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Can the State Protect Minority Investors From Tyranny of the Family Shareholders? (A Corporate Governance Comparison Between Indonesia and Korea)

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Abstract: In the aftermath of the 1997 Asian Financial Crisis that hit both Indonesia and Korea, both countries' government saw the needs for revisiting and revitalizing its corporate governance. This case is particularly important given the dominance of family shareholders, both in the form of conglomerates in Indonesia and Chaebol in Korea. This paper aims to analyze the historical trajectory of the corporate governance framework development in both Indonesia and Korea. Based on that research objective, this study finds that despite the fact that both countries were developing the standard according to the latest global norms at the time, the presence of specific business situations and cases in each country forced each country to tailor their corporate governance framework accordingly. These divergent trajectories thus created corporate governance frameworks that are unique for both Indonesia and Korea.

Keyword: path dependence, corporate governance, 1997 Asian Financial Crisis.

INTRODUCTION

In 1998, Indonesia and Korea got hit by the 1997 Asian Financial Crisis. The crisis brought economic devastation to both countries, bringing down GDP by 13.1% and 5.1% respectively (World Bank, 2022). During that crisis, the public expressed their dissatisfaction with the existing institutions, deemed too weak to discipline and govern the conglomerates and their business. The bitterness of the crisis became the driving force behind the upcoming institutional reforms enacted by the government aimed specifically to regulate the conglomerates through improved accountability and transparency (Shin, 2003; Prianto, 2011; Lim, 2012; Min, 2016).

One of the parties most impacted by the crisis was the minority shareholders in various listed companies. With the loss of between 50-55% for Korea Composite Stock Price Index (KOSPI) and Indonesia Composite Stock Price Index (*Index Harga Saham Gabungan*, IHSG), minority shareholders were the most impacted, while family ownership with higher control rights and lower

cash flow rights were better protected from the crisis (Baek et al, 2004). In this instance, family ownership retained its control rights while facing less severe cash flow right impact due to the pyramidal structure of their ownership (Almeida et al, 2011). To address this market failure, the State has to intervene through strings of regulatory and institutional reforms which were performed between 1998-2004 in form of strengthening corporate governance regulations (Scott, 1998; Choe, 2003; Ahmadjian and Song, 2004).

The State needs to intervene when the market fails to meet its objective in allocating resources and restore the efficiency of the market (Wallis and Dollery, 1999). As an institution with its own consciousness and interest (Skocpol, 1984), the State will influence relationships between actors within civil society (Heclo, 1974). Since the State possess all the capacity to influence and enforce its interest upon these actors through administrative, legal, bureaucratic, and coercive systems (Stepan, 1979), the State, as an actor itself, has the responsibility to diagnose societal problems and frame the necessary policies to deal with the problems (Skocpol, 1984). Thus, in the case of expropriation of minority shareholders by family ownership during the 1997 Asian Financial Crisis, the State managed to diagnose corporate governance as the problem and took necessary steps to reform the related institutions.

Korea and Indonesia took different approach in strengthening the corporate governance aspect post-1997 Crisis. While Korea reformed its existing institutions by strengthening the existing Commercial Code and Securities and Exchange Act, Indonesia reformed its institutions by strengthening the Capital Market Supervisory Body (*Badan Pengawas Pasar Modal dan Lembaga Keuangan*, Bapepam-LK) which later evolved into Financial Service Authority (*Otoritas Jasa Keuangan*, OJK).

This paper aims to study and understand the political economic process behind corporate governance reforms initiated after 1997 Asian Financial Crisis and to see whether the State, through its autonomy and intervention has been able to adequately protect minority investors against the expropriation and tyranny of family ownership. By understanding the process, it is hoped that this paper can shed light on how political institutions strengthen and modify the relationship between market actors. The paper will be presented in five separate sections. Section 2 will contain research framework, including the theoretical analysis and variable identification. Then on Section 3 and Section 4, this paper will explore and compare how Korea and Indonesia conducted their reforms on corporate governance and the political process behind the institutional reforms. Finally, Section 5 will provide the concluding statements, explain the limitations behind this research, and provide future possibility for the research in the similar field.

Research Framework

Theoretical Review

Family Ownership and Minority Shareholder Expropriation

Firms are seen as nexus of contracts between individuals (Jensen and Meckling, 1976). In this nexus, principals engage agents to perform services on their behalf to maximize the wealth of the principals. However, as utility maximizers, agents do not always act in the best interest of principals (agency problem). To reduce the agency problem, principals incur monitoring cost to check the agent, while agents incur bonding cost to ensure favor from their principal, and the divergence result in residual loss (agency cost).

Firms evolve into conglomerates by expanding their business into multiple lines of business and diversifying their activities (Christiningrum, 2015). However, as firms grow larger, agency costs increase, which reduces the firm value (Berger and Ofek, 1995). To minimize the agency cost,

principals close the distance between principals and agents by concentrated ownership, particularly family ownership (Claessens et al, 1999).

The reduction of agency costs through family ownership creates a difference between control rights and cash flow rights. While minority shareholders hold more cash flow rights, they experience decision-making expropriation since family owners retain their control rights (La Porta et al, 1999). This is evident in the 1997 Asian Financial Crisis where minority shareholders experience more cash flow losses through share price fall than family owners who keeps their position through control rights (Scott, 1998; Choe, 2003; Ahmadjian and Song, 2004).

State Autonomy and Corporate Governance Reform

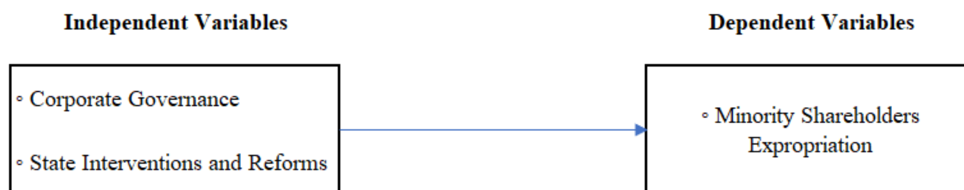
The discrepancy between control rights and cash flow rights experienced by family-owned listed companies signifies the failure of the market in allocating resources appropriately (Wallis and Dollery, 1999). To fix the market and restore its efficiency, the State should intervene. However, the question became on whose behalf will the State intervene. Neo-Marxist argued that the State is merely an agent of the capitalist class (Solo, 1978). In this view, the State will arguably intervene on the behalf of the family owners, which are also thought to form an oligarchy with a single consciousness and influence the decision of the State (Winters, 2013).

However, these theories are challenged by pluralists, who see the State as an autonomous agent, which have its own consciousness and interest (Skocpol, 1985). State Autonomy theory view that the State will formulate their own goals, which might not be reflective of the demands and interests of any social groups, classes, or society. In many opportunities, the State has been known to observe the problems that occur in the civil group and formulate solutions to solve the problems (Heclo, 1974).

Since the end of the 1997 Asian Financial Crisis, the State of both Korea and Indonesia saw that reforms in corporate governance are fundamental to better protect minority shareholders from expropriation. However, such reforms are not seen as preferable by family-owned controlling interest in the capital market, who maintained their control rights, Thus, reforms in corporate governance were initiated by Korean government (Ahmadjian and Song, 2004) as well as Indonesian government (Setyahadi and Narsa, 2020).

Conceptual Framework and Hypothesis Development

Conceptual Framework



Hypothesis Development

While articles argued that Corporate Governance has not yet succeeded in reducing expropriation of minority shareholders by controlling interest, State intervention in the form of legal requirements have shed more hope in protecting the minority shareholders. However, there is also still room for improvements in legal mechanisms to better protect the minority shareholders.

Cho et al (2022) had listed several legal mechanisms which the State enforces to protect minority shareholders, such as the rights to inspect firms accounting books, propose a shareholder

meeting and propose meeting agendas, and request an injunction against a director's unlawful conduct. Legal complications in several takeover attempts in Korea also helped the State to better strengthen its legal frameworks to ensure the prevalence of Rule of Law in protecting minority shareholders against expropriation by controlling interest (Kim and Kim, 2009). In Indonesia, Law No. 40 of 2007 on Limited Liability Company has managed to serve as a guideline on minority shareholders protection (Sridana et al, 2020). Indonesian government further enhance this protection through various Bapepam regulations specifically aimed to protect minority shareholders of listed companies.

Several articles have also argued that reforms in corporate governance, which were initiated by the State, have been able to reduce and moderate the degree of minority shareholders expropriation by controlling interest. However, most research agrees that the prevailing reforms in corporate governance have not yet adequately able to protect minority shareholders. This phenomenon is applicable for both Indonesia and Korea.

In Korea, Kim and Kim (2008) found that the corporate governance reforms initiated by the Korean government, including mandating 50% independent director in publicly listed companies' board, managed to improve the protection of minority shareholders. Meanwhile, in Indonesia, research found that corporate governance practices which included independent commissioners, managed to reduce minority shareholders expropriation (Rahayu, 2018).

However, other research finds that the prevailing corporate governance practices have not yet been able to adequately protect minority shareholders against expropriation by controlling shareholders. The lack of detailed practices guideline that assure fairness in the lack of guidelines on affiliated mergers in Korea shows conflict between minority shareholders and controlling interest (Park et al, 2018). This is in line with the findings by Kim et al (2021) which also expressed that minority shareholders are not yet protected by the prevailing corporate governance practices in Korea. This is inline with findings in Indonesia which stated that many corporate governance practices still fail to protect minority shareholders' interest (Rahayu. 2018).

Based on the discussion above, this research hypothesizes that:

H2: Corporate Governance and State Interventions and Reforms have adequately protected minority interest in Korea and Indonesia.

METHOD

This paper will study and prove both hypothesis through normative research method which analyzes various governance and legal-related articles while also providing real-life examples to understand how each independent variables interact with dependent variables. In the meantime, this research will also analyze any difference and similarities between Korean and Indonesian guidelines for minority shareholders protection through studying prevailing corporate governance practices and legal frameworks as well as cases on expropriation. This paper will also analyze the political negotiation process between the states and business, particularly in the legal framework.

RESULT AND DISCUSSION

State Interventions and Reforms and Minority Shareholders Protection in Korea and Indonesia

Since the end of 1997 Asian Financial Crisis, both Korean and Indonesian government believe that they need to reform the commercial and corporate regulations to enhance corporate governance atmosphere and to better protect the minority investors from expropriation by controlling interest. This sentiment was also shared by IMF and World Bank which stated that the crisis in Korea was

caused by malfunctions in corporate governance. However, while Korea managed to reform right away, Indonesia did not kick of its full institutional reform until 2004 when National Committee for Governance Policy (*Komite Nasional Kebijakan Governance*, KNKG) was formed.

Korea Road to Reforms

Before the 1997 Asian Financial Crisis, *chaebol*-dominated Korean firms have been competing internationally and face elevated international pressure. These pressures motivated Korean firms to diversify using debt as their financial engine, which exposed the firms to additional risks and left them prone to external shocks (Ahmadjian and Song, 2004). While diversification allows the *chaebol* to grow and expand in size, their reckless use of leverage cost them to lose firm values, profitability, and most importantly, shareholder values. This race to increase firm size was motivated by *chaebol's* desire to add further political influence as well as reducing borrowing cost through "too big to fail" mentality (Heo et al, 2008).

This vicious cycle of business expansion at the cost of profitability and shareholder values was worsened by the widening gap between control rights and cash flow rights, a landmark of minority shareholders expropriation (Moskalev and Park, 2010). It all exploded in 1997, when Korea experienced a massive capital outflow, amounting to US$ 8.7 billion due to rampant value destruction of the companies by (Kim, 1998). Through 1992-1996, only 27% of Korean listed companies actually create value to their shareholders; the rest did not generate enough operating earnings to cover their capital cost (Kim et al, 1998).

In 1998, Kim Dae-jung was elected as the 8th President of Korea. Right after his election, President Kim's first move was to enact a sweeping reform to discipline the *chaebol* in order to restore investor confidence (KoreaTimes, 1998). One of the monumental acts that President Kim made was to invite the Top 5 *Chaebol* in 1998 and agreed on the drastic measures to reform the business, including holding *chaebol* leaders more accountable to corporate performances, boost managerial transparency, improve financial health, re-focus on core business, and eliminate loan guarantees between affiliates (Yanagimachi, 2004). This act became the first out of several reform programs initiated by the States, which were followed up by the founding of Financial Supervisory Commission in 1998 as well as enactment of several laws, including Outside Auditor Act (which mandated listed companies to adopt consolidated financial statements).

In a political sense, the enactment of all these new rules hindered the capability of the capitalist class (*chaebol*) to accumulate further wealth. This failed to fit the Marxists' notion that viewed the State as an agent of the capitalist class. Rather, in this case, President Kim directed the country as an autonomous actor, with its own interest and goal. To achieve the interest and goal of the State, which is the maintenance of the capitalist system, President Kim did not hesitate to act against the behalf of the capitalist class, fulfilling the definition of Bonapartist State, which emphasized state relative autonomy (Skocpol, 1985; Poulantzas, 1973; Gulalp, 1987).

These politico-economy moves executed by President Kim through state intervention of the market managed to improve investors confidence, which was shown by the amount of foreign investment which surpassed the total cumulative amount of investment of the last 40 years. This increase in foreign investment also signified that the market is confident that, as minority shareholders, they would be protected against expropriation by controlling shares; thus, making the existing legal framework perceived adequate. However, the legal and institutional reforms enacted by President Kim were not enough to significantly reduce the discrepancies between control rights and cash flow rights, thus, still not enough to fully protect minority shareholders from controlling

interest. Based on the analysis above, it can be concluded that legal frameworks in Korea are perceived to be adequate enough to protect minority shareholders' rights.

Indonesian Reform Process

While Korea enjoyed a massive peaceful reform in 1998, Indonesia experienced the otherwise. Before 1998, Indonesia was entangled in a crony capitalism spearheaded by Soeharto and its cronies. In the system of crony capitalism, Soeharto picked and awarded influential people lucrative business concessions as the starting point in kickstarting Indonesian capitalism and nurturing Indonesian capitalist class. Thus, capitalism in Indonesia born not out of business practices, but instead came from a collusion between political and business class. In this sense, Indonesian capitalists also experience a similar phenomenon as Korean *chaebols*, where their diversification attempt was mostly funded by non-hedged bank loans (Tarmidi, 1999).

Reckless investment using non-hedged bank loans as well as foreign exchange fluctuations, contracted from Thailand, forced Indonesian Central Bank to abandon managed floating policy and adopt free floating policy. In less than 10 years prior to the crisis, the private sector had borrowed US$ 80 billion, unhedged, and unsecured. Meanwhile, the annual export stood only on US$ 55 billion and debt-service payment was only on 30% level (Sadli, 2008). The recklessness did not explode until 1998 monetary crisis forced business, small and large, to close in order to repay for its debt, causing further economic crisis. This economic crisis was followed by political crisis and general uprising as Soeharto resigned from his 32-years tenure as a president on May 21, 1998. During this crisis, which includes a fall of 53.18% of share prices as indicated on IHSG, minority shareholders lost virtually all its value, while controlling ownership remains survive through minimal cash flow rights, and some of the family-owner still retain its position up until this very day (Dick and Mulholland, 2018).

Following the economic turmoil of 1998, Indonesian government intervened by founding the National Committee on Corporate Governance Policy (*Komite Nasional Kebijakan Corporate Governance*, KNKCG) in 1999, with the aim of revisiting corporate governance policy in Indonesia. Furthermore, Indonesia also employed some of the recommendations by International Monetary Fund (IMF) which include deregulation and building several new institutions including regional autonomy and Bapepam-LK (later evolved into Otoritas Jasa Keuangan). However, the political situation of Indonesia did not finish its consolidation until 2004 when Susilo Bambang Yudhoyono (SBY) was elected the President of Indonesia. Between 1998 and 2004, Indonesia still experienced political consolidation, adapting to the new reformation climate post-1997 (Ziegenhain, 2008). Indonesia did not conduct any massive legal reform until the issuance of Law No. 40 of 2007 on Limited Liability Company.

Since the emergence of Law No. 40 of 2007 and various regulations issued by Bapepam-LK (which is binding for all publicly listed companies) has managed to improve minority shareholders' protection from expropriation cases. The absence of any strongman figure which drive reforms also suggested that the State in itself has a general consciousness to intervene the market and enforce its interest and goal in order to improve its efficiency while maintain social stability and the rule of law. Furthermore, the return of foreign direct investment to Indonesia also signifies that investor confidence on minority shareholders protection has also been deemed as adequate. Thus, it can be concluded that legal frameworks in Indonesia are perceived to be adequate enough to protect minority shareholders' rights.

Korea-Indonesia comparison

State intervention in the aftermath of the crisis is fundamental in restoring investor confidence and attracting back investment to the State. While Korean and Indonesian companies have different ownership structures, both countries experienced similar minority shareholders expropriation problem by the controlling interest. State's intervention through the foundations of new institutions, reformation of existing institutions, as well as enactment of new regulations, all played significant role in restoring investors' confidence as well as providing protection for minority shareholders against the tyranny of the controlling interest. From the explanation above, we can conclude that both Indonesian and Korean States' legal frameworks and institutions, although not completely, has been deemed adequate to protect minority rights shareholders.

CONCLUSION

Indonesia and Korea had experienced bitter consequences of inadequate corporate governance and inadequate minority rights protection against the *chaebol* and the cronies in 1997. Ever since, amending and reforming the institutions of governance through a strong state involvement is deemed essential. In 1998, President Kim with his newly gained status as the President of Korea managed to bring upon sweeping wind of changes to improve governance within the *chaebol* firms and restoring investors confidence. The sweeping change managed to be enacted largely due to the consolidated democracy that has existed in Korea. Indonesia followed the same route of institutional changes and reforms, however, without the presence of a strong man leading the changes, Indonesia relied on State relative autonomy to act as a single actor, performing the changes necessary to improve its economic situation. It was only after Indonesian democratic consolidation was completed in 2004 with the rise of President SBY that Indonesia managed to enact a groundbreaking Law No. 40 of 2007 on Limited Liability Companies as the general guideline for the protection of minority shareholders against tyranny of the controlling interest.

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