

Legal Change in Post-Authoritarian South Korea: Corporate Changes As Viewed Through the Fates of Kukje, Hyundai, and Hanbo

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This paper argues that Korea failed to learn from its mistakes during the period of transition toward a market-oriented economy. It describes the legal reforms that the country has undergone by focusing on case studies involving three conglomerates, the Kukje Group, Hyundai Group and Hanbo Group conglomerates, in the authoritarian and post-authoritarian period. In this process, it describes the legal changes that have occurred in the post-authoritarian era. Some of the legal reforms can be attributed to a maturing economy at a particular stage of development. This paper will argue that a legacy of post-authoritarian legal reforms is the importance of minimizing state intervention in the economic realm. While making progress on the path to a market economy, Korea failed to replace the strong state with effective market-based checks and balances. As a result, it argues that the lax excesses that followed post-authoritarian rule contributed to the catastrophic collapse that occurred during the 1997 financial crisis. Hence, it concludes that an efficient and disciplined market-based economy must be in place to avoid similar disasters in the future.

Keywords: Kukje, Hyundai, Hanbo, corporate governance, corruption, legal changes, fair trade, defunct, due process, economic freedom, tax audit, chaebol, financial crisis, embezzlement, bribery, reforms, post-authoritarian

1. Introduction

As has been widely documented, Korea has achieved a stunning degree of

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economic growth in the past 40 years. From being one of the poorest countries in Asia, Korea became a developed country, joining the ranks of the OECD as the eleventh largest trading country in the world. Korea's success story has attracted countless studies seeking to unravel the origins of its miraculous development.¹ Modern Korea's growth can be traced back to the controversial period under President Park Chunghee, who guided the country from 1961 until 1979, especially in later years under his iron will and fist. This type of stern, authoritarian legacy continued through the succeeding Chun Doo-hwan administration until 1988 when for the first time in nearly two decades a peaceful transition of power occurred through democratic and relatively scandal-free elections. Hence, 1988 marks a pivotal juncture in assessing the effects of democracy on Korea's economic development. How was Korea's economy affected as a result of the onset of democracy and what is in store for the future?

This paper will seek to argue that Korea failed to learn from its mistakes during the period of transition toward a market-oriented economy. It will describe legal reforms that the country has undergone by focusing on case studies involving three conglomerates, the Kukje Group, Hyundai Group and Hanbo Group conglomerates, in the authoritarian and post-authoritarian period. In this process, it will try to describe the legal changes that have occurred in the post-authoritarian era. Some of the legal reforms could be attributed to a maturing economy at a particular stage of development. This paper will argue that a legacy of post-authoritarian legal reforms is the importance of minimizing state intervention in the economic realm. While making progress on the path to a market economy, Korea failed to replace the strong state with effective market-based checks and balances. As a result, it argues that the lax excesses that followed post-authoritarian rule contributed to the catastrophic collapse that occurred during the 1997 financial crisis. Hence, it will be concluded that an efficient and disciplined market-based economy must be in place to avoid similar disasters in the future.

1. Amsden, Alice. 1989. *Asia's Next Giant: South Korea and Late Industrialization*. New York: Oxford University Press; Jones, Leroy P., and Sakong, Il. 1980. *Government, Business, and Entrepreneurship in Economic Development: The Korean Case*. Cambridge, MA: Harvard University Press; Cho, Soon, 1994. *The Dynamics of Korean Economic Development*. Washington: Institute for International Economics.
2. The Korean Supreme Court determined that the rise to power was a "military uprising." Supreme Court, Judgment of April 17, 1997.

2. Disintegrate In Midair: The Collapse of the Kukje Group (1980-1987)

Chun Doo-hwan, a former general, assumed power in the midst of the power vacuum that was left behind following Park Chung-hee's assassination in 1979.² Faced with legitimacy questions surrounding his ascension to the presidency, Chun focused his attention on economic growth and prosperity. According to one assessment, despite Chun's heavy-handedness, much in the manner of his predecessor Park, the Korean economy at the time was marked by "generally good macroeconomic management," which led to rising performance.³ After undergoing considerable turmoil in the first year, the economy grew on average by 8.7 percent on a yearly basis until December 1987 when Chun's term was ending. During Chun's term the last vestiges of industrial policy were implemented, with a focus on the semiconductor and automobile industries. Samsung, LG, and Hyundai, among others, entered the semiconductor industry. Furthermore, in 1981, Kia was granted a monopoly in the truck business, while Hyundai and Daewoo were granted a duopoly in the passenger car business.

In terms of other policy achievements, the Monopoly Regulation and Fair Trade Act was enacted in 1980 and a Korea Fair Trade Commission (KFTC) was established. In addition to promoting fair competition, one of its primary goals was to constrain the excesses of the chaebol, the large conglomerates that dominated Korea's economy. Starting from 1986, the KFTC specifically began to focus on "economic concentration" issues. But despite its lofty goals, KFTC's achievements were overall uneventful. One reason for this lack of effectiveness was that the KFTC remained under the powerful Economic Planning Board (EPB). This hierarchy thereby subordinated competition policy to industrial or trade policy.⁴ KFTC only became an independent agency directly under the Prime Minister's office in 1994.

Against this general background, the most significant corporate event during the Chun era involved the spectacular break-up of the Kukje Group. The collapse and subsequent legal actions surrounding the Kukje Group were significant for a host of reasons. First, it demonstrates how powerful the state was prior to 1988 when authoritarian rule dominated hand in hand with remarkable eco-

3. Graham, Edward M. 2003. *Reforming Korea's Industrial Conglomerates*, p. 74. Washington, D.C.: Institute for International Economics.

4. Graham 2003:58.

conomic growth. The variety of methods that a state could employ to intervene in a company's affairs, particularly including the total control of the banking and financial system, were all utilized to dissect one of the largest conglomerates in Korea. Second, the case vividly illustrates the limitations of the legal system and rule of law at the time. Various legal decisions in fact acknowledged how the judicial system was unable to offer due process and proper recourse for victims. Third, the case illustrates the transition to a post-authoritarian age, when the constitutional court subsequently rendered a landmark decision that held for the first time that the government exceeded its statutory authority. According to the court, due process and the importance of the rule of law provided the central reasoning behind the seminal decision.

A. The Collapse of the Kukje Group

Founded in 1949 by Yang Jungmo, the Kukje Group at its peak was considered the seventh largest chaebol in Korea. It claimed over 22 companies, 38,800 employees, Korean Won (KW) 1.79 trillion in sales, and \$ 934 million in exports in 1984. Kukje's fate offers a glimpse into the vast array of power that the state possessed when it wanted to install discipline in the economic realm. When Kukje was declared defunct on February 21, 1985, reports circulated widely that Kukje was sacrificed as a political victim to show an example to other large conglomerates of the consequences of not meeting the expectations of the Blue House.⁵ Due to the suddenness of the break-up, it was described as though it had "disintegrated in midair."

Subsequently, with the beginning of the post-authoritarian Sixth Republic in Korea, the founder, Yang Jungmo, filed a claim in the Korean Constitutional Court on February 27, 1989. In a landmark decision, this Court largely redeemed him, at least legally, and found in his favor on July 29, 1993, albeit some four years later.⁶ The damage already done, however, Yang's persistent efforts to regain control of the companies in his empire have proven unfruitful.

5. Yang suggests that he lost favor of the administration largely because he was not generous in providing questionable donations to the Saemaoul and Ilhae Foundation, he was late to a Presidential dinner due to a snow storm, and he was held responsible for the poor showing of the ruling party in the February 12, 1984 National Assembly elections in the Busan region, where he was head of the Chamber of Commerce. Chosun Ilbo, July 30, 1993, p. 11; Han, Yoorim. 1993. *Kukje Group Yang Jungmowa Che 5 Konghwaguk (Yang Jungmo of the Kukje Group and the Fifth Republic)*. 11. Seoul: Yoojung Publishing; Milhaupt, Curtis J. 1998. "Property Rights in Firms." In *Virginia Law Review* Vol. 84: 1145-1176, n.94.

6. Korea Constitutional Court, Judgment of July 29, 1993, 89 Hunma 31.

The Kukje Group precariously relied upon short-term capital and with its enormous debt, the Kukje Group was undergoing financial difficulty at the end of 1984. The conglomerate as a whole had over KW 1.68 trillion in debt. Kukje suffered from over-competition in its mainstay shoe market, shrinking overseas construction projects, a shortage of funds due to the construction of its new headquarters, and senior management that was filled with unqualified family members. Finally, the overall economy at the time was undergoing a downturn.

In December of 1984, the Ministry of Finance (MOF) decided to terminate a critical source of short-term financing (*wanmaechae*) that Kukje had heavily relied upon. The group borrowed frantically from several leading commercial banks in an effort to cover its rapidly maturing short-term debt which amounted to KW 550 billion. Kukje's debt-to-equity ratio stood at 800 percent at the time of its collapse according to the President of Korea First Bank (KFB).⁷ Its net income went from a KW 3 billion surplus in 1983 to a KW 30.7 billion deficit in 1984.

Without any prior consultation with Kukje's primary creditor bank, KFB, the Minister of Finance proceeded to implement the break-up of Kukje according to a plan approved by President Chun on February 7, 2003. According to the Constitutional Court's findings, one significant reason for this decision was to instill a sense of urgency that even chaebol conglomerates could be subject to a break-if their mismanaged companies became defunct. The plan provided that Kukje Corporation's shoe operations would be sold to Hanil Synthetic Fiber, its construction operations to Kukdong Construction, and Yonhap Steel to Dongkook Steel. The Minister directly contacted the heads of these companies and obtained their approval to purchase the operations. Korea First Bank (KFB) was not aware of the initial plan to break-up the Kukje conglomerate. On February 13, 2003, under the direction of the MOF, KFB commenced bank receivership of Kukje's finances. KFB required Kukje to place in trust all assets and real estate in KFB's care and in the meantime persuaded Kukje that if it quickly implemented a restructuring plan then it would receive financial support.

Then, on February 21, 1985, KFB staff learned from a press release provided by MOF that stated that KFB was initiating the break-up of the Kukje group to avoid further damage to the bank.⁸ Hence, the break-up proceeded in total secre-

7. Chosun Ilbo, July 30, 1993, p. 11.

8. The press release was apparently delayed until after the February 12, 1984 National Assembly elections.

cy at breakneck pace and was completed within two weeks after its initial approval by Chun. The restructuring plan that KFB and Kukje had initially agreed upon that would have reduced the conglomerate to six core companies became meaningless. In essence, the break-up and sale of Kukje did not proceed according to ordinary market dynamics or normal legal procedures such as bankruptcy, reorganization, or auction. Instead, shrouded in secrecy, it occurred according to the pre-written script of the Ministry of Finance. Furthermore, the companies that acquired Kukje's various subsidiaries received tremendous government benefits. The Hanil Group, for instance, benefited from KW 100 billion in debt forgiveness and its KW 150 billion in loans were deferred, to be repaid over a period of 15 years.

B. Redemption under the Law: The Constitutional's Court Landmark Kukje Decision

In 1993, in a landmark seven-to-one decision, the Constitutional Court found that the official actions taken by the Minister of Finance to dissolve the Kukje Group were unconstitutional.⁹ The Court found that the MOF's official actions violated numerous basic freedoms and rights guaranteed under the constitution. First, under Article 119 of the Constitution, the Court outlined that the economic order of Korea dictates that all individuals and enterprises are guaranteed economic freedom and creative initiative.¹⁰ These remain fundamental rights that can be abridged only in exceptional circumstances. Article 126 further provides that the state shall not interfere in the management of private companies unless for national defense or the national economy.¹¹ The Court emphasized therefore that for the government to involve itself in the management of defunct companies it must have either explicit statutory authority to do so, or it must be according to an emergency decree issued under financially or economically extenuat-

9. Huh, Young. 1994. "Gonggwonnyeoke uihan Kukje Group haechui wibeopseong (The Illegal Break-up of the Kukje Group through Public Authority)," in *P'allyewolpo* Vol. 280:16; Yoon, Dae Gyu. 1995. "New Developments In Korean Constitutionalism: Changes And Prospects." In *Pacific Rim Law and Policy Journal* Vol. 4:413-414.

10. The economic order of the Republic of Korea shall be based on respect for the freedom and creative initiative of enterprises and individuals in economic affairs. Article 119 (1).

11. Private enterprises shall not be nationalized nor transferred to ownership by a local government, nor shall their management be controlled or administered by the state, except in cases as prescribed by Act to meet urgent necessities of national defense or the national economy. Article 126.

ing circumstance in the country. The government must follow such due process under these situations.

Furthermore, the Court's opinion provided incredible foresight concerning the importance of banks being independent from governmental interference. It is eerily coincidental that Korea First Bank would later serve as the critical lynchpin in Korea's subjugation to the financial contagion that swept through Asia in 1997, due to its catastrophic bad loans to the Hanbo Group and Kia Group. The Court held that MOF's official actions differed fundamentally from general "administrative guidance", which would have been more of a recommendation or suggestion and more acceptable. Instead, the MOF engaged in unauthorized action that violated the constitutional right of businesses to be free from "arbitrary and discriminatory treatment." The Court explained that an exercise of public authority that replaces the dominant shareholder and managers of a private enterprise without legal basis destroys the market economy and governance by the rule of law. The Court stated that "democracy is the respect of means and procedures, and the ends alone cannot be the primary purpose." Measures that disregard proper procedures, despite their purpose, should be considered as an abuse of public authority and could not be constitutional according to the court.

The Court explained in great detail the normal options available to a bank when one of its debtors becomes defunct. As described in the opinion, the bank could have proceeded under bankruptcy procedures, bank directed management, the Composition Law or Corporate Reorganization Law, or could have held a public auction of collateral. KFB could also have followed other banking regulations, could have pursued a third-party acquisition or merger, or it could have requested that the owner of the company sell their personal assets. Whichever option taken, the bank must make such decisions independently by itself without interference.

Even when a distressed company may cause widespread national and social damage, the Court stressed that any attempts to resolve the problem must occur within the "confines of the law." The Court found that the Minister's actions occurred without statutory authority and violated the fundamental due process guaranteed under a country governed by the rule of law. The freedom and equal rights to engage in corporate activity were infringed upon. The Court concluded that through its decision it sought to reemphasize the constitutional values and order that must be protected such as rule by law in financial and economic affairs and not by discretionary interventionist government policy. In this "historic decision," the Court reconfirmed "a simple principle of democracy and

capitalism that had often been ignored by the government.”¹²

Overall, the stunning break-up and subsequent judicial redemption surrounding the Kukje Group provided a true measure of how powerful the state was prior to 1988 when authoritarian rule dominated, in conjunction with solid economic growth. The state fully utilized its vast web of policy tools, particularly the total control of the banking and financial system, in terminating the life support system of one of the largest conglomerates in Korea. The case also illustrated the limitation of the legal system, due process and rule of law during that era. A host of subsequent legal decisions in fact acknowledged how the judicial system was unable to offer proper recourse for victims during the Fifth Republic. Yet, in the end, the constitutional court rendered a landmark decision that for the first time held that the government had exceeded its statutory authority, marking the arrival of the post-authoritarian era. The 1988 onset of democratic liberalism thus brought about the bona fide application of the rule of law.

3. The Onset of Democratic Reforms and Post-Authoritarian Governance (1988-1997)

A. Repercussions of the Post-Authoritarian Era

The establishment of the Sixth Republic in 1988 marked the first time in over 17 years that a president was democratically elected based upon popular vote. From the Roh Taewoo administration forward, economic policymaking in South Korea was subject to “far greater popular demands and scrutiny” as summarized by one commentator.¹³ The Sixth Five-Year Economic Plan that started from 1987 consisted of a host of reforms including the banking sector and financial sector, chaebol conglomerates, labor laws, industrial policy and various efforts to guarantee the freedom of the press. The Ministry of Finance and Economy was merged with the Economic Planning Board. Many of these reforms served as a precursor to Korea joining the OECD and signing the Code on Liberalization of Capital Movements. Overall, the post-authoritarian governance structure saw a gradual return to various facets of the rule of law. Nevertheless, the failure to firmly establish rule by law at this critical juncture

12. Yoon 1995: 414.

13. Noland, Marcus. 2000. *Avoiding the Apocalypse: The Future of the Two Koreas*. Washington, D.C.: Institute for International Economics. p. 25.

contributed to the disastrous consequences of the financial crisis. While the role of the state declined, corresponding market-based disciplines in the forms of checks and balances were not established to fill the void.

An upsurge in populist democratic activity occurred as decades of pent-up popular demand was unleashed. This period immediately following authoritarian control witnessed a rapid increase of resorting to legal means to seek retribution, redemption and the reclaiming of legal rights that had been repressed. The outpouring of popular demand of basic rights was most apparent in the labor sector. In July and August of 1987, for example, right after the June 29 declaration for a new constitution and the democratic transition to power, Korea experienced more strikes than in the previous 25 years combined.¹⁴ The number of labor-management disputes surged from 276 in 1986 to 3,749 in 1987, 1,873 in 1988, 1,616 in 1989 and back to the hundreds in 1990. This outpouring of labor demands represents the most vivid example of Korea's transition from an authoritarian to a post-authoritarian society.

Most of the facts surrounding abuses carried out during President Chun's administration that involved himself, his family, and senior government officials came to light during the historic 1988 National Assembly Hearings, the first such legislative hearings in Korea's history.¹⁵ The Hearings focused on problems such as the government's involvement in the break-up of financially distressed companies such as the Kukje Group. In addition to the Kukje Group, the circumstances regarding 57 other companies determined to be in distress during the Fifth Republic underwent similar investigations.¹⁶ The investigations revealed that the beneficiary companies that acquired these distressed companies received considerable, preferential governmental incentives during the restructuring process. The Prosecutor Office's subsequent investigation regarding the corruption committed during this process supplied further evidence of the involvement of the senior government officials and even the Blue House. Companies such as Kukje that collapsed in 1985 were unable to seek any type of legal recourse until 1989, not only because of the legal restraints, but largely because these companies were unable to provide evidentiary facts.

Despite the onset of the post-authoritarian age and the gradual establishment of the rule of law, the financial and banking sector still remained subjected to

14. Noland 2000:36-37.

15. National Assembly Act, Article 65.

16. White Paper on Restructuring of Defunct Companies, July 21, 1988.

government intervention. The mix of a decentralized weakened state and awkward remnants of governmental control fueled corruption and distorted incentives. Companies would seek banks loans not based upon merit but by bribing government officials, family members of powerful politicians, and bank directors. Companies and bank directors did not act on behalf of their shareholders. This ultimately led to the spread of disastrous non-performing loans that crippled Korean banks and enfeebled conglomerates as they became dependent upon debt financing that was obtained through corruption. In an attempt to provide some independence, bank privatization was attempted in the mid-1990s. Furthermore, starting from 1988, interest rates also began to be deregulated and policy loans declined to 18 percent of bank credit by 1995. Despite these efforts, financial institutions “largely remained under effective governmental control.”¹⁷ The precipitous collapse of Korea’s leading banks proved how detrimental it would later become for the failure to guarantee the independence of board of director decisions.

In 1989, another classic example of disastrous market intervention occurred. To artificially revitalize the stock market, the government forced investment trust companies (ITC) to borrow money to buy listed equities. Later in May 1991, more than two trillion won in public money was used to compensate ITCs when these equity investments later failed.¹⁸ The burden of the interest payments from these losses would further haunt the ITCs. This type of government meddling in the investment decisions of ITCs against the interests of the ITC’s own shareholders would also prove near fatal to these financial firms during the financial crisis, largely as a result of defunct Daewoo corporate bonds.

At the same time, various chaebol reforms were attempted during this period. In 1987, monopolies that were granted Hyundai and Kia in the automobile markets were allowed to expire and both companies entered each other’s markets with Hyundai entering the light commercial vehicle market and Kia entering the passenger market.¹⁹ In 1986, new rules to limit cross investment and cross shareholding were introduced but were ineffective. On May 8, 1990, the government went on mission to force the chaebol to sell non-operating real estate that they had largely purchased through funds gained from favorable bank loans and to prevent them from acquiring more land. The government sought to pressure the

17. Graham 2003:59.

18. Graham 2003:77.

19. Samsung was subsequently allowed to enter the passenger car market in July 1992.

chaebol conglomerates to redirect their investments into their operating businesses for which they were given the financing in the first place and to prevent them from engaging in speculation in the real estate market. The top 30 chaebols also faced a ceiling on the equity investments and on the amount of mutual debt guarantees that they could make in other related firms.

On August 1, 1990, to stem the sale of equity by the dominant shareholders of major listed companies, the ownership cap that existed for individual investors was lifted. Individual investors were then allowed to purchase up to the amount of stock that the dominant shareholder held at the time the company was listed. On a different front, to promote small and medium companies, the restrictions that prevented them from issuing bonds were lifted in 1992.

Despite these attempts at reform, many problems remained unsolved. First, many chaebol conglomerates became adept at utilizing non-bank financial institutions, primarily through life insurance companies, liability insurance companies, investment trusts, and merchant banks for their financing. Most chaebols rapidly increased their borrowing from these largely unregulated and unprotected non-bank-financial intermediaries. By 1991, the portion of borrowing from these non-bank financial institutions reached 45 percent among the top 30 chaebol.²⁰ Second, market dominance in the form of monopolies and oligopolies persisted. In 1990, 135 markets were characterized by market dominance and almost 80 percent of these were associated with the chaebol. Third, over expansion prevailed as the number of top 30 chaebol subsidiaries grew from 557 in 1991 to 819 in 1997. Gross assets of these chaebol rose from KW 96.7 trillion in 1990, to KW 156.7 trillion in 1992, KW 199.5 trillion in 1994 and KW 348.4 trillion in 1997. Meanwhile, the debt to equity ratio of the top 30 chaebol remained around four-to-one for most of the period.

B. Hyundai Chairman Chung Juyoung for President

Perhaps, the most telling sign of the onset post-authoritarian Korea involved the run for the presidency in 1992 by Chung Juyoung, the legendary founder of the Hyundai Group. First, the most notable fact remains that Chung, a chaebol chairman, felt that the post-authoritarian environment was open enough for him to run for the presidency. This would have been unthinkable under any prior regimes. At one point, rumors had also surfaced that Kim Wochung the

20. Sakong, Il. 1993. *Korea in the World Economy*. Washington: Institute for International Economics.

founder of the now-defunct Daewoo Group also harbored thoughts of running as well. In the end, according to one commentator, Chung Juyoung's bid for the presidency in 1992 represented "a symbol of the increasing strength of the private sector."²¹ Second, in the process of the election, the ruling party and government once again utilized the vast network of means available to try to prevent Chung from improperly using Hyundai in his election campaign. Third, from the opposite perspective, the case also demonstrated the various ways that chaebol chairman were able to utilize public companies for their personal ambitions.

Starting from January 10, 1992, the same day that Chung established his new Reunification Peoples' Party (RPP), the National Tax Office announced that as a result of its recent tax audit on the Hyundai Group it was levying a charge of KW 136.1 billion.²² Following this tax audit, Chung Mong Hun, Chairman of Hyundai Merchant Marine and later Chung Juyoung's primary heir, was arrested for tax evasion and falsification of company documents.²³ On August 15, 1992, Chung Mong Hun was sentenced to 3 years with a 5-year stay of execution, fined KW 12 billion and forced to return KW 13.4 billion. Senior management of the Hyundai Group subsidiaries were then investigated throughout 1992 for holding Chung Juyoung's shares on his behalf to avoid taxes and the Chung family were later charged for securities violations for the manner in which these shares were secretly transferred.

Later, the Korea Listed Company Association's New Offering Adjustment Committee denied Hyundai Machine and Hyundai Lumber's applications to issue KW 48.9 billion and KW 19.8 billion in new equity respectively. On February 14, 1992, the Securities Supervisory Commission denied the Hyundai Group's similar request for new offerings and bond issuances. Several Hana Bank senior managers were called in for questioning for their decision to lend KW 30 billion to Hyundai Petrochemical in February. At the same time, the Minister of Finance and later Korea Exchange Bank (KEB), which served as Hyundai's primary transaction bank, pressured Hyundai to repay over KW 240 billion in loan advances. When Hyundai delayed, KEB denied all new loans to Hyundai until they finally repaid these advances in August 1992. The Labor

21. Yoon 1995:415.

22. The additional tax that the Hyundai Group would have to pay was later reduced by 5.2 billion won in an announcement made on January 16, 1992.

23. Chung Mong Hun would survive this investigation, but tragically would commit suicide in August 2003 in the midst of prosecutorial investigations for his involvement in sending tens of millions of dollars to North Korea through Hyundai and Asan.

Ministry investigated a number of former Hyundai Motors and Hyundai Heavy Industries personnel who now worked for the RPP's campaign to determine whether they had formally submitted their resignations and received their severance payments or were merely on leave and improperly working for the campaign in violation of election laws. A host of senior Hyundai officials and personnel were later arrested for these types of campaign law violations.

Chung ultimately claimed 16 percent of the popular vote in the presidential election and was, a distant but significant, third overall. In the aftermath of his candidacy, Chung and the Hyundai group faced even further legal troubles. Special facility fund loans that were approved by the Ministry of Trade and Industry were terminated after the election. Hyundai was also denied the issuance of depository receipts (DRs). Furthermore, prosecutors indicted and charged Chung and loyal Hyundai supporters for violating the Presidential Election Law and the Special Economic Crime Aggravated Punishment Law.²⁴

The Seoul District Court found them guilty and sentenced Chung to three years imprisonment for multiple violations, including the expropriation of KW 43.3 billion from Hyundai Heavy Industries that were used for his political campaign. The sentence was unusually heavy given that election violations normally receive a stay of execution of actual sentences. Given his age, 78, however, the District Court did not place him under court arrest for the entire duration of his appeal. On appeal, the Seoul High Court affirmed his three-year sentence, but he was granted a stay of execution of the sentence for four years due to his age and "his enormous contributions to the economic development of the country." On August 11, 1994, President Kim Young Sam granted him a full pardon.

Chung learned a powerful lesson that was widely viewed as an example to all chaebol conglomerates that sought to directly challenge the political system. Some commentators considered Chung's prosecution retribution for his political challenge, but a more benign perspective viewed these legal checks in the aftermath of the election as a means to curb over involvement in the political arena by the chaebol. From another viewpoint, a wide degree of sentiment held that the chaebol had overreached their ambitions by also daring to seek political dominance. To prevent further improper subsidization of subsidiaries, over expansion into new business industries, and to decentralize control, policy makers sought to lure chaebol groups into dispersing their ownership. In fact, the

24. Seoul District Court, Judgment of November 11, 1993; Seoul High Court, Judgment of July 11, 1994; Supreme Court, appeal withdrawn on August 9, 1994, 94 Do 2326.

critical mistake at this juncture was that this decrease in ownership was not combined with a corresponding increase in the means of supervision by such entities as stakeholders and shareholders.

4. The Financial Crisis and Recovery Reforms (1998-2002)

A. Corporate Origins of the Financial Crisis

In January 1997, the Hanbo Group filed for bankruptcy, making it the first major conglomerate to collapse since the Kukje Group in 1985. Following the collapse, it was not granted massive government aid and was not sold to political cronies. In other words, “[p]ossibly because of the scandal, Hanbo’s crisis was not resolved in what had become the typical Korean style.”²⁵ Thereafter, a string of corporate failures followed as a line of failing dominoes and sparked the spread of the Asian financial contagion to Korea. In March 1997, the Sammi Group, in April, the Jinro Group, in October, the Kia Group and Ssangban Wool Group and in November, the Newcore Group fell in succession. Half of the top thirty chaebols would ultimately collapse during the abrupt crisis. Korea First Bank (KFB), Cho Hung Bank, and Seoul Bank were nationalized in the process. These widespread failures in the corporate and banking sector were indicative of weak market discipline. Appropriate checks and balances did not exist to maintain effective management of companies and banks in the post-authoritarian era.

As financial contagion spread throughout Asia, rollover rates, primarily of short-term loans, fell from 80 percent in October 1997 to 30 percent in December in a matter of two months.²⁶ At the time, two-thirds of Korea’s \$109 billion in foreign liabilities were in short term debt.²⁷ Net private lending went from \$100 billion in the first three quarters of 1997 to minus \$20 billion in last the quarter of 1997.²⁸ The top five chaebol accounted for 50 percent of corporate debt and 70 percent of external corporate debt. Coupled with the pummeling currency speculation against the Korean won and the central banks vain efforts

25. Graham 2003:102.

26. Jwa Sung-hee and Huh Chan-guk, 1998. *Risk and Returns of Financial-Industrial Interactions: The Korean Experience*. KERI Working Paper 9801. Seoul: Korea Economic Research Institute.

27. Noland 2000:196-197.

28. Adelman, Irma and Song Byung-rak, ed. 1999. *Visible and Invisible Hand: The Economic Development of Korea*. forthcoming

to prevent its collapse, Korea's currency reserves bottomed out. Eventually, on December 1997, Korea was humiliatingly forced to sign a \$55 billion rescue package with the IMF.²⁹

The Hanbo Group that precipitated the crisis in Korea was founded by Chung Tae Soo and at one time ranked as the 14th largest chaebol conglomerate in Korea. Hanbo's ambitious attempts to build a grand new steel factory in Dangjin played a fatal role in its downfall. From September 1996 to January 1997 alone, Hanbo was forced to receive over KW 500 billion from four leading commercial banks to prevent bankruptcy. Overall, from 1993 to 1996, Hanbo's primary-transaction bank, KFB had lent over KW 1.8 trillion to Hanbo Iron & Steel. Already by June 1996, Hanbo's total liabilities equaled KW 4.3 trillion and its debt-to-equity ratio stood at an astonishing 1,900 percent.

Several senior national assemblymen, the president and several directors of KFB, and Chung and several of his family members were all indicted in February 1997 as a result of the fiasco. President Kim Young Sam's own son was also subsequently sentenced for receiving bribes from Chung. Chung himself received a 15-year sentence for embezzlement, violation of the Special Economic Crimes Law, and fraud that the Supreme Court upheld on appeal in December 1997 just as the country was suffering from the depths of the financial crisis.³⁰ Chung allegedly bribed across the political spectrum and banking sector in order to continually finance his empire. As of August 2003, some six years later, Chung still remains imprisoned, unlike almost all of the other figures that were similarly jailed, despite being in his late 70s and apparently in ill health. Sacked with over KW 1 trillion in bad debts from Hanbo, KFB eventually had to be nationalized, and later became the first commercial bank taken over

29. The Economic Advisor to the President, Kim Inho, and the Minister of Finance and Economy, Kang Kyungsik, at the time, were subsequently prosecuted and tried for their dereliction of duty surrounding their handling of various events leading up to the crisis. Both the lower court and appeals court found they were both not guilty. Although, Kang was found to have abused his official position in pressuring banks to support the Jindo Group. Seoul District Court, Judgment of August 20, 1999, 98 Kohap 504; Seoul High Court, Judgment of October 17, 2002, 99 No 2359.
30. Supreme Court, Judgment of December 26, 1997, 97 Do 2609. In April 1998, 18 months were added to Chung's sentence. Seoul District Court, Judgment of Apr. 20, 1998. In 1990, when Chung was found guilty for another enormous scandal, he was granted a suspended sentence based upon his contributions to economic development. He was also arrested in 1995 following the slush fund trials involving President Roh Taewoo.
31. Supreme Court, Judgment of March 24, 2002.

by foreign interests in Korea. In the end, KFB's directors became liable for the first shareholder derivative action in Korea for accepting bribes and illegally granting bad loans.³¹ Hanbo and KFB's stunning failures shattered confidence in Korean corporations and showed how important rule of law in the corporate sector could be. As with Kukje and Hyundai before, Hanbo and KFB boards proved ineffective in preventing the reckless borrowing, irresponsible lending, and accounting fraud that plagued them.

B. Reforms in the Aftermath of the Crisis

One of the many outgrowths of the crisis was a widespread need to implement reform. Many considered that the government had lost control of the economy and had failed to curb the excesses of the chaebol, leaving Korea vulnerable to the contagion. An awkward method to promote industrial specialization and concentration involved the so-called, "bid deals," which entailed conglomerates swapping competing subsidiaries in different industries with each other. For instance, LG Group sold its semiconductor business to Hyundai, and Samsung attempted to sell its automobile business to Daewoo. When these big deal negotiations failed to produce the desired transactions by the summer of 1998, the government "stepped up the pressure for the deals to go forward."³² Furthermore, the entire banking, financial, and corporate sectors were overhauled. For the first time, significant market-based reforms such as strong investor rights, open market for corporate control, open access for total foreign ownership, stricter accounting standards, tougher disclosure requirements, and effective bankruptcy procedures were all established.

5. Conclusion: Awkward Transition to the Market Economy

In the post authoritarian era, Korea has undergone widespread legal change. The moral hazard of "too-big-to-fail" no longer seems to hold true. Companies have become more transparent and accountable. Nevertheless, according to Noland, "progress in policy reform has been the greatest where the international involvement has been the highest."³³ Overall, in showing how Korea's economy was affected as a result of the onset of democracy, this paper suggests that Korea

32. Graham 2003:123.

33. Noland 2000:354.

failed to learn from its mistakes in its post-authoritarian transition toward a market-oriented economy. It described the legal changes that the country experienced by focusing on the fates of the Kukje Group, Hyundai Group, and Hanbo Group conglomerates.

The most significant legacy of post-authoritarian legal reforms is the importance of minimizing direct state intervention in the economic realm while at the same time providing effective market-based checks and balances. Government action must be based upon the rule of law and due process. Market-oriented discipline must exist so that corporations cannot operate as vehicles for malfeasance, corruption or expropriation. The lax excesses that followed the post-authoritarian rule where neither effective state nor market control could be found, for instance, contributed to the catastrophic collapse that occurred during the 1997 financial crisis. The pillars of an efficient and disciplined market-based economy therefore must be in place for Korea to avoid similar disasters in the future.

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