
Korean Studies Workshop for American Educators 2008

Korean Corporate History: The Rise and Fall of Daewoo

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AGENDA

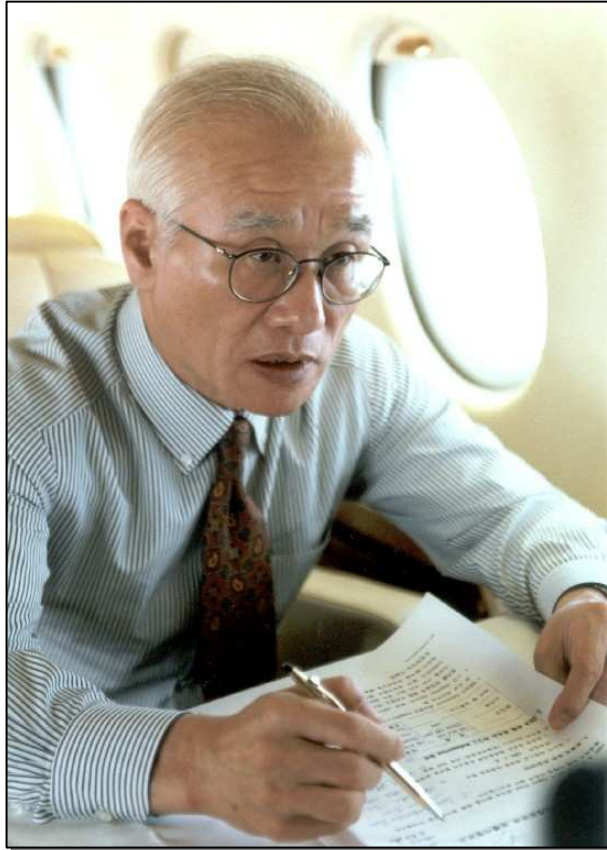
- **Introduction**
- **Asian Conglomerates & Korean Chaebol**
- **Concentrated Decision-Making and the Failure of Oversight**
- **Conclusion**

Asian Conglomerates & Korean Chaebol

- **Business and Government Relations**
- **Ownership Structure**
- **Related-Party Transactions and Self-Dealing**
- **Accounting Fraud and Loan Fraud**
- **Financial Structure**

Business and Government Relations – The Rise of Daewoo

- **Founded in 1967, became the largest transnational company among developing countries in less than three decades**
- **Acquired distressed companies from the government, restructured & turned them around**
- **Benefited from personal ties with President Park Chung-Hee (1961~1979)**
- **State-oriented corporate governance through industrial policy**
 - **Policymakers guided business decisions**
 - **Regulatory landscape**



대우가족

大宇



DAEWOO MOTOR



YONSEI
UNIVERSITY

Business and Government Relations – The Rise of Daewoo

- **Potential Incentives**
 - Preferential policy financing & credit
 - Subsidies
 - Tax benefits
 - Tariff protection
 - Bailouts

- **Negative Incentives**
 - Failure to obtain lucrative licenses and permits
 - Administrative sanctions or fines
 - Tax audits
 - Criminal investigations & prosecution

Chaebol

Business and Government Relations – The Rise of Daewoo

- **Government ties created enormous windfalls and phenomenal compressed growth, but also**
 - **clientelism**
 - **cronyism**
 - **corruption**
- **First crisis in 1988 due to severe liquidity problems**
 - **bailed out through government rescue plan**
 - **failure to deal decisively fueled dependence**
 - **created moral hazard**
- **Paradigm change**
 - **financial crisis & decline of state influence**
 - **privatization of financial institutions**
 - **expansion of equity markets**

Chaebol

Ownership Structure

- **Ownership structures in Asia generally based on family-control**
- **Control secured through interlocking, cross-shareownership between affiliates**
- **Divergence of cash flow rights and control rights**
- **Strong state influence**

Ownership Structure

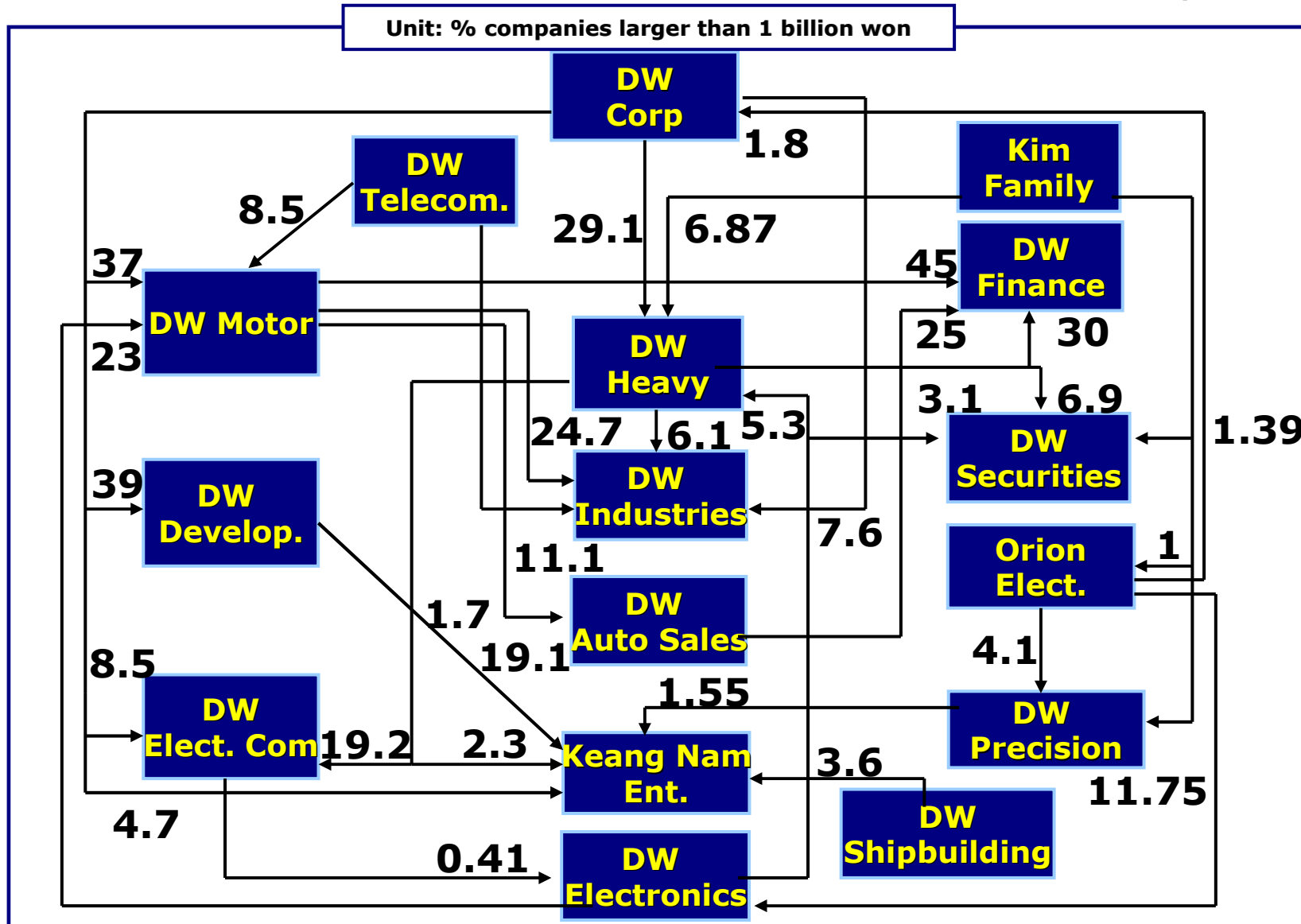
- **For listing on the stock exchange, legal and regulatory system protected controlling interests**
 - Institutional investors had to shadow vote shares
 - Unfriendly mergers and acquisitions were curbed
 - Disclosure standards remained minimal
 - Minority shareholder rights faced high ownership requirements
 - Accounting audits and internal controls were ineffective
- **Ownership dispersion policy led to misalignment between controlling and minority shareholders**

Daewoo

Investor Investee	DW Corp	DW Electron	DW Heavy	DW Telecom.	Orion Elect.	DW Motor	DW Precision	DW Auto Sales	DW Develop.	DW Ship-build _{ing}	DW Elect. Com	DW Securities	Treas. shares	ESOP	Kim Family	TOTAL
DW Heavy	29	5.3		1.1	1.1		2.3	0	0.8					0.2	6.9	47
DW Corp		0.4			1.8			0.4					4.3	1.1		8
DW Motor	37	23		8.5												69
DW Securities		3.1	6.9	0.2		0.1							2.9	0.1	1.4	15
DW Electronics					2						0.4		1.7	0.5		4.6
DW Telecom.		5.7												2.1		7.8
Orion Elect.								0.4					2.8	0.5	1	4.8
Keang Nam Ent.	4.7	4.7	2.3	2.3			1.6		1.7	3.6		1.1	1.2	2.7		26
DW Industries	7.6		6.1	11		2.5										50
DW Auto Sales						19							0.8			20
DW Precision					4.1							0.9		3.3	1.2	20
DW Finance			30			45		25								100
DW Develop.	39															39
DW Elect. Com	8.5		19										0.5	0.1		28
TOTAL AVE	-	-	-	-	-	-	-	-	-	-	-	-	1	0.8	1.5	31

Source: Chaebol Information Center, Inha University

Daewoo in 1997



Related-Party Transactions & Self-Dealing

- **Chaebol trace their corporate history to subsidization through related-party transactions**
- **With scarce credit and financing, government promoted these transactions among affiliates**
- **Interlocking debt guarantees**
 - In Dec. 1997, Daewoo's cross-guarantees amounted to 8.5 trillion won
 - Weaker affiliate's default could start a chain reaction of payment demands and a collapse
 - Exacerbated "too-big-to-fail" mentality and moral hazard

DW Related-Party Transactions & Self-Dealing

- **Entered into risky automobile industry**
 - Joint venture with GM; later bought GM stake
 - Acquired numerous other domestic and foreign automobile makers, e.g., Ssangyong Motor
 - Employees were pressured to buy cars
 - Affiliates assumed most of the burden
- **Daewoo Motor, Ssangyong Motor, Daewoo Corp and Daewoo Heavy Industries accounted for close to 83% of the entire net debt of the conglomerate**

Related-Party Transactions & Self-Dealing

- **Moral hazard led to riskier ventures and more improper acts**
 - Self-dealing for personal benefits
 - Appointing unqualified relatives as executives
 - Various forms of earnings management
- ***Kim and senior managers did engage in limited amounts of self-dealing***
 - *decisions were apparently carried out on behalf of the company, not for their own personal gains*
 - *unaccounted BFC funds*
- **Ultimately, accounting fraud and loan fraud represented another form of self-dealing**

Chaebol: Daewoo

Improper Internal Trading

Unit: No. of, 100 million won

	Group	Provider companies	Supported companies	Amt of transactions	Amount of support	Subcharge
Jun-98	Daewoo	6	7	4,229	-	89
	Average*	18.5	7	9,009	-	133.3
Jul-98	Daewoo	11	3	415	-	44.6
	Average*	5.5	4.5	3,628	-	41.2
Jul-99	Daewoo	7	10	54,301	858	135
	Average*	11.5	7	17,257	410.5	164.8

Source: FTC

Accounting Fraud and Loan Fraud

- **Internal and external corporate governance failed to detect or prevent 22.9 trillion won in accounting fraud**
- **Government tacitly condoned accounting opacity**
- **To attract foreign capital, inflation of financial figures were deemed necessary**
- **State-controlled banks focused on the size of revenues, sales volume and assets, rather than profits and cash flow**
- **Daewoo chose to overcome its financial difficulties through expansion, and with it, more deception**
 - **With the financial crisis, the company could no longer sustain accounting and loan fraud**

Accounting Fraud

Unit: trillion Won

Companies	Capital (99.8)		Initial FSC Report	Final Gov't Report
	Company Figures	Due Diligence		
Daewoo Corp.	2.6	-17.4	20	14.6
Daewoo Motor	5.1	-6.1	11.2	3.2
Daewoo Heavy	3.1	1	2.1	2.1
Daewoo Electron.	0.7	-3	3.7	2
Daewoo Telecom	0.3	-0.9	1.2	0.6
Subtotal	11.8	-26.4	38.2	22.5
7 Other Daewoo Affiliates	2.5	-2.2	4.7	0.4
Total	14.3	-28.6	42.9	22.9

Source: Government Final Report, Sept. 15, 2000

Accounting Fraud and Loan Fraud

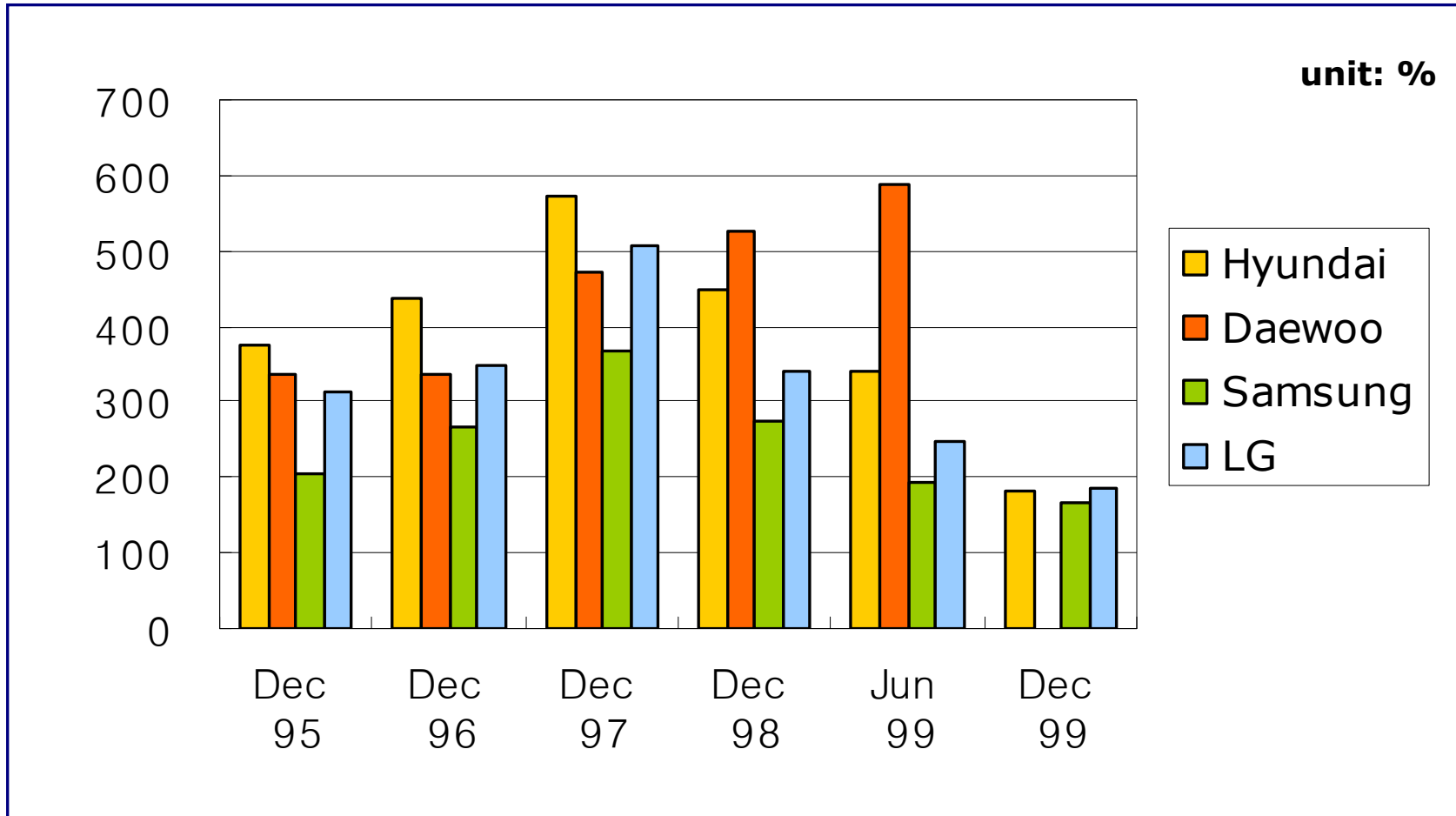
- **Used affiliates and overseas BFC accounts to reduce debts and manipulate export returns**
- **BFC used for related paper companies to obtain fraudulent commercial invoices, bills of lading, and packing lists**
- **Asset swaps between sister companies at discounted or inflated values**
- **15 trillion won in off-balance sheet liabilities**
- **4 trillion won in non-performing loans**
- **3 trillion won in false inventories**
- **1 trillion won in false research and development expenses**

Chaebol

Financial Structure

- **operated under state-supported debt financing as part of industrial policy**
- **top four Chaebol debt-to-equity ratios exceeded 450% at the time of the financial crisis in December 1997**
- **Daewoo's financial structure had several distinctive features**
 - **Over-relied on debt gearing**
 - **Increased debt-to-equity ratio, not decreased**
 - **Daewoo Corp was not the main profit center and could not provide financial support to sustain weaker affiliates**

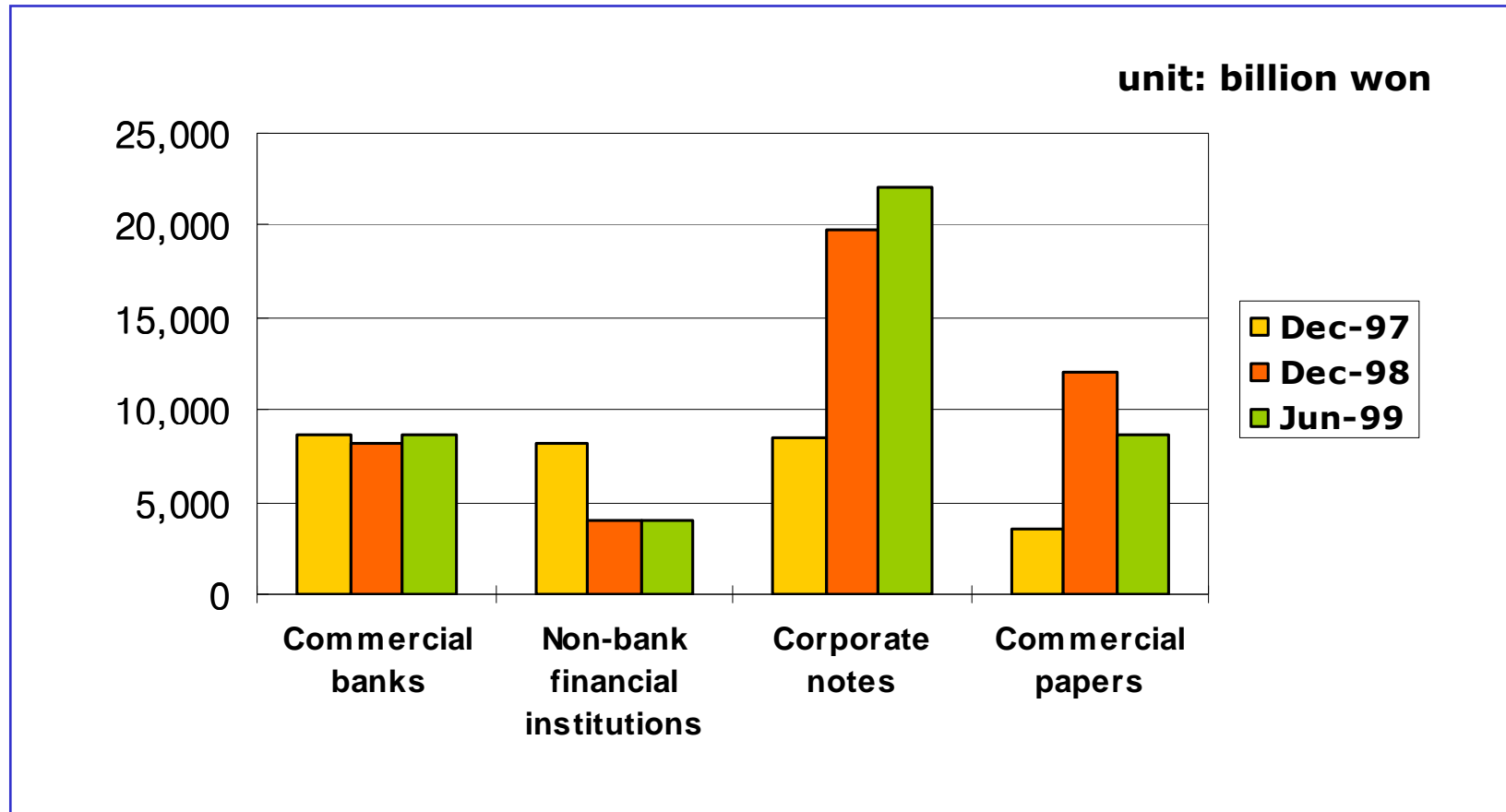
Debt/Equity Ratio of Top Four Chaebol



Financial Structure

- **Due to the financial crisis, Daewoo Group could no longer maintain financial balancing act**
 - **Foreign debt jumped from 26.3 trillion won to 49 trillion won**
 - **\$5.1 billion in foreign currency loans; \$1.9 billion in foreign currency loans to convertible bond owners**
 - **Sudden increase in interest rates led to financing costs jumping from 3 trillion won to 6 trillion won**

Daewoo Group's Domestic Borrowings



Source: Korea Financial Supervisory Commission

Concentrated Decision Making & Failure of Oversight

- **Concentrated Decision Making**
- **Failure of Oversight by representative directors, boards of directors and statutory auditors**
- **Shareholders & Stakeholders**

- **Common attributes of large Asian conglomerates**
 - Management styles
 - Business cultures
 - Business models
- **Daewoo's success and fate is linked with its founder, Kim Woo-Choong**
- **As chairman and controlling shareholder of the conglomerate, he maintained total control**



Concentrated Decision-Making

- **Dominated all major decision-making**
 - **International and domestic financing**
 - **Appointment of all CEOs and board members for all companies**
 - **Business strategies**
 - **Inter-company relations**
 - **Overseas operations control**

- **Decisive, vertical, efficient and speedy decision-making**
- **Despite corporate governance breakdown, Kim made exemplary decisions**
 - **Management succession → no relatives**
 - **Donated personal holdings in Daewoo Corp to the Daewoo Foundation**
 - **Sceptics claim served ulterior purposes**
 - **preempt political crackdown**
 - **foundation acted as a shelter to minimise personal inheritances taxes**
 - **de facto holding company to help maintain control**

Concentrated Decision-Making

- **Financial crisis exposed the weaknesses of concentrated governance structure**
- **Structure played a critical role in accounting and loan fraud and ultimate collapse**



Failure of Oversight

Directors and Auditors

- **ineffective check and balance and internal control mechanisms**
- **failed to counterbalance controlling shareholders; instead succumbed to their dictates**
- **did not provide oversight and act as independent, front-line monitors**
- **disregarded roles as fiduciaries**
- **directors & officers not legally distinguished; internal & external auditors**

Failure of Oversight

Directors and Auditors

- **no non-executive outside directors until 1998; no audit committees**
 - **25% outside directors did not change matters**
- **colleagues of Kim's generation**
 - **could advise and monitor decision-making**
 - **replaced by new executives who were unable to effectively counsel and confront**
- **failed to persuade chairman to pursue a contraction-oriented policy and prevent fraud**

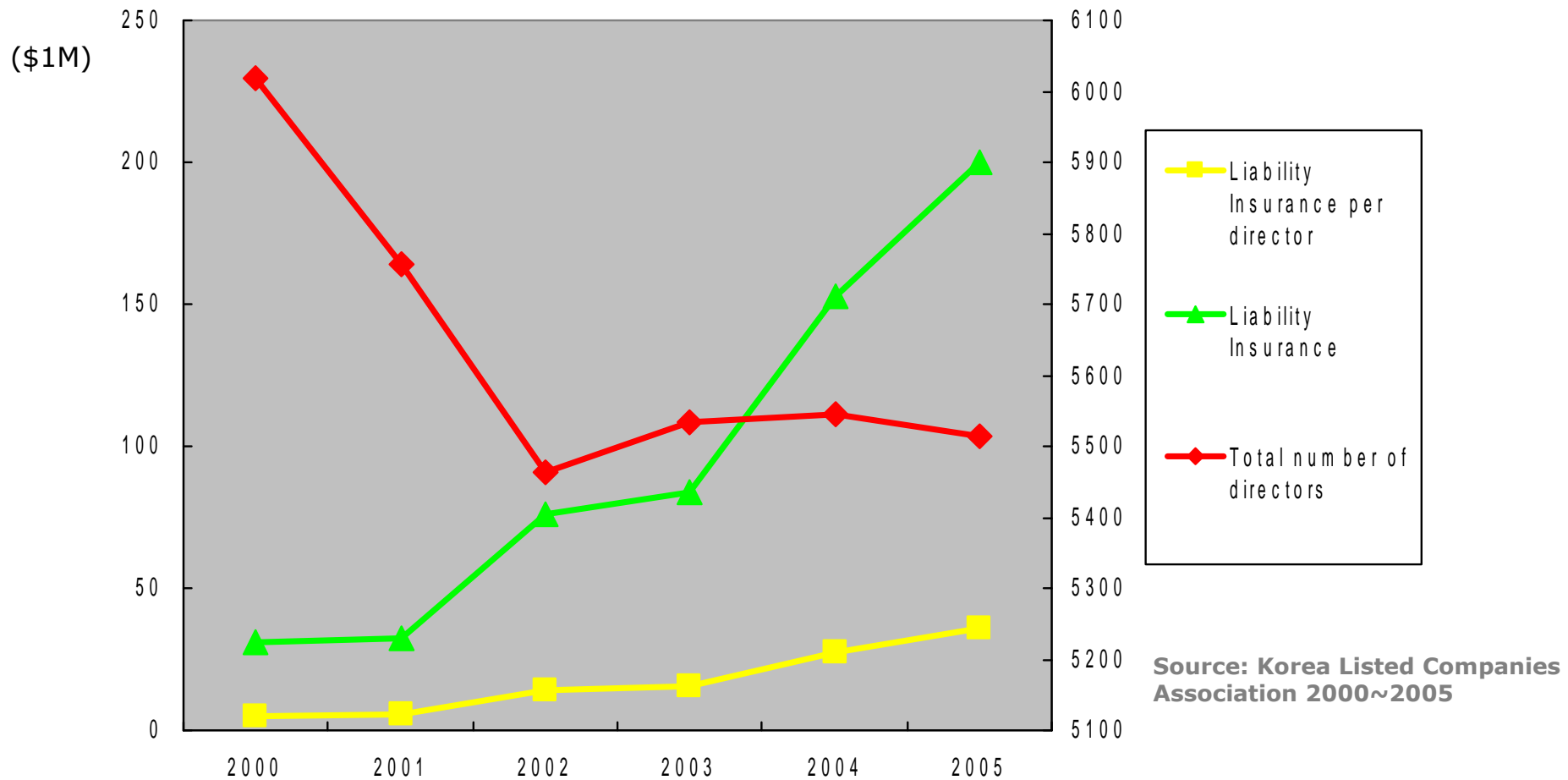
Failure of Oversight

Directors and Auditors

- **only held accountable to controlling shareholder & conglomerate**
 - **no labour market flexibility**
 - **remained captive to their conglomerates**
 - **insufficient outside scrutiny**
 - **for auditors only major client**
 - **only after the collapse did they face civil and criminal liability; Chungun & Sandong**

Failure of Oversight

	2000	2001	2002	2003	2004	2005
Liability Insurance (\$1M)	30.9	32.6	76.1	84	152.8	199.8
Total # of directors	6019	5757	5464	5535	5544	5514
Liability Insurance/director (\$1000)	5.1	5.6	13.9	15.2	27.6	36.2



Failure of Oversight

Shareholders and Stakeholders

- **passive in monitoring management**
 - **did not question or challenge**
 - **did not seek information**
 - **did not attempt to get representation on the board**
 - **did not attend AGM or vote**
 - **failed to take any action, no matter how dire the case**

Failure of Oversight

Shareholders and Stakeholders

- **weak shareholder rights; lack of awareness**
- **investment on a short-term basis**
- **difficult to obtain information due to weak disclosure standards**
- **absence of a class action vehicle and obstacles to litigation**
- **confined institutional investors to shadow voting**
- **ineffective proxy rules**

Failure of Oversight

Shareholders and Stakeholders

- **Stakeholders such as creditors, employees, labor and consumers failed to serve as checks and balances**
- **Employment stock ownership plans (ESOP) did not serve as monitoring forces**
 - **voting rights rarely exercised**
 - **limited ownership**
 - **complicated proxy procedures**

Failure of Oversight

Shareholders and Stakeholders

- **Strong sense of group loyalty & strong corporate culture against whistleblowers**
- **Lack of access to information and little incentive to question the decision-making of executives**
- **Rarely challenged questionable decision-making or contemplate exposing wrongdoings**

Daewoo & Hyundai Motors



Woo-Choong Kim convicted of embezzlement, fraud and currency law violations (May 31, 2006)

- privately using \$116 million
- diverting 25 trillion won in slush funds overseas by forging import-export transaction documents
- 20 trillion won of accounting fraud
- 10 trillion won of illicit lending from banks based on falsified company documents
- sentenced to 10 years in prison; \$ 21.44 billion won fine



Mong-Koo Chung found guilty of embezzlement and breach of trust (June 2008)

- embezzled \$109m in company funds
- raised \$130m of slush funds since 2001
- transferred funds and shifting corporate controls to his son, Chung Eui-Sun
- incurred more than \$300 million in damages to the company

Conclusion



Additional Info

Joongi Kim

*A Forensic Study of Daewoo Corporate Governance:
Does Responsibility for the Meltdown Solely Lie with the
Chaebol and Korea?*

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