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Outside Directors on Korean Boards: Governance and Institutions

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ABSTRACT Drawing on institutional theory, this study examines the factors that pressured Korean firms to appoint outside directors to their boards. While this practice could be considered to be a management innovation in Korea, in the Anglo-American corporate governance system it has long been used as one of several mechanisms to mitigate agency costs between management and shareholders. As such, this response by Korean firms, following the 1997–98 currency crisis in Asia, could be seen as an example of corporate governance convergence on the Anglo-American model, where higher levels of outside director representation on the board are the norm. We examine the antecedents of having a higher proportion of outside directors on Korean boards. Our findings indicate that larger firms that are under stricter control by the government have higher representation of outside directors on the board. We also find a positive and significant relationship between the proportion of outside directors and business group affiliation, poor prior firm performance, higher levels of debt and foreign ownership.

INTRODUCTION

Corporate governance reform is a global phenomenon (Klapper and Love, 2004) that, in the language of institutional theory, has been taken for granted as a legitimate need in society (Scott, 1987). Evidence of these reforms can be seen in the adoption of corporate governance codes (Aguilera and Cuervo-Cazurra, 2004, 2009) and other governance elements from different systems. One example is the appointment of outside directors to the board (Cho and Kim, 2007; Payne et al., 2009), a governance element with a relatively long history in the USA, but in some economies (e.g. China) it may be viewed as a management innovation (Peng, 2004). Outside directors are usually defined as 'all non-management members of the board' (Johnson et al., 1996, p. 417) but are not necessarily the same as independent directors in the USA (Rediker and Seth, 1995). Like corporate governance codes (Aguilera and Cuervo-Cazurra, 2004, 2009) and other

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governance elements (Ahmadjian and Robbins, 2005; Sanders and Tuschke, 2007), outside directors could be adopted in isomorphic fashion (DiMaggio and Powell, 1983) in many countries. This perspective is consistent with an extensive discussion in the literature about the possibility of governance systems diverging from, or converging on, the American model (Bruton and Lau, 2008; Buck and Shahrim, 2005; Guillen, 2000; Miller and Triana, 2009; Yoshikawa and Rasheed, 2009). Indeed, Hansmann and Kraakman (2001) foresee the end of comparative corporate law as the world converges on the Anglo-American model.

Many studies on corporate governance reform and board composition (e.g. Dahya and McConnell, 2007) employ agency theory as their analytical lens. While this approach may be relevant to institutional environments where stock markets are liquid and shareholder primacy is emphasized (Fama and Jensen, 1983), in other institutional contexts, an alternative analytical tool may be necessary (Dacin et al., 2002). Indeed, institutional theory has recently been proposed as a suitable framework for the analysis of corporate governance reform (Aguilera and Jackson, 2003; Buck and Shahrim, 2005), in contrast to the more traditional agency or transaction cost perspective. Indeed, recent studies on board composition and firm performance in China (Peng, 2004), the adoption of stock options in Germany (Chizema, 2009; Sanders and Tuschke, 2007) and foreign investors and corporate restructuring in Japan (Ahmadjian and Robbins, 2005) have employed an institutional theory lens. However, these studies do not trace the reaction of local actors following radical changes in the external environment such as the Asian currency crisis of 1997–98. Moreover, to our knowledge, no studies have considered the appointment of outside directors using an institutional theory lens, at least in countries that were affected by the Asian currency crisis. Peng (2004) has come closest to remedying this omission, but in the context of China and without comprehensively exploiting the institutional isomorphism framework (DiMaggio and Powell, 1983).

In this paper, the institutional context is set in South Korea (hereafter, Korea), at the height of corporate governance reform following the currency crisis of 1997–98. Using institutional theory, we analyse the process and antecedents of appointing outside directors on Korean boards, in what may be viewed as a reaction to radical changes in the macro environment (i.e. the Asian currency crisis). With this approach, we extend the literature on the convergence/divergence of corporate governance systems by studying a potentially contestable management innovation in a country whose governance system can be classified as representing neither the shareholder system of the US and UK (Shleifer and Vishny, 1997) nor the stakeholder system of Japan and Germany (Hall and Soskice, 2001). We also heed the warning by Aguilera and Jackson (2003) that agency theory is under-socialized by employing institutional theory to study governance change at a time when Korea was undergoing institutional change following the currency crisis. While international differences in domestic institutional environments may explain the diversity of national corporate governance systems (Aguilera and Jackson, 2003; Yoshikawa and McGuire, 2008), we argue that institutional forces from organizations that seek to maximize shareholder value may pressure firms in search of legitimacy (DiMaggio and Powell, 1983) to imitate or adopt the governance structures of Anglo-American capitalism, even in emerging economies like China (Peng, 2004) or Korea.

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Our paper claims three theoretical contributions to the field of corporate governance. It argues for the importance of the institutional context to the study of governance change and counters the universal application of agency theory in an 'off-the-shelf' manner. Specifically, our paper argues for the particular relevance of institutional forces and dynamics to governance change in emerging economies. Finally, it tentatively proposes the wider application of institutional theory to governance change in advanced economies during periods of governance and financial crisis. In addition to these theoretical contributions, the paper goes on to identify and measure the contribution of different institutional variables to a particular governance innovation.

STUDY CONTEXT

Corporate governance has attracted a variety of approaches in the literature, and the diversity of governance practices around the world almost defies definition (Aguilera and Jackson, 2003). However, the dominant Anglo-American system, from which many elements of governance are taken and imitated by others (Witt, 2004), emphasizes the primacy of shareholders (Shleifer and Vishny, 1997) and presumes that top executives' primary responsibility is to maximize shareholder wealth (Jensen and Meckling, 1976). This Anglo-American model focuses on a number of governance mechanisms including the separation of ownership from control, financing through the stock market, and the use of independent directors (Dalton et al., 1998). These governance mechanisms operate interdependently, and where one fails, the other or a combination of the rest may substitute for it or even play a complementary role (Rediker and Seth, 1995). One such mechanism is the board of directors.

Under stock market capitalism, a unitary board of directors is composed of executive and independent outside directors, a structure intended to mitigate conflicts of interests between agents and principals. For example, the Combined Code in the UK recommends that the board should have at least three executive directors and an equal number of non-executives. In 1996, just before the financial crisis in Korea, the average number of non-executive directors in the top 100 of listed corporations was 6.5 in the UK (Pope et al., 1998).

The effectiveness of higher proportions of independent outside directors has been observed in relation to strategic change (Johnson et al., 1993), restructuring (Pearce and Zahra, 1992) and international diversification (Tihanyi et al., 2003). Moreover, in the conceptual, practitioner and policy literatures there is a near consensus in favour of high proportions of outside directors (Peng, 2004). For example, in the UK, following the publication of the Cadbury Report in 1992, there was a widespread increase in the number and ratio of outside directors on boards, accompanied by a significant improvement in operating performance (Dahya and McConnell, 2007).

Corporate Governance in Korea before the Asian Crisis

Studies have shown that Asian countries that had weak legal environments and poor governance systems (Johnson et al., 2000) suffered greater exchange rate depreciation and more severe stock market declines during the 1997–98 crisis. Moreover, corporate

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governance measures such as high disclosure quality and concentrated ownership affected stock market valuations (Mitton, 2002).

Corporate ownership in Asia is typically concentrated, with controlling owners (La Porta et al., 1999) who usually have voting rights in excess of cash flow rights. These controlling owners have the power and incentive to influence strategic decisions by participating in or personally monitoring management (Grossman and Hart, 1988). This arrangement, prone to agency problems, characterizes Korean business groups, otherwise known as *chaebols*, which are sets of firms that, though legally independent, are bound together by a constellation of formal and informal ties that facilitate coordinated action (Ma et al., 2006). From an economics perspective, business groups substitute for imperfect market institutions in emerging economies (Chang and Choi, 1988).

In the standard theory of the firm, agency costs are typically associated with hired managements working under dispersed shareholders (Jensen and Meckling, 1976). Such is the case in Anglo-American governance where ownership and control are often separated and legal mechanisms protect owners' interests in the conflicts between owners (principals) and managers (agents) (Jensen and Meckling, 1976). However, the main agency problem in Asian firms is seen to be caused by having control in the hands of owner-managers with little ownership, while other shareholders own the majority of shares but with little control (Chang, 2003). In this light, the structure of the Korean *chaebols* can be considered as a variant of the controlling minority structures, where the agency problem lies in the exploitation of other minor shareholders by the controlling owners (Baek et al., 2004; Young et al., 2008). This has led to the development of a new perspective on corporate governance that focuses on the conflicts between the controlling and minority shareholders in a firm – the so called principal–principal model (Young et al., 2008).

In emerging economies, the institutional context makes the enforcement of agency contracts more costly and problematic (Peng and Delios, 2006; Wright et al., 2005), as social and legal institutions determine ownership structures (La Porta et al., 1999). For example, in Korea, until 1994 the security exchange law permitted only existing incumbent controlling shareholders to hold more than 10 per cent of shares, and foreign ownership was restricted until the end of 1997. Moreover, both hostile and foreign takeovers were prohibited until 1998, a situation that sustained Korean controlling shareholders despite their small ownership stakes. In over 80 per cent of large firms, the largest and controlling shareholder or family members were also represented among the top executives (Claessens et al., 2000). Given their high level of protection and influence, controlling shareholders selected most of the directors on the board, rendering the internal governance system ineffective (Young et al., 2008). Indeed, the selected directors, lacking independence, rarely opposed agenda items (Joh, 2003).

THEORETICAL BACKGROUND

In deciding corporate strategies and structure, managers not only aim to improve internal efficiency but also to adapt to the external environment in order to acquire and maintain institutional legitimacy (Meyer and Rowan, 1977) and subsequently have access to resources (Pfeffer and Salancik, 1978). At a firm-level, therefore, managers may

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make decisions based on their institutional environment (Meyer and Rowan, 1977). Moreover, a clear shift in strategies may be witnessed as decisions may be influenced by various institutions when a new manager with a different vision for the growth of the company is appointed. This is also true when a company suffers from low performance and management faces a high level of uncertainty. Thus, the influence of a shared institutional environment or a set of conditions may persuade many companies to change or adopt similar management innovations.

DiMaggio and Powell (1983) talk of institutional isomorphism, a tendency for countries and organizations to adopt similar institutions (e.g. corporate governance structures). They argue that institutional isomorphism can occur through one, or a combination of three mechanisms, namely *coercive*, *mimetic*, and *normative* pressures. Coercive isomorphism is driven by pressures from other organizations on which a focal organization depends and by pressures to conform to the cultural expectations of society at large. Mimetic isomorphism is a response to uncertainty. In situations where a clear course of action is unavailable, managers may imitate a peer organization perceived to be successful. Normative isomorphism is traditionally a result of professionalization, where members of professions receive similar training and interact through professional bodies. However, this concept may be stretched to embrace the norms of investment practices on capital markets, even though formal training may not be responsible. These mechanisms lead many organizations to adopt similar management innovations to solve problems leading to similarities in their strategies and structures (DiMaggio and Powell, 1983).

Scott (1987) argues that, through authority, power, and inducement, the upper level organization can force similar forms in the strategies and structures in lower level organizations. For example, governments tend to require that firms within their territories adopt certain kinds of management procedures and structures. Indeed, coercive power imposed by the government or headquarters are uncontrollable elements for a manager who may make decisions to secure legitimacy rather than to improve internal efficiency. Scott (1987) argues that decision makers exposed to external institutional designs may attempt to model their own structures on patterns thought to be more modern, appropriate, or professional. However, the characteristics and structures between the imitating and the imitated company may be incompatible (Scott, 1987), resulting in inefficient outcomes.

Abrahamson's (1991) 'pro-innovation bias' states that innovation that occurs in the management process does not always function positively for the improvement of corporate performance but can be diffused inefficiently among organizations. He developed four types of innovation diffusion processes. In one case, innovation contributes to the improvement of efficiency with opposite effects in the other three. This inefficient diffusion process, observed in the three cases, is explained by the concepts of 'forced-selection', 'fashion', and 'fad'. Although Abrahamson's (1991) research is focused on the selection and diffusion of innovation within and among organizations, this model can be applied to changes in strategies and structures of firms and echoes the institutional isomorphism thesis.

According to Oliver (1997), managers influenced by institutional environments tend to make decisions based not on economic but on normative rationality. Normative ratio-

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nality means that decisions are made from habitual and embedded norms and traditions, and the objective is not to optimize resource choices but to justify them. Forced selection, fashion, and fad in Abrahamson (1991) are inefficient diffusion processes of innovation that can occur when economic and normative rationality issues are not properly balanced in decision making.

Board Reform in Korea: A Case of Institutional Isomorphism?

After the Asian crisis, governance reforms sought to improve transparency, the disclosure of financial and corporate information and the financial health of *chaebols* (Joh, 2003). Reforms were also aimed at ensuring the effectiveness of the board system, the main thrust of the governance shake-up in Korean companies, and the focus of this study. One of the conditions that the International Monetary Fund (IMF) suggested when it lent emergency funds to the Korean government was to carry out corporate board reform (Joh, 2003), including the appointment of outside directors.

Before the introduction of outside directors in 1998, the board of directors in the Korean company was generally composed of insider executives who were effectively neutralized by the controlling shareholder. The Korean government therefore pressured all listed companies, through the amendment of the Commercial Code in 1998 and through the Securities Exchange Act, to have at least 25 per cent of outside directors on the board. Moreover, in September 1999 the Korean Committee on Corporate Governance adopted the Code of Best Practice for Corporate Governance, an informal guideline for listed companies that operated on the principle of voluntary compliance. Following these governance changes, Korean firms with more than two trillion Korean *won* (about US$1.68 billion, based on 1999 exchange rate) of total assets were required to have at least 50 per cent of outside directors on their boards.

However, as a management innovation, the concept of outside directors has been highly contested in Korea, with some questioning its effectiveness (Kim, 2007), others arguing that 'independent' directors help to monitor owner-managers and to minimize agency problems (Cho and Kim, 2007) of the principal–principal form (Young et al., 2008). Opponents of this innovation have argued that because Korea has a different institutional environment to the USA and/or UK, outside directors would be ineffective in Korea. This notion draws support from studies that attribute variations in corporate governance systems to differences in institutional environments (e.g. Aguilera and Jackson, 2003).

The introduction of outside directors in Korean companies was a reaction to external institutional pressure following the currency crisis. In institutional theory terms, this innovation represented an adaptation to outside institutional pressures, in order that these companies could obtain legitimacy and access resources (Scott, 1987). Following this observation, we now attribute Korean board reform to three kinds of institutional isomorphism defined above: coercive, mimetic, and normative (DiMaggio and Powell, 1983).

HYPOTHESES

Since the 1970s, the Korean government encouraged and facilitated investment by large firms (*chaebols*) in business sectors that were designated as important for national

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economic development. For example, the Samsung Group, the largest *chaebol*, invested in textiles, electronics, chemicals, semiconductors, and telecommunications. The economic role played by these large firms was rewarded or supported by the government. However, the currency crisis was blamed on the poor governance and performance of these large firms. Consequently, the Korean government decided to reform corporate governance, particularly in the *chaebols*, pushing for shareholder-value maximization.

Abrahamson (1991) identified 'forced selection' as a situation in which a powerful institution such as a government can exert political pressures on organizations so that they adopt innovations that raise shareholder value or reject those that damage it. DiMaggio and Powell (1983) described this institutional pressure as coercive isomorphism, and Lee and Pennings (2002) confirmed that the partitioning of firms according to size was appropriate for applications of institutional theory.

Oliver (1997) emphasized two processes through which institutional pressures are exerted on subordinate organizations: legal coercion and voluntary diffusion. Although conformity to such pressures may not increase a subordinate organization's ability to achieve its ends, it will at least enhance its legitimacy (Scott, 1987), consequently enabling it to access resources (Pfeffer and Salancik, 1978) that may enhance firm value. Coercive pressure therefore tends to be more effective when an organization's resource dependence on others is high (Pfeffer and Salancik, 1978).

Two important factors make this institutional perspective relevant to Korea's governance reform. First, large Korean firms were highly dependent on the government for resources (Peng, 2004). Second, the Korean government, being aware of the role that large business groups play in the economy (Cho and Kim, 2007), and following recommendations from the IMF, sought to reform corporate governance, particularly the board structure of large firms. Powell (1991) argues that society tends to pay more attention to large rather than small firms and that organizational response to institutional pressure varies with size.

This view could be particularly relevant for the legal environment in Korea where government policies discriminate between large and small/medium-sized firms. For example, legal changes required that large companies with more than two trillion *won* of total sales (i.e. large business groups) should have at least 50 per cent of outside directors on their boards. Thus, we argue that the Korean government, as a powerful institution, imposes discriminatory coercive/regulative pressure on large firms in relation to the appointment of outside directors. We therefore hypothesize:

Hypothesis 1a: The larger the size of the firm in Korea, the higher the representation of outside directors.

Large business groups (*chaebols*) in Korea assume the characteristics of a conglomerate and have upstream and downstream vertical integration (Chang and Choi, 1988), connecting their main manufacturing firms with smaller affiliates that provide raw materials and intermediate goods and services. Large *chaebols*, such as Samsung, have as many as 80 affiliates (Chang and Hong, 2002); they typically accumulate a pool of funds from affiliated companies and use them to form new business ventures or to rescue poorly performing affiliates. Moreover, they also share technological resources among group-

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affiliated firms by transferring key personnel between companies. Consequently, individual affiliates are very much dependent on *chaebols* whose actions can substantially influence the profitability of the former (Chang and Hong, 2002). Moreover, an affiliated firm can share a group's reputational capital simply by being associated with a prestigious business group.

In this context, it is argued that business groups may generate coercive isomorphic pressures that parallel the internal pressures within multinational enterprises (MNEs) that force subsidiaries to adopt organizational practices advocated by the parent firm (Kostova and Roth, 2002). As discussed in the development of Hypothesis 1a, large business groups in Korea have a close relationship with the government (Guillen, 2000), leading to superior political capital and the ability to extract considerable support from the state (Peng, 2004). Given the way business groups operate, this governmental support is likely to spill over to affiliates. We argue that, because large business groups are pressured by the state to have a higher representation of outside directors on their boards (as in Hypothesis 1a), this should also be the case with their affiliates. In order to secure legitimacy, affiliates require the endorsement and support of their dominant business groups, and it is a central tenet of institutional theory that organizations can gain the endorsement of the authorities by conforming to their prescriptions (Heugens and Lander, 2009). To attract the support they need, affiliates may thus follow the prescriptions dictated by the business groups on which they are resource-dependent (Pfeffer and Salancik, 1978). The aggregate of such conformity is a certain degree of isomorphism across the business affiliates exposed to the same pressures and business practices as the business groups to which they are affiliated. Therefore we suggest:

> *Hypothesis 1b*: Business group affiliation in Korea will be associated with a higher representation of outside directors.

Mimetic isomorphism results from processes that induce the imitation of existing structures and practices (DiMaggio and Powell, 1983). Faced with environmental uncertainty, organizations may imitate or model themselves after other organizations, especially those that are perceived to be more effective or successful (DiMaggio and Powell, 1983). However, organizations face uncertainties when their objectives are unclear or unachievable.

After the Asian currency crisis, there was a high level of uncertainty in corporate Korea due to institutional transition in the country. Thirteen of the 30 largest Korean *chaebols* were liquidated. The overall performance of many companies declined and practically all Korean large firms underwent a restructuring process (Park and Kim, 2008) in several areas of governance, including board reform.

In the face of this uncertainty, Korean firms could analyse their internal resources (Barney, 1991) and the external environment to formulate strategies that could improve their efficiency. Alternatively, they could benchmark prominent and fashionable governance reforms from outside (DiMaggio and Powell, 1983). In uncertain times, poor firm performance may be a precipitating factor for such changes (Greenwood and Hinings, 1996), as groups less committed to prevailing governance fashions may legitimately raise and promote alternative configurations (Oliver, 1997) in the expectation that the adop-

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tion of isomorphic templates may improve both symbolic and substantive business performance (Heugens and Lander, 2009). Poor firm performance, as a source of organizational uncertainty, may therefore prompt the appointment of more outsiders on boards who may help the turnaround process (Boeker and Goodstein, 1991). In this manner, poor performance acts as a catalyst to trigger organizational changes (Ahmadjian and Robinson, 2001; Greenwood and Hinings, 1996), and board reform is an adaptive response to uncertainty faced by a firm in its environment (Boeker and Goodstein, 1991).

We argue that Korean firms with weak operating performance experienced higher levels of uncertainty and thus mimetically reformed their boards. These firms were faced with strong reform pressures and might have wanted to signal to outside stakeholders that they were changing their governance structures by appointing outside directors to their boards. We therefore hypothesize:

Hypothesis 2: The lower the prior performance in Korean companies, the higher the representation of outside directors.

High leverage was one of the common features in Korean companies before the currency crisis (Joh, 2003). In 1997, the average debt-equity ratio of Korean firms, at 396 per cent, exceeded that of other countries (e.g. USA, 154 per cent, Japan, 193 per cent, and Taiwan, 86 per cent, see Joh, 2003). While the debt–equity ratio was high, the average rate of return on equity was often lower than the prevailing interest rates for loans; this situation went on for ten years prior to the crisis (Joh, 2003). We argue that firms that had high debt levels faced a lot of uncertainty and difficulties in raising alternative finance. These firms thus needed to signal to diverse stakeholders such as investors that they were changing for the better by adopting a new governance template (Greenwood and Hinings, 1996). Corporate governance mechanisms that are associated with shareholder value maximization were likely to be adopted.

In the context of Korean firms, the role of outside directors in potentially reducing uncertainty in highly leveraged firms would be seen as significant. This is because high debt was due to a lack of managerial control as firms borrowed and engaged in unprofitable diversification at the expense of focusing on core competencies. Both the external and internal elements of Korea's corporate governance system had failed to provide sufficient monitoring and discipline to end such inefficiencies (Joh, 2003), yet this is a typical agency problem that may be solved by the presence of outside directors on the board (Dahya and McConnell, 2007). The need for governance reform was therefore stronger in firms that had high debt, and to acquire legitimacy and subsequently have access to resources, such firms were likely to imitate the practice of having outside directors on their boards. We therefore hypothesize:

Hypothesis 3: The higher the debt ratio in Korean companies, the higher the representation of outside directors.

After the currency crisis of 1997–98, the corporate ownership structure in Korea changed. Government ownership declined following the privatization of state-owned

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companies like POSCO, and with the amendment of the Commercial Code (Park and Kim, 2008). Foreign investors increased their share of the market and now hold a significant percentage of ownership in Korean firms. For example, foreign shareholdings of firms listed on Korea Stock Exchange grew from almost 12 per cent of the total market capitalization in 1995 to about 42 per cent in 2004, and more than 40 per cent of this investment came from the USA and UK (Korea Stock Exchange, 2004). This significant increase in foreign ownership, particularly from stock market economies, notably the USA/UK, has the potential to accelerate the diffusion of the Anglo-American corporate governance system (Chizema, 2008) in emerging economies.

Foreign shareholders, often in the form of institutional investors, have two means of promoting their interests. First, they could use the threat of *exit*, i.e. the possibility of selling their shares if they are not satisfied with management decisions. Second, they could use *voice* through shareholder activism. These two options (Nooteboom, 1999) would suggest that foreign investors could achieve their interests through coercive pressures. However, this observation may only be true in governance environments where the notion of shareholder value is widely accepted, with active stock markets. We argue that such is not the case in emerging or transition economies such as Korea where institutional change promoting shareholder value may be resisted (especially just after the currency crisis of 1997–98), and where shareholder activism is weak. We argue that the role of foreign investors during these early stages of governance reform may have been to represent and diffuse, in a non-coercive fashion, alternative norms and mechanisms of shareholder capitalism. This would ensure a shift in the ideational boundary (Suddaby et al., 2007), implying a break with traditional practice as new actors (i.e. foreign investors), relying on commercial expertise and experience, advocate new management practices that favour shareholder value. In institutional theory parlance this amounts to normative isomorphism.

DiMaggio and Powell (1983) explain that normative isomorphism in organizational structures comes from professionalization interpreted as the collective struggle by members of an occupation to define the conditions and methods of their work, to control production and to establish a cognitive base and legitimization for their professional interests. The Anglo-American corporate governance system, diffused by foreign institutional investors (Ahmadjian and Robbins, 2005), is arguably taken as a global or professionally-accepted standard (Witt, 2004). Foreign investors, particularly those from the USA and the UK, have norms and values that emphasize the maximization of shareholder value (Ahmadjian and Robbins, 2005; Yoshikawa and McGuire, 2008). According to Dacin et al. (2002, p. 49), '. . . the boundaries erected to segregate and protect these [institutional] fields have been breached, allowing the penetration of more conventional corporate forms.'

Recent empirical studies confirm the professional influence and governance role of these foreign investors in emerging economies (e.g. Dahlquist and Robertson, 2001), and a strong relationship between the percentage of shares owned by foreigners and corporate behaviour reminiscent of Anglo-American governance such as downsizing (e.g. Ahmadjian and Robinson, 2001). Since the appointment of outside directors is a typical Anglo-American governance innovation we therefore hypothesize that:

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Hypothesis 4: The higher the foreign ownership ratio in Korean companies, the higher the representation of outside directors.

METHODOLOGY

Sample

To test our hypotheses we used data on Korean firms that were listed on the Korea Stock Exchange (KSE) between 2002 and 2006. The data on board characteristics was based on the financial years 2002–06, the observation period of the study. The data for ownership structure and financial characteristics was obtained from the TS2000 database, compiled by the Korea Listed Company Association. Data on board composition was collected manually from companies' annual reports.

Although the Korean government introduced the outside director system in 1999, firms did not reveal enough information in their annual reports about the composition of their boards until 2001. In 2001 only 226 companies offered data about their board structure, and it must be conceded that these disclosing firms may have had good governance generally, and were therefore more likely to adopt the innovation of outside directors before legislation forced them to do so. The effects of a series of regulations on corporate governance reform, including the adoption of the outside director system, was strong immediately after the crisis as it became apparent that firms had little choice but to conform to government requirements to improve corporate governance as set in law or by binding KSE regulations. We excluded financial companies because of their atypical financial structures. We also excluded firms with missing data, yielding 2233 firm-year observations.

Measurement

Dependent variable. The dependent variable is the representation of outside directors on the board, measured as the *ratio of outside directors* to total directors.

Independent variables. *Firm size* is measured by the natural log of total assets. *Group affiliate* is a dummy variable taken as 1 if the firm belongs to one of the 30 largest business groups and 0 otherwise. Return on invested capital is a proxy for *prior performance*. *Debt ratio* is measured by total debt divided by total assets. *Foreign ownership* represents the ownership ratio by foreign investors. Data on all the independent variables were obtained from the TS2000 database. We make the assumption that the board structure in a given year is determined by ownership structures and financial conditions of the firm in the previous year. Independent variables, except for prior performance are therefore lagged by one year. For prior performance, given the possibility of wide annual variations, we use the average of the three years prior to the year in which the dependent variable is observed.

Control variables. One of the objectives of governance reform in Korea was to monitor the controlling shareholder, whose objective may be to block any changes to the status quo. We therefore use *controlling ownership* as our first control variable. This is taken as the percentage of outstanding stock owned by dominant or controlling shareholders.

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Following studies (e.g. Fiegener et al., 2000) that explain that CEOs do not welcome board vigilance exerted by outside directors, and firms with high CEO ownership have fewer outside directors, we control for CEO ownership. We also control for *research and development*. This is because the enhanced vigilance of outsider-dominated boards may ensure that firms limit unrelated diversification, promoting research and development activity because such actions are consistent with shareholder interests (Fama and Jensen, 1983).

Previous studies (e.g. Dennis and Sarin, 1999) have reported that firms with higher growth opportunities have fewer outsiders on their boards. We therefore control for *corporate growth* which is the ratio of sales in the current year to sales in the prior year. Lastly, as the appointment of outside directors may be time-dependent, we control for year effects.

DATA ANALYSIS AND RESULTS

Table I shows the descriptive statistics of the variables and the results of the correlation analysis. The average ratio of outside directors on the board is about 30 per cent, thus slightly higher than the legal requirement for the outsider ratio of 25 per cent.

As indicated in Table I, only 12 per cent of the firms in our sample belong to the 30 largest business groups, with the average of controlling large shareholder ownership being about 40 per cent. The research and development ratio is 0.8 per cent of total sales and the sales growth rate is about 13 per cent. Correlations between independent variables are low; the highest one between foreign ownership and firm size is 0.490. As a check we carried out variance inflation factors (VIF) tests; all the condition indices are below 10, indicating no serious problems with multicollinearity (Neter et al., 1990). We carried out further tests to ensure the applicability of OLS regression to our data. For example, using the P–P plot, our data satisfied the assumption of normality of the dependent variable, and scatter graphs suggested a linear relationship between the dependent and independent variables. Tests for heteroscedasticity and correlation error terms showed that neither of these problems were in the data.

Table II shows the results of the OLS regression analysis. Model 1 contains control variables only. Models 2, 3, 4, 5, and 6 contain the controls and the independent variables: firm size, group affiliate, prior performance, debt ratio, and foreign ownership, respectively. Model 7 is the full model. In each model, we report a standardized coefficient estimate along with its standard error (in parentheses).

From the control variables, controlling ownership is negatively associated with the ratio of outside directors in all seven models ($\beta = -0.001$; $p < 0.001$). The coefficients on CEO ownership are insignificant in Models 2 and 4, but negative and significant in the rest of the models. CEO ownership is only negatively and significantly associated with the dependent variable in models that exclude independent variables. Corporate growth is negatively associated with the ratio of outside directors in Model 7 ($\beta = -0.006$; $p < 0.10$). Except for 2006 and only in the final model, results on year dummies are insignificant.

Turning to independent variables, Hypothesis 1a states that the larger the size of the firm in Korea, the higher the representation of outside directors on the board. This

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Table I. Descriptive statistics and correlation analysis

	Mean	*SD*	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
1. Ratio of outside directors	30.010	10.240	1									
2. Firm size	12.281	1.345	0.483***	1								
3. Group affiliate	0.121	0.326	0.119***	0.120***	1							
4. Prior performance	0.028	0.096	−0.035	0.212***	0.030	1						
5. Debt ratio	1.172	1.497	0.126***	0.021	0.011	−0.265***	1					
6. Foreign ownership	0.099	0.151	0.230***	0.490***	0.060**	0.247***	−0.118***	1				
7. Controlling ownership	0.403	0.165	−0.140**	−0.024	−0.034	0.154***	−0.109***	−0.086***	1			
8. CEO ownership	0.017	0.059	−0.071**	−0.181**	−0.017	0.027	−0.052*	0.090***	0.095***	1		
9. Corporate growth	1.132	0.843	−0.010	−0.018	−0.013	−0.172***	0.020	−0.002	−0.015	0.020	1	
10. Research and development	0.008	0.017	0.039	−0.010	−0.043*	−0.030	−0.050*	0.055*	−0.061**	0.099***	−0.029	1

Notes: * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.
Number of observations = 2233.

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Table II. OLS regression analysis

	Ratio of outsider directors						
	Model 1	*Model 2*	*Model 3*	*Model 4*	*Model 5*	*Model 6*	*Model 7*
Constant	0.343 (0.010)***	–0.133 (0.021)***	0.337 (0.010)***	0.343 (0.010)***	0.328 (0.010)***	0.328 (0.010)***	0.169 (0.023)***
Firm size		0.037 (0.001)***					0.039 (0.002)***
Group affiliate			0.039 (0.007)***				0.016 (0.006)**
Prior performance				–0.014 (0.025)			–0.135 (0.023)***
Debt ratio					0.008 (0.002)***		0.006 (0.001)***
Foreign ownership						0.001 (0.001)***	0.009 (0.001)***
Controlling ownership	–0.001 (0.000)***	–0.001 (0.000)***	–0.001 (0.000)***	–0.001 (0.000)***	–0.001 (0.000)***	–0.001 (0.000)***	–0.001 (0.000)***
CEO ownership	–0.001 (0.000)**	0.001 (0.000)	–0.001 (0.000)**	–0.001 (0.000)**	–0.001 (0.000)*	–0.001 (0.000)*	0.001 (0.000)+
Corporate growth	0.001 (0.004)	–0.001 (0.003)	0.001 (0.004)	–0.001 (0.004)	–0.001 (0.004)	0.001 (0.004)	–0.006 (0.003)+
Research and development	0.195 (0.136)	0.222 (0.118)+	0.222 (0.135)+	0.193 (0.136)	0.236 (1.350)+	0.110 (0.135)	0.247 (0.117)*
2003	0.008 (0.009)	0.009 (0.008)	0.007 (0.009)	0.008 (0.009)	0.011 (0.009)	0.005 (0.009)	0.011 (0.008)
2004	–0.010 (0.009)	0.004 (0.007)	–0.012 (0.009)	–0.010 (0.009)	–0.006 (0.009)	–0.014 (0.008)	0.008 (0.007)
2005	–0.012 (0.008)	0.001 (0.007)	–0.013 (0.008)	–0.011 (0.009)	–0.007 (0.008)	–0.015 (0.008)	0.007 (0.007)
2006	–0.001 (0.008)	0.010 (0.007)	–0.002 (0.008)	–0.001 (0.008)	0.003 (0.008)	–0.006 (0.008)	0.014 (0.007)+
R^2	0.028	0.267	0.044	0.029	0.040	0.072	0.295
Adjusted R^2	0.024	0.263	0.039	0.024	0.036	0.068	0.290
F-statistics	7.182***	79.429***	9.991***	6.416***	9.181***	16.869***	62.867***

Notes: Standardized regression coefficients.
+ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.
Standard errors appear in parentheses.
Number of observations = 2233.

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hypothesis is supported, as results show that firm size is positively associated with the ratio of outside directors in Models 2 ($\beta = 0.037$; $p < 0.001$) and 7 ($\beta = 0.039$; $p < 0.001$).

Hypothesis 1b states that business group affiliation in Korea will be associated with a higher representation of outside directors. Results show that business group affiliation is positively associated with the ratio of outside directors in Models 3 ($\beta = 0.039$; $p < 0.001$) and 7 ($\beta = 0.016$; $p < 0.01$).

Hypothesis 2 predicts that firms with lower prior performance will have a higher representation of outside directors on the board. This hypothesis is supported in the full Model 7 ($\beta = -0.135$; $p < 0.001$), but not in Model 4 where the coefficient is insignificant. Hypothesis 3 states that the higher the debt ratio in Korean companies, the higher the representation of outside directors on the board. In keeping with this hypothesis, the coefficients for debt ratio are statistically significant in Models 5 ($\beta = 0.008$; $p < 0.001$) and 7 ($\beta = 0.006$; $p < 0.001$).

Hypothesis 4 proposes that the foreign ownership ratio will be positively associated with higher representation of outside directors on the board. In support of this hypothesis the coefficients in models for foreign ownership are statistically significant in Models 6 ($\beta = 0.001$; $p < 0.001$) and 7 ($\beta = 0.009$; $p < 0.001$).

DISCUSSION

The present study examines the antecedents of higher proportions of outside directors on Korean boards; results indicate that larger firms are positively associated with the higher representation of outside directors. They also show a positive and significant relationship between the proportion of outside directors and business group affiliation, weak prior firm performance, higher levels of debt, and foreign ownership.

The practice of appointing outside directors to the board, already standard practice in Anglo-American governance, was adopted after the currency crisis in Korea. This makes a good case for the possible convergence of Korean corporate governance on the Anglo-American variety, where firms may be coerced to adopt, or voluntarily imitate, management innovations from an external source.

Our study provides evidence of the utility of institutional theory to explain changes in governance in Korea. First, board reform may be seen as the result of coercive isomorphism, where the Korean government pressured large firms through legislation and political power to appoint more outside directors to their boards. The institutional argument that government reforms first target large firms (Powell, 1991) is supported by our analysis, and the legal requirement in Korea that firms with assets over two trillion *won* must have at least 50 per cent of their boards as outsiders may be reflected in this significant result. Moreover, prominent large firms tend to be scrutinized more intensely by stakeholders, including government officials (Peng, 2004), and are thus likely to be under greater pressure to maintain legitimacy by responding to institutional demands (Meyer and Rowan, 1977).

Second, our results show that business group affiliation is positively associated with the ratio of outside directors. The prevailing view that business groups have close relationships with the government (which spill over to affiliates according to the arguments preceding Hypothesis 1b) that give them access to resources, is supported in our analysis.

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Third, prior firm performance seems likely to have been a factor that promoted mimetic isomorphism. Poorly performing Korean firms may have sought to imitate strategies and structures of firms perceived to be successful in order to reduce levels of uncertainty. Thus, Korean firms with poor performance and faced with high uncertainty after the currency crisis may have pursued board reform as a restructuring process. This reform would leave them comparable with successful firms from advanced economies, with more outsiders on the board.

Fourth and finally, foreign investors, the majority of whom were from the UK and USA (Korea Stock Exchange, 2004), exposed firms to international business norms that are mostly informed by stock market capitalism, and these foreign investors may have been the agents of normative isomorphism. Consistent with our results, the role of foreign investors in the Korean economy is increasing. In listed firms, about 40 per cent of the shares (by value) are owned by foreign investors. Foreign investors in other emerging economies may take a normative attitude towards US management skills that are taught and diffused in colleges and research institutions. However, in Korea, management tends to be concerned about the increase in foreign ownership, perceiving it as a threat to their power.

Figure 1 links our conceptual framework to a summary of the findings discussed in this section. We present the full model (i.e. Model 7).

While several agency theory studies have seen the appointment of outside directors as a means of solving principal–agent problems (e.g. Johnson et al., 1993), this paper has offered a different perspective. Using an institutional theory lens, it has provided an alternative insight into what may catalyse or influence the adoption of a management practice in an environment where firm actors may view elements from a different governance system as illegitimate (Chizema, 2008; Sanders and Tuschke, 2007). The institutional theory approach seems preferable since agency theory, though relevant in stable stock market economies (Fama and Jensen, 1983), ignores the influence of the social and institutional environment, particularly in an emerging economy (Aguilera and

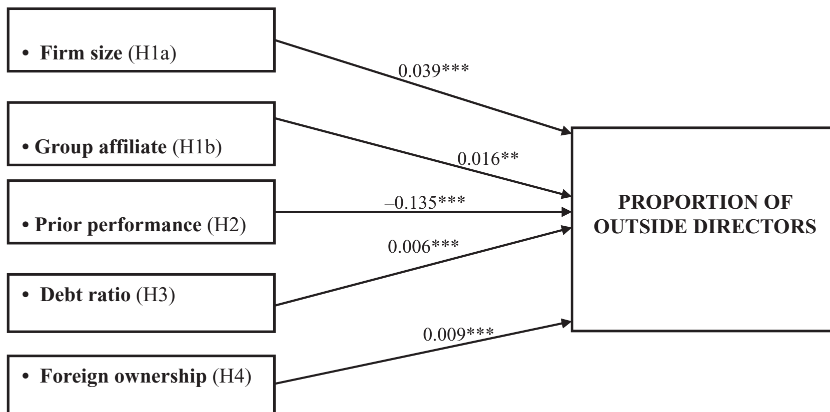

Figure 1. A summary of results through the conceptual framework. Dependent variable: ratio of outside directors on the board

Note: ** $p < 0.01$; *** $p < 0.001$.

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Jackson, 2003). In the case of Korea, and especially before and during the period of the financial crisis, market-based dynamics were less relevant, while institutional pressures deriving from actors such as the state or from the business environment were dominant. Our argument is that these institutional dynamics may trigger social influences on firms that are less relevant to stable and mature economies, although even here, a governance crisis may make institutional dynamics more relevant. In situations where institutional forces are salient, institutional theory provides a better interpretation of governance changes (Aguilera and Jackson, 2003). Following this argument, this paper joins previous work that has applied institutional theory to an understanding of governance reform (e.g. Aguilera and Jackson, 2003; Peng, 2004).

In relation to firm size, Peng's (2004) study, drawing on institutional theory, has already reported a positive relationship in China between firm size and the adoption of outside directors. However, our paper significantly extends Peng's work.

First, it has been argued by economics-based institutional theorists that economic crisis may produce '. . . a sharp break from established procedures. Rare windows of opportunity to effect broad reforms are thereby opened' (Williamson, 2000, p. 598). The period after the 1997–98 Asian currency crisis therefore provides an interesting laboratory for the analysis of firm-level innovation adoption following sharp legal and economic changes in the external environment. This study therefore extends Peng's work by considering the appointment of outside directors in a radically different institutional context.

Second, while Peng's (2004) study was restricted to an analysis of coercive isomorphism, we provide a full application of the institutional isomorphism framework, and thus a more detailed analysis of institutional pressures following a currency crisis preceding the study period. We therefore go beyond firm size by considering weak firm performance/high debt and foreign ownership as triggers of mimetic and normative isomorphism, respectively.

In this paper, we further demonstrate the relevance of time and the institutional context in studying governance reform. For example, in shareholder capitalist economies such as the USA/UK, foreign ownership may be interpreted as a coercive element drawing on shareholder activism arguments. However, in Korea shareholder activism is weak and further weakened after the currency crisis. This means that foreign investors lacked the capacity to coerce Korean firms to appoint outside directors shortly after the currency crisis. Their chance to effect change was through the professional transfer of knowledge of the value and relevance of shareholder-value practices in Western capital markets. In this context, foreign investors (the majority of them from the USA/UK), represented norms and values of shareholder capitalism and their subsequent diffusion, hence our arguments for normative isomorphism.

Limitations and Future Research

Notwithstanding the relevance and timeliness of this study, we identify some limitations and suggest avenues for further research. In terms of limitations, first, we used only indirect measures of institutional effects which do not represent institutional processes directly. We therefore employ measures that arguably represent evidence that institutional isomorphism occurred.

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Second, while it is argued that the appointment of outside directors in Korea followed an isomorphic pattern, such a conclusion cannot be easily generalized as our study is based on a single institutional setting and a particular point in time. Further research involving other Asian countries that faced the same crisis may be worthwhile. Such studies could use direct measures of institutional effects possibly derived from surveys. Moreover, for the purpose of embracing a wider, more varied, and later institutional context, our understanding of the implications of the current global financial crisis for both national and firm governance may be enhanced.

Third, our study was limited to the identification of the ratio of outside directors on boards, neglecting their personal demographics (e.g. their outside affiliations). It would therefore be interesting to make comparisons with studies of corporate governance in the USA and UK, where outside directors have been reported to include ex-government officials (Lester et al., 2008), women, and foreigners (Singh et al., 2008). Further research on the characteristics of outside directors, in relation to firm performance, could improve our understanding of the effectiveness of these officers, who in the case of Korea, were possibly appointed in search of legitimacy.

Finally, from our study, a number of issues are relevant to the current global financial crisis. For example, for many economies, the current crisis, like the Asian currency crisis of 1997–98, is a macro dynamic to which micro actors at firm-level must react. In addition, in both situations, the role of supranational organizations such as the IMF is evident, calling for a paradigm shift in the regulation of business. Indeed, central to both crises is the failure of corporate governance mechanisms, hence the need for reform. Only time will determine whether isomorphic patterns of policy and regulation adoption will emerge from the current global financial crisis.

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