role in leadership succession.

However, POSCO currently does not have a formal mechanism to align management incentives with shareholder interests and lacks sufficient board involvement in management development, evaluation, and compensation Therefore, POSCO's board should develop leadership succession plan and monitor execution, evaluate CEO and top executives annually and review CEO's evaluation of top executives, and link compensation of CEO and top executives with performance.

Fourth, the board must govern itself taking full and independent responsibility for effective functioning of the core processes in order to achieve high performance. POSCO's board, however, currently has significant room for improvement in director selection and compensation, board meeting effectiveness, and board evaluation Therefore, the board will require establishing formal processes for director selection and board evaluation and

designing board calendar and dynamics for maximum productivity in order to improve its self-governing capability

Finally, protecting the company from unethical or irresponsible behavior and ensuring transparency is a core responsibility of the board Also, oversight of values, ethics and financial integrity by external directors will ensure proper check-and-balance Every company is vulnerable to unethical or irresponsible behavior, with potentially devastating consequences Therefore, global investors will demand the board and management to be aware of vulnerabilities, and ensure the appropriate control system is in place and reviewed annually However, POSCO's board currently does not review the company's values and ethics, and external directors do not lead any discussion on this topic For the board to assume this role, it is recommended to hold annual review of company values and ethics by a committee led by external directors, and amend board operational rules to ensure that all values and ethics issues are raised at the board meeting

5 3 2 Board Composition

It is vital to organize a board appropriately in order for the board to function "check and balance" effectively The elements of effective board organization covers board independence, board experience, and board's size

First, an independent board can better monitor management and ensure that shareholder value is maximized As the core objective of the board is to monitor management, board must be independent to oversee, select, and evaluate managers Also, to ensure shareholder value maximization, the board must be independent to review, approve, and

evaluate management's strategy In the Unite States, a clear majority (above 70%) of directors is independent In the United Kingdom, the chairman is separate from the CEO and 40 – 50% of directors are independent It is true that different definitions exist regarding director independence POSCO, however, should adopt one that is highly valued by the international investor community, if it is to become a truly global company Institutional investors will not consider the director who is a present or former employee, a lawyer, a consultant, a banker, a supplier, or a customer of POSCO to be independent. In that sense, POSCO currently lags global companies in terms of board independence because it has only 53% independent directors (8 out of 15), compared to 91% of IBM and 89% of AK Steel, and 73% of USX Corporation

POSCO can establish an independent board either by separating the CEO and Chairman positions or increasing the ratio of independent directors. However, as it would be possibly difficult to implement the former, the latter make more sense given POSCO's situation Although there are several perceived barriers to POSCO achieving an independent board such as a lack of qualified candidates, difficulties in increasing the number of independent directors, and so on, all of them can be overcome For example, POSCO may look to other Asian countries, Europe, Australia, and USA, if it finds very few qualified candidates for directors in Korea.

Second, an experienced board contributes to maximizing shareholder value and is better able to monitor management The experienced board is important because board must have understanding of different industries and diversity of viewpoint in order to provide objective advice to management The experienced board can be achieved if it has top

three or four executives on board, and majority of experienced independent directors However, POSCO has more executives on its board and fewer non-standing directors with experience as CEO, chairman or president of major corporations than competitors and best-practice companies In addition, the experience of POSCO's non-standing directors is concentrated in banking industries POSCO is recommended to improve its board's overall experience by placing only top layer of executives on the board and by attracting more qualified non-standing directors

Third, smaller boards have better board dynamics and relationships with managers, and are better able to attract qualified directors Why is board size important? Smaller board makes it more efficient, makes board-management relationship better, and makes selection of new directors more feasible As board becomes larger, it becomes difficult to make individual directors accountable Directors lose individual responsibility and groupthink prevails POSCO's board currently consists of 15 members It is recommended to target a board size of 10-13, compared to the number of directors in global companies' board

In summary, POSCO has room to improve all three elements of board composition - board independence, experience and size Assuming POSCO does not separate CEO and Chairman positions, it can improve all three elements best by decreasing the number of standing directors and non-independent non-standing directors, and increasing the number of independent directors.

5 3 3 Committee

It is very critical for the board to take advantage of committees for increasing its efficiency and effectiveness Committees can not only leverage board's time to permit extended discussion of most important issues in full board meetings, but also bring the board to focus on detail oriented and/or complex topics that are difficult to address within the constraints of full board meetings Also, it can make to leverage board's experience by focusing directors on topics with which they are familiar – for example, CFO of industrial company In addition, it can allow independent directors to handle issues requiring objectivity when the board selects a CEO of the company

Although POSCO's board reorganized its committees to enhance effectiveness and efficiency of the board this year, there are still some points to be improved as follows

First, POSCO can more effectively use committees to leverage board's time POSCO's committees only consult to the board and do not have authority to make decisions, all issues go to the full board, compared to the best practices in which only issues requiring all directors' input are discussed by the full board. Moreover, the committees do not have formal operating charters. The board does not handle sufficient number of issues or tasks to save board time Therefore, POSCO's board is recommended to delegate more authority to committee, to develop a charter to clarify roles, responsibilities and authority of each committee

Second, POSCO can better use committees to accomplish complex tasks In 1998, committees met only a few times with each meeting lasting only approximately thirty

minutes  To improve the role of committees, the following are recommended

- Identify recurring, complex tasks and form committees around them  These tasks may contain director nomination and board operation, management selection and evaluation, and financial controls and policies
- Develop a calendar for committee meetings
- Convene longer committee meetings more frequently

Third, POSCO can make better use of its board's expertise  In POSCO's board, qualifications of committee members do not necessarily match expertise required by the committee, and non-standing directors have limited range of expertise concentrated around government and banks  Its practices are compared to the best practices where directors with particular expertise assigned to appropriate committees – for example, accountant to audit committee  POSCO's board can improve by recruiting directors with relevant experience to sit on each committee

Fourth, special committees can be formed from time to time in order to handle non-recurring, complex tasks

# CHAPTER 6: CONCLUSIONS

The Anglo-Saxon model is inescapable in today's trend of intensifying global competition In this regard, it is a matter of survival rather than choice to adopt the global standard The basic objective and direction of recent changes in Korean board's system *does* make sense The objective of the board is well described by Robert Lightfoot[17] "the corporate governance system relies on the board of directors as its main organ Elected by shareholders, the board safeguards interest by overseeing management, reviewing financial performance and allocation of funds, and ensuring that the corporation acts in a legally and socially responsible manner"

Concerns, however, still remain regarding the effectiveness of the new board system even though Korean companies have already started to introduce the new board system emphasizing the role of outside directors Whether the system will be successful or not will depend on how to fully take advantage of the role of outside directors In this regard, proposals to improve the performance of boards such as cumulative voting for election, sub-committees and others should be introduced

In general, it is acknowledged that simply transplanting a new system that has proven to be successful in one country may not guarantee success in other country with different social, political, economic, and cultural setting[18]. Therefore, it is important for the Korean government and corporations to make greater efforts to set up the proper infrastructure

[17] Robert Lightfoot. Note on Corporate Governance Systems, Harvard Business Review, 1995

[18] Lee, Young Ki, "Corporate Governance The structure and Issues in Korea", Korea Development Institute, 1998 4, p 270

necessary for the new system to function successfully In the era of global competition, the "competition of governance systems" will significantly affect the future of the Korean economy

In that sense, the reform of POSCO's board implies some directions which Korean companies shall take in the course of their reform

In line with the privatization plan, POSCO has just started to establish a 'Global Professional Management (GPM)', an advanced ownership and governance structure, which separates management from ownership and places top priority on shareholder value To this end, the company plans for its board of directors to consist of independent and knowledgeable people who can represent the interest of all shareholders, instead of speaking for special groups of shareholders. It is expected that bringing in directors with expertise in diverse fields will greatly contribute to enhancing board efficiency, strengthening its ability to provide advice about strategic plans, and closely monitoring the company operations In the future, POSCO will continually pursue shareholders' value maximization by appointing professional managers to lead the company with full authority and accountability of their activities. To fulfill the objectives, POSCO is recommended to reform its board continuously in term of roles and operating practices, composition, and committees. For this purpose, the Anglo-Saxon model and the OECD principles shall be usefully referred under more and more globalizing business environment.

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