

Theoretical Perspectives of Managerial Power and CEO Compensation in Korean Chaebol

Ji-Young Ahn

Assistant Professor, Ewha Woman's University, Ewha School of Business, Seoul, Korea

*Corresponding Author

Ji-Young Ahn

Email: ji-ahn@ewha.ac.kr

Abstract: This paper survey on related literature on how top management pay is influenced by poor quality of governance structure (controlling shareholder managerialism) and derives various testable implications by examining top manager's cash compensation – salary and bonus- in Korean Chaebol. Moreover, this paper is aiming at explaining , compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation.

Keywords: CEO Compensation, Chaebol, Corporate Governance.

INTRODUCTION

Executive compensation, in particular, the level of compensation and the extent of pay-for-performance for CEOs has been a topic of controversy in the academic and business areas [1]. The most researched topic in this literature is the relationship between executive compensation and firm performance from agency framework [2]. Under the agency theory, managerial compensation contract is designed to minimize the agent costs by aligning their compensation with the firm performance.

However, the empirical studies in the 1990s have generally found weak pay-performance relationships, suggesting there is a lot of variation in CEO compensation practices unexplained by agency framework [3]. Some organization scientists introduced the notion of managerial power determined by corporate governance constituencies such as board's monitoring and ownership mechanism as alternative theory for explaining managerial contract. For example, Barkema and Gomez-Mejia [2] pointed that an important reason for weak pay-performance results is that previous research has typically ignored a firm's governance structure (e.g. ownership conditions, board of directors, and the market for corporate control) and other contingencies for executive pay (e.g. firm strategy, industry structure). Most literature suggests that the board does not independently structure the CEO's compensation package to maximize value for firm's shareholders because the CEO substantially influences the board of directors.

The term "corporate governance" refers to the distribution of corporate control rights over stakeholders including shareholders, board members, and managers [4]. The corporate governance structure is a mechanism designed to reduce the conflict of interests between investors and the management thereby eliminating barriers that may hinder the growth of the value of the firm [4]. Previous research generally concerns with a particular mechanism alone, say, the effect of *ownership structure* on compensation strategy or the relationship between board composition and compensation practices [1,5]. This paper extends the existing literature by integrating various components of corporate governance. I investigate the relationships between each governance constituency and the level of compensation.

The present study focuses on these issues in chaebol firms in Korea. The reason I focus on Korean chaebol case is the following. First, the governance structure of Korean chaebol is quite different from that of U.S. corporations. According to Hwang and Seo [6], they characterized the governance structure of chaebol as controlling shareholder or family-controlled managerialism to differentiate it from U.S. shareholder capitalism [6]. Under the controlling shareholder managerialism, a founder or controlling family participates in the management of all the affiliates, and there is usually no effective management disciplining mechanisms in place while management is constrained to maximize the shareholder values under the shareholder managerialism in U.S. [6]. Moreover, controlling shareholder maintain full control over whole business group through pyramid control.

It is often thought that ownership wields power, particularly, if owners are also managers in their firms [7]. However, controlling shareholder (CEO)'s control rights exceed their ownership right built on pyramid control over whole business group. It is expected these managers to be extremely powerful than managers in other firms and use the power to serve their personal goals such as augmenting their pay [7].

In addition, compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation [8]. As a result, executives can receive pay in excess of the level would be optimal for shareholders. This paper survey on related literature on how top management pay is influenced by poor quality of governance structure (controlling shareholder managerialism) and derives various testable implications by examining top manager's cash compensation – salary and bonus- in Korean Chaebol.

Few studies have analyzed the power of top managers in family-owned firms owned by the manager or family [7] in the literature. It is expected that these managers to be more powerful than managers in other firms and more successful in expropriate firm resources since the power of having a position in the firm might be magnified by the power derived from employing family control as well as being a shareholder (owner) [7]. Contrary to prediction, Allen [9] found that the direct pay (salary, bonus, and deferred compensation) of CEOs was lower in family-owned firms in US [9]. It explained that in US, most of the family controlled firms are restricted to usually small-sized firms such as restaurant, it might be difficult to generalize the results in public large corporation setting. Allen also found that family control is not only rooted in equity holdings but also in different forms of power sources such as firm's history and CEO's authority that derived from the nature of small firm itself [9]. However, the Korean chaebols are not constrained by a specific industry and size (usually large). In that sense, this study is meaningful in that it may fill the gap by utilizing data with industry variations by investigating family-controlled or controlling shareholder firms like chaebol.

THEORETICAL BACKGROUND AND PROPOSITIONS

Managerial Power Theory

The dominant approach to the study of executive compensation among academics has for been “the optimal contracting theory” or “equilibrium wage” [10]. Under this approach, executive compensation practices in large, publicly traded companies are viewed

as designed to minimize the agency costs that exist between senior executives (the agents) and shareholders (the principals) [11,12]. The board is viewed as seeking to maximize shareholder value, with the compensation scheme being designed to serve this objective [8]. Financial economists have largely worked within this model in attempting to explain the various features of executive compensation arrangements as well as the cross-sectional variation in compensation practices among firms [8].

However, following Berle and Means [13] who argued that the distribution of ownership has important implications for the efficiency and strategic development of firms [13], the managerial and socio-political scientist introduced the notion of “managerial power” or “managerial discretion”, implying that boards do not operate at arm's length in devising executive compensation arrangement; rather, executive have power to influence their own pay, and they use that power to extract rents [14]. In other words, the excess pay that executives are able to extract because of their positional power. Top executives generally have a least some power and therefore can extract at least some excess compensation, but the particular characteristics of a firm, especially its ownership and board structure that are components of firm's internal governance, give its executives more or less power [14]. Under managerial power perspective, the greater the CEO's power, the higher the rents will tend to be.

It is worthy in noting that some writers in agency theory have recognized that power is a relevant factor regarding top management pay [7]. Jensen and Murphy [3] explicitly referred to power, within and outside corporations, as a determinant of CEO pay [11]. For example, they argued that the public outcry over large bonuses and other financial rewards for CEOs has prevented efficient contract that would ensure strong pay-performance relationships. Milgrom and Roberts [15] suggested that executives make all kinds of efforts to influence their pay, which in fact, might weaken the actual impact of corporate performance [15]. However, within agency literature, they have not examined thoroughly issues of politics and power. There is, however, an extensive body of organizational literature that has begun to explore these issues. I will discuss in details in later section.

Controlling Shareholder –Korean Chaebol Governance

Built on literature on Korean corporate governance, Korean economy can be characterized by the prevalence of business group (Chaebols) that consist of legally independent, horizontally and vertically distributed firms. The largest shareholder, usually the founder, typically control and manage a Korean firm

[6]. In over 80% of large firms, usually Chaebol, the largest shareholders or family members are among top executives [4]. Note that the share of controlling family has steadily decreased in 1990s while the total number of a chaebol's affiliates has persistently increased. This implies that controlling shareholder maintain full control over the whole business group despite such a small share. One may reasonably ask what is the basis of this ownership structure that supports the sustenance of such a governance structure.

Many scholars have claimed that the main feature of chaebol ownership structure is the cross-shareholding among subsidiaries. In addition, the concept of the pyramid control may help us understand the connection between chaebol's ownership and internal control systems. Core et al. [10] argues "a pyramid ownership structure, a wealthy family controls assets worth vastly more than its investment by holding controlling interests in companies which hold controlling interests in other companies, and which in turn hold controlling interests in still more companies" [10]. In Korean Chaebol, the controlling families make use of control pyramid to expand the number of affiliates with only small amounts of their own capital. It should be also noted that Japanese business groups, largely dependent on the cross-shareholding, have horizontal cooperative structures while the chaebol has an authoritative and hierarchical structure. It suggests that controlling shareholders retain power beyond their ownership rights. Core et al. [10] criticized the pyramid control structure may exacerbate agency problem through management entrenchment [10]. We can conclude that Korean chaebol has much weaker corporate control mechanism than their counterparts in US firm.

Chaebol Ownership Structure, Managerial Power, and Pay

From the managerial power approach, the power of the CEO will depend in who owns the firm – ownership structure of the firm [14]. In other words, the power of top managers may vary with firm's ownership structure, which in turn may affect top management pay [7]. Prior research argued "ownership represents a source of power that can be used either to support or oppose management, depending on how it is concentrated and used [16]. In general, the more concentrated ownership is the more potent potential support or opposition. Prior research classified firms as (1) owner-managed, those for which ownership was concentrated among its executives; (2) management-controlled, for which ownership was divided among many shareholders; (3) externally controlled, for which ownership was concentrated among a few individuals who did not manage the firm [15]. Executives in

externally controlled firms were expected to have little influence on their pay.

Consistent with predictions, some scholars found that the cash pay (salary and bonus) of these managers was more strongly tied to their firms' profit and market value than for managers in the other two types of firms. The later studies confirmed this result that pay-performance relationships for managers in externally controlled firms were stronger than in management-controlled firms [1,5]. Therefore, it concluded that agency theory might be valid in externally controlled firms, but that managerialist theory is more appropriate in explaining in management-controlled firm under weak governance.

In contrast to the management literature, in financial economics there have been relatively few studies of the relation between ownership structure and the level of CEO compensation. Previous literature provides evidence that managers who are majority shareholders (defined as individuals owning at least half but not all of the common stock) in publicly held corporations receive marginally higher salaries than other officers [1,10]. However, Allen finds that the level of CEO compensation is a decreasing function of the equity held by the CEO (and his family), as well as the extent of equity holdings by board members not related to the CEO. Some presented that CEO compensation is lower when the CEO's ownership is higher and when there is an internal member on the board other than the CEO who owns at least 5 % of the shares [8,10]. Finally, using a sample of Canadian companies (30% of which have multiple classes of voting stock). Core [10] finds that CEO compensation is increasing in insider control of share votes and decreasing in insider ownership of share value [10].

Taken together, without an appropriate monitoring or governance mechanism, managers are more likely to be encouraged to build a corporate empire and therefore, Korean chaebol places the controlling shareholder's interest as utmost priority.¹ Prior research presented evidence that when controlling shareholders' control rights exceed their ownership

¹ However, there is argument that pyramid control may have some beneficial effects depending upon the stage of economic development. At the early stages of economic development characterized by a lack of entrepreneurship and investment capital, pyramid control can contribute to the diffusion of entrepreneurship and the expansion of industrial foundation. The pyramid ownership structure, by protecting the management from the threat of hostile takeovers, also allows them to implement long-term strategies. But this issue is beyond of the scope of this research.

rights, they have an incentive to expropriate firm resources, as their private benefits exceed their costs [6]. These controlling shareholders therefore have greater incentives and means to expropriate firm resources than their counterparts in independent firms since the locus of control corporate control in these firms is the CEO. Thus, CEO compensation is based on CEO preferences, leading to higher CEO pay. This idea gives rise to my first proposition.

Proposition 1: CEO cash compensation (salary plus bonus) is more likely to be higher in firms managed by controlling-shareholders than their counterparts in independent firms.

As discussed above, despite controlling shareholder's low ownership, they maintain control for at least two feasible reasons. First, ownership among individual shareholders is dispersed. If shareholders are dispersed, they do not usually take active interest in the firm. Thus, it is possible, indeed straightforward, for management to extract excess compensation for their personal interests. This is because dispersed shareholders, with small interests in the firm, are unlikely to incur the large monitoring costs that are sometimes required to keep management at bay. They are more likely to make management their proxy, or to abstain [17].

Moreover, it argued that firms may not be able to build credible reputations for treating shareholders well if dispersed shareholders do not take an active interest in the firm and if important decisions such as mergers or replacements of CEOs are infrequent [17]. Indeed, large firms in Korea often have more dispersed ownership than those in most other East Asian countries [10]. This reported that in 1997, the aggregate individual ownership was about 40% of shares [6]. More than 95% of all shareholders were small individual shareholders less than 1% of total shares. These small shareholders could not easily oppose the controlling shareholder, and therefore, CEO has more discretion over setting his/her pay. Hence, this leads to the following proposition.

Proposition 2: CEO cash compensation (salary plus bonus) is more likely to be higher in firms managed by controlling-shareholders with more dispersed individual shareholders than in firms managed by controlling-shareholders with less dispersed individual shareholders.

Another possibility that controlling shareholder maintain his or her control is that there is no strong large shareholder (blockholders) to monitor firm activity. Blockholders have an interest in monitoring management and the power to implement

management contract changes. Although this role for blockholders is less common in the U.S. and U.K.- because of regulatory restrictions on blockholder actions – some form of concentration of ownership or control is the dominant form of corporate governance arrangement in continental Europe and other OECD countries including Korea. Under a fully dispersed ownership structure, optimal monitoring incentives require concentrated ownership [18]. In Korea, most non-financial firms ownership consisted of cross-holding or interlocking ownership of affiliated firms within chaebol. However, the more shares owned by strong or concentrated unrelated parties, i.e., blockholders, the less will be the CEO's influence on decision-making in firm's activity including extracting excess pay. Thus, the power of the CEO tends to decrease with the percentage of shares owned by outside blockholders. I replicate chaebol data based on Hambrick and Finkelstein's following proposition.

Proposition 3: CEO cash compensation (salary plus bonus) and equity holdings of the blockholders are negatively related.

CONCLUSIONS

The main purpose of this paper is to examine how the power of top managers in family-owned firms owned by the manager or family play in determining their own pay. It is expected that these managers to be more powerful than managers in other firms and more successful in expropriate firm resources since the power of having a position in the firm might be magnified by the power derived from employing family control as well as being a shareholder (owner).

Moreover, this paper is aiming at explaining , compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation. As a result, executives can receive pay in excess of the level would be optimal for shareholders. This paper survey on related literature on how top management pay is influenced by poor quality of governance structure (controlling shareholder managerialism) and derives various testable implications by examining top manager's cash compensation – salary and bonus- in Korean Chaebol.

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