

Samsung: Third Generation Chaebol Faces Unexpected Challenges

Part C: Lee Jae-yong Gets a Time Out



Lee Jae-yong at the Seoul Detention Centre in Uiwang, Seoul

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The essence of this case is the corrupt alliance between government and big business. The people's disappointment seemed irreparable because the corrupt alliance between the president and the conglomerate existed not just in the past but in our present reality.

Kim Jin-dong, Presiding Judge of the Three-Judge Panel¹

Corruption at Core of Conviction

In August 2017 after a four-month trial, the Seoul Central District Court convicted Lee Jae-yong guilty of bribing former president Park Geun-hye and sentenced him to five years in prison. Having immediately appealed the lower court's verdict, lawyers for Lee Jae-yong have started the appeals process which involves more defence witnesses, different lawyers, and a new trial before the Seoul High Court in late September 2017.² Once the appeal has run its course, the appellate court is expected to make a final ruling by January 2018, as Lee Jae-yong can only be kept in detention for four months during the appeals process.³

Lee Jae-yong was found guilty by the lower court of corruption. His alleged crimes occurred in the run-up to the 2015 merger of Samsung C&T and Cheil Industries (see Case B), a merger that he thought was a necessary step in strengthening his control of Samsung Electronics and ultimately advancing his succession as the de facto leader of the Samsung empire.⁴ However something totally unexpected happened on the way to the merger. Before the merger was even announced a veteran Wall Street hedge fund manager took a position in C&T.

Paul Elliott Singer, the founder of Elliot Management and now a minority shareholder in C&T, did everything he could to try and prevent the merger from being approved by C&T shareholders. He launched a high-profile campaign in the Korean press on behalf of investors in his hedge fund which owned a 7.12% stake in C&T. In trying to sway public opinion against the merger on the grounds that it undervalued C&T shares dramatically, he caught the attention of other minority investors who were also opposed to the deal.

In order to comply with the rules, all of C&T shareholders were mailed ballots by which they could approve or reject the proposed merger, as a two-thirds majority was necessary for the merger to go through. The vote was fraught with negative publicity, but in the end the merger was approved. Soon questions began to be raised in the press about the integrity of the voting process.

It turned out that before the vote took place, a highly influential advisory firm, the Korea Corporate Governance Service, was said to have recommended to the Korean National Pension Service (NPS), which owned a 10% stake in C&T, to reject the merger on the same grounds as those given by Elliot Management. It also emerged that NPS held the deciding vote. The question then arose as to why NPS would vote for a merger that was allegedly not in their own financial interest. More investigations followed.

¹ As cited in *Lee Jae-yong is sentenced to five years behind bars*, Korea JoongAng Daily, 26 August 2017

² *Samsung scion Lee appeals against 5-year jail term for bribery*, Reuters, 28 August 2017

³ *ibid*

⁴ <http://observer.com/2015/07/spat-between-samsung-and-nyc-hedge-fund-takes-nasty-detour-into-jew-baiting/>

Eventually, fingers started pointing at Lee Jae-yong. At some point in time before the vote took place, it was alleged that he offered money (\$6.27 million) to the then President of Korea in exchange for her services, which were to ensure that NPS voted in favour of the merger. Indeed, C&T was acquired by Cheil and this paved the way for the Lee family and in particular Lee Jae-yong to obtain a controlling stake in Samsung Electronics.

He was not the only Samsung executive caught up in a scandal: Choi Gee-sung, a former vice chairman of the Samsung Group and Chang Choong-ki, a former president of the powerful Samsung Future Strategy Office were also convicted by the same court. They were each sentenced to a four-year prison term.⁵ Two other Samsung executives were convicted but not jailed.

Lee Jae-yong has been behind bars for almost all of 2017, having been first arrested and detained in late February 2017. At that time, Lee Jae-yong and the Samsung Group denied any wrongdoing. “Samsung has absolutely never bribed the president seeking something in return or sought illicit favours,” the Group said in a statement. Following the lower court’s conviction, Samsung lawyers have continued denying that Lee Jae-yong was involved in Samsung bribes. Until such time as Seoul’s High Court makes a final ruling, Lee Jae-yong will keep his position on the board of Samsung Electronics.⁶

Also appealing against the decision is Special Counsel Park Young-soo, who demanded that the lower court double the prison sentence to 10 years.⁷ Lee Jae-yong was convicted by the lower court of all five charges that he was indicted on, but was sentenced to the mandatory minimum sentence. During his detention up until the first trial, Lee Jae-yong was incarcerated in a tiny cell measuring 68 square feet with a partitioned toilet at a detention centre in Seoul.⁸ Meals are rice and side-dishes costing \$1.26.⁹ In the confines of his cell, Lee Jae-yong can see his lawyers but otherwise is allowed only three ten-minute conversations a day with visitors through a grated window, all monitored by prison guards.

Park Geun-hye Removed from Power

The corruption scandal also had grave consequences for the former president. In March 2017, Park Geun-hye was removed from office following a unanimous vote by the Constitutional Court. The daughter of former military strongman and four-term president General Park Chung-hee, Park Geun-hye was the first woman to be elected as president of Korea in 2013. She was impeached in December 2016 and removed from office in March 2017. She has denied any wrongdoing. Choi Soon-sil, her confidante, is also facing charges in connection with the scandal and has also denied wrongdoing. Their trial is expected to be completed sometime in October 2017.

⁵ *Lee Jae-yong is sentenced to five years behind bars*, Korea JoongAng Daily, 26 August 2017

⁶ *Samsung heir files appeal against jail ruling for bribery*, ShanghaiDaily.com, 29 August 2017

⁷ *What does jailing of Samsung heir mean for ex-president Park?* by Ock Hyun-ju, The Korea Herald, 29 August 2017

⁸ *Samsung Heir's Prison Life: Seven Hours of TV on an LG Screen, \$1.25 Meals*, by Eun-Young Jeong and Timothy W. Martin, Wall Street Journal, 28 February 2017

⁹ *If convicted, Samsung's Lee could be c/o Uijeongbu Prison*, Reuters, 24 August 2017

Having lost her presidential immunity, Park Geun-hye was arrested in late March 2017 and has been incarcerated in a pre-trial detention centre in Seoul ever since. She is facing a separate trial on 18 charges, including bribery and coercion. Her demise has been blamed on her decades-long relationship with her confidante, the daughter of a cult figure in Korea who himself started the relationship with the former president in the mid-1970s. Although not a civil servant, Choi Soon-sil exerted an enormous amount of influence over Park.

Park Chung-hee stands accused of colluding with Choi Soon-sil in an extortion scheme whereby 53 companies including Samsung were coerced into transferring 77.4 billion won (\$65.7 million) to the two charitable foundations which the confidante controlled. The sticking point central to Samsung's defence centres on the lower court's interpretation of the law regarding bribery:

When a public servant [Park Chung-hee] conspires with a non-public servant [Choi Soon-sil] to receive bribes and the non-public servant, who is an accomplice, takes the bribes, it is the same as the public servant taking it.¹⁰

Lower Court Judge Kim Jin-dong

According to a number of legal experts in Korea who have studied the case, Samsung is likely to base its appeal on a logical fallacy embedded in the above legal interpretation. Samsung will argue, according to the experts, that Lee is not guilty because Samsung's support of Choi-backed ventures was not the same as giving bribes to the president. Furthermore, Samsung will argue that there were extenuating circumstances since the de facto heir could not reasonably refuse the demands of the country's highest decision-maker.

If Samsung wins the appeals process, Lee Jae-yong might have his sentence reduced from five year to three years or less. He might also get it suspended, which would result in his immediate release from detention.¹¹

The likelihood of the appeals court ruling in favour of Samsung is difficult to know in advance, but one thing is certain. South Korea is way down on the list of countries perceived to be corrupt. In 2016, Transparency International, an organization that works with governments, businesses and citizens to stop the abuse of power, bribery and secret deals, ranked South Korea 52 out of 176 countries, just behind Rwanda and Mauritius, both emerging Sub Saharan countries.¹² In other words, the idea that anyone in South Korea could be as naïve as Lee Jae-yong about the link between bribery and corruption stretches the imagination.

The Confidante: Choi Soon-sil Convicted

In June 2017, Choi Soon-sil was sentenced to three years in prison, found guilty of obstruction of duty by using her ties with the impeached former president of South Korea in

¹⁰ As cited in *What does jailing of Samsung heir mean for ex-president Park?* by Ock Hyun-ju, The Korea Herald, 29 August 2017

¹¹ *Samsung scion Lee appeals against 5-year jail term for bribery*, Reuters, 28 August 2017

¹² https://www.transparency.org/news/feature/corruption_perceptions_index_2016, accessed 29 August 2017

order to force a university to give her daughter preferential treatment.¹³ The court also sentenced the former president of Ewha Woman's University to two years in prison and the university's former admissions head to 18 months in prison for complying with Choi's demands.

Even though she had no official job in the government, Choi Soon-sil is accused of using her influence over the president in an illegal and abusive manner.¹⁴

The accused [Park] let Choi, who had no official position, intervene in state affairs . . . and they abused power and pressurised business companies to offer bribes, thus taking private gains.

Senior prosecutor Lee Won-Seok¹⁵

Choi Soon-sil is the daughter of Choi Tae-min, the founder of the church of eternal life. This obscure cult combined Catholic and Buddhist teachings along with shamanistic powers and rituals. Choi Tae-min declared himself Messiah and Buddha Maitreya all in one. He befriended Park Geun-hye after her mother's assassination in August 1974. He told Park that her mother had appeared to him in a dream, asking him to help her daughter. He described Choi Soon-sil as the royal messenger of the cult. Eventually, the two of them father and daughter would exercise an enormous power over the future president.

Park Chung-hee and Choi Soon-sil became good friends, with the latter often playing the role of companion and personal aide to the head of state. Park Chung-hee, for example, sought Choi Soon-sil's advice on how to deal with North Korea, convincing her that the North Korean regime was about to collapse.

Chung Yoo-ra

Samsung's connections to Choi Soon-sil also involved her daughter Chung Yoo-ra, age 21, who has been under investigation. She was arrested in the Danish city of Aalberg, Denmark in January 2017, after spending months in hiding after the scandal broke. After negotiations with the South Korean authorities, she finally agreed to be extradited to Seoul in May 2017.¹⁶

Samsung is alleged to have financed the equestrian courses of her daughter in Germany and most recently Denmark. In May 2017, the daughter was extradited from Denmark for her alleged involvement in the wide-ranging corruption scandal. While in Denmark, Chung Yoo-ra tried to apply for citizenship in Malta. In addition to the illegal funding of her equestrian courses, she is alleged to have hid about \$7 million in bribes from Samsung that were masked as funds for her training.¹⁷

It was a Korean civil servant named Roh Tae-kang who first raised concerns about the amount of money Chung Yoo-ra was spending on pure-bred horses. However the whistle blower was

¹³ *Ousted South Korean president's confidante Choi Soon-sil sentenced*, by Katie Hunt, Sol Han and Taehoon Lee, CNN, 23 June 2017

¹⁴ https://en.wikipedia.org/wiki/Park_Geun-hye, accessed 26 May 2017

¹⁵ As cited in <https://www.ft.com/content/ea352892-3f5c-11e7-9d56-25f963e998b2>, accessed 26 May 2017

¹⁶ *Ousted Korean leader's friend jailed*, by Chang May Choon, The Straits Times, 24 June 2017

¹⁷ *Prosecutors Push to Arrest Choi Soon-sil's Daughter Again*, Chosun Ilbo, 19 June 2017

fired by Park Geun-hye in 2013. But the new President of South Korea, Moon Jae-in, rehired Roh Tae-kang to be his vice minister to prepare for the upcoming Winter Olympic Games.¹⁸

Lee Family No Stranger to Court Cases

In 1996, the second generation leader of Samsung Lee Kun-hee was convicted of bribing former presidents and received a two-year jail sentence, which was later suspended. He was also investigated in 2005 for using corporate funds to support presidential candidates, but was cleared of the charges.¹⁹

The Lee family have been involved in numerous court cases, some as a result of internal family feuds and some as a result of external events. Samsung founder Lee Byung-chull was investigated in 1966 for a saccharin smuggling case but never prosecuted.²⁰ Second generation leader Lee Kun-hee, twice received presidential pardons for wrongdoing, one for bribery in 1996 and the other for tax evasion in 2008.²¹

In April 2008, Lee Kun-hee was indicted on charges of tax evasion and breach of trust. Nine other Samsung executives were indicted on similar charges, although no one was arrested and the chairman escaped the most serious charge of bribery. A three-month court inquiry focused on Lee Kun-hee's attempts to pass control of the Chaebol to Lee Jae-yong. In November 2007, a former legal adviser alleged that Samsung managed huge slush funds, ran a bribery network and used illegal bond trades in Samsung Everland, the Group's de facto holding company, to help both his son begin his succession plan and his family retain control over the empire. Through Samsung Everland, the amusement park operator, the Lee family held controlling stakes in Samsung Electronics and Samsung Life Insurance, the country's largest insurer. During the trial, it was revealed that Lee Kun-hee had enabled his three children to acquire big stakes in Samsung Everland and in Samsung SDS at prices far below market value during the 1990s.²²

After deliberations, the court found Lee Kun-hee guilty for not paying taxes on income of 4.5 trillion won (\$4.5 billion)²³ and he was convicted and forced to resign as the chairman of Samsung. He was handed a three-year suspended prison sentence, but President Lee Myung-Bak pardoned the Chaebol boss four months after the April 2008 conviction, claiming that the country needed the world-respected leader to shore up the Korean Olympic committee which had been bidding to host the Winter Olympics. In reality, it was his family's political network that proved to be a resilient asset keeping him out of jail.

Following the court case, Kim Sun-woong, who worked for the Centre for Good Corporate Governance, expressed doubts that the court case would bring about better corporate governance at Samsung. He said, "They could bring in some minor changes, for example,

¹⁸ *Roh Tae-kang, fired by Park, is appointed vice minister*, Korea JoongAng Daily, 10 June 2017

¹⁹ <https://www.ft.com/content/ce073e32-0ca6-11dd-86df-0000779fd2ac>, accessed 26 May 2017

²⁰ *Lee Jae-yong is sentenced to five years behind bars*, Korea JoongAng Daily, 26 August 2017

²¹ *Samsung Verdict Sends a Tough New Message to South Korea Inc.*, by Choe Sang-Hun, Jeyup S. Kwaak and Paul Mozur, International New York Times, 25 August 2017

²² <http://www.reuters.com/article/us-samsung-group-succession-tax-idUSKBN0EG2SC20140605>, accessed 3 May 2017

²³ <http://www.independent.co.uk/news/business/news/disgraced-samsung-boss-returns-after-presidential-pardon-1926852.html>, accessed 3 May 2017

some executives could step down. But it is hard to expect any fundamental changes in its ownership structure.”²⁴

In fact, Lee Kun-hee made a remarkable comeback, returning as chairman of Samsung Electronics in 2010 at the age of 68. He claimed that the Samsung stakeholders wanted him back so that they could tap into his “seasoned management skill and leadership”.²⁵ But four years later, the workload finally caught up to him.

In 2012, the brother named Lee Maeng-hee and some relatives filed a 4 billion won court case against Lee Kun-hee, arguing that he had hidden shares in other people’s names to avoid detection. In this case, the court found in favour of Lee Kun-hee on the grounds that the 10-year period for inheritance claims had expired and therefore the brother’s case was null and void.²⁶ Ironically, the extra shares will eventually increase an already massive inheritance bill waiting to be paid by Lee Kun-hee’s three children.

Lee Kun-hee’s trials over allegations of bribery were not unlike those of other Chaebol bosses who had also been accused of wrongdoing in Korea. In 2007, Chung Mong-koo, the chairman of Hyundai Motor Group, was convicted of embezzlement and breach of duty; he received a suspended three-year prison sentence and a presidential pardon. The chairman of SK Group Chey Tae-won was convicted twice and received a presidential pardon twice. Kim Seung-youn, the chairman of Hanwha Group, also received a presidential pardon for assault in 2008.²⁷

New Korean Government Puts Chaebol Leaders on Alert

Despite the weight of courts cases against them, Chaebol leaders have always been protected by successive Korean governments. The four largest Chaebol, Samsung, Hyundai, SK and LG, which account for about half of the country’s stock market value, have been criticised recently for using their power for political ends. In the past, few politicians have had the power to stop Chaebol abuses but not the political will necessary to overcome the lax enforcement.

This could change under the new government of President Moon Jae-in, who won a snap election in early May 2017 on a populist platform to shake up the country’s business environment and to improve the lives of working and middle-class South Koreans and tackle unemployment. Moon’s Democratic Party only won 40% of the seats in the legislature, but will need three-fifths to pass contentious legislation to reform the Chaebol. To follow up on his campaign promises, therefore, Moon must resort to regulatory powers and budgetary measures.

²⁴ As cited at http://www.ft.com/cms/s/0/ce073e32-0ca6-11dd-86df-0000779fd2ac.html?ft_site=falcon&desktop=true#axzz4kXPlru5A, accessed 20 June 2017

²⁵ <http://www.independent.co.uk/news/business/news/disgraced-samsung-boss-returns-after-presidential-pardon-1926852.html>, accessed 3 May 2017

²⁶ <http://www.bbc.co.uk/news/world-asia-pacific-26066975>, accessed 3 May 2017

²⁷ *Samsung’s New Board Gets Back to Business*, by Bruce Einhorn, Sohee Kim, and Jungah Lee, *Global Economics*, March 6 – March 12, 2017

To this end, Moon Jae-in appointed Kim Sang-jo, a former economics professor and shareholder-rights activist, as head of the Korea Fair Trade Commission. Known as the “chaebol sniper”, Kim Sang-jo said, “I will pursue chaebol reforms through a positive campaign where companies voluntarily create exemplary cases.”²⁸ Moon Jae-in has also appointed Jang Ha-sung, a long-standing corporate governance activist as his chief of staff at coordinating economic policies.

In addition, the new administration has changed the focus of government spending, which in the past went to supporting the family-run Chaebol and their mainly export-driven industries.

Fiscal policy needs to play a bigger role in creating a virtuous circle of job creation, distribution and growth. Next year is the first full year for the Moon Jae-in administration to implement its policies.

Kim Dong-yeon, South Korea’s finance minister

Under the proposed record \$380 billion budget in 2018, the minimum wage will be increased by 16% to \$6.60 per hour, and the basic pension for South Korea’s elderly, half of whom live in relative poverty, will be increased by 50%. While the main opposition party said these measures will hurt the Chaebol such as Samsung, neither this party nor Moon Jae-in’s party have a majority in Parliament. Hence Koreans can therefore expect a fierce debate about the 2018 budget.²⁹

Conclusion

Historically, many Chaebol leaders have resisted transforming their conglomerates into more acceptable holding-company structures. They cite some pretty impressive statistics to remain in the same mould: In 1970 less than half of South Koreans went to secondary school, but now Koreans are more likely to graduate from university than people in any other country. In this same period, GDP per capita has risen to nearly \$40,000, a 20-fold increase. Behind this impressive figures have stood a group of stable family-run Chaebols which have provided a structure for this fast export-driven growth.³⁰

But Korea now finds itself in a completely different economic environment than 50 years ago, when the Chaebol first came into their own. The Chaebol-driven economy following the Korean War has run out of steam. Some Chaebol leaders are accused of choking off innovation if it comes from outside the firm, distorting external markets, and as the Lee Jae-yong affair exemplifies, engaging in corrupt practices to ensure that the founding families retain control.

Overall, Korea has been hit by downturn in investment, especially affecting smaller family-owned businesses who cannot gain access to capital. According to Oliver Salmon, an economist with advisory firm Oxford Economics in Singapore, the Chaebol have absorbed

²⁸ As cited in *The End of the Chaebol Era*, the Wall Street Journal, 28 August 2017

²⁹ *Korea set for biggest spending boost since financial crisis*, by Bryan Harris, Financial Times, 29 August 2017

³⁰ *Democracy and business move on in South Korea; Trials of a former president and Samsung’s leader are a first step*, Financial Times, 29 August 2017

much of the available capital in Korea. “The Chaebol have really strangled investment. The growth model of the past 40 years is not so good now.”³¹

In a campaign speech, President Moon Jae-in made it clear that if elected he would end the practice of offering presidential pardons to executives convicted of corruption.³² Now that he has been elected, President Moon Jae-in has said he plans to loosen the concentration of economic power in the hands of the Chaebol, while curbing unfair trade practices including cross-subsidies between Chaebol units and implementing tougher regulations. Moreover, he said he would prohibit any new cross-shareholdings within the family-owned Chaebol system.³³

³¹ As cited in *Samsung's New Board Gets Back to Business*, by Bruce Einhorn, Sohee Kim, and Jungah Lee, Global Economics, March 6 – March 12, 2017

³² <https://www.ft.com/content/5341147a-3dd4-11e7-9d56-25f963e998b2>, accessed 26 May 2017

³³ *Samsung heir's jailing may spark reforms*, ShanghaiDaily.com, 28 August 2017

Questions for Discussion

1. Why was Lee Jae-yong arrested, convicted and sentenced to five years in prison?
2. Why do you think the lower court sentenced Lee Jae-yong judges to a five-year prison sentence instead of a 12-year sentence, which was recommended by the prosecution?
3. Even if the appellate rules in favour of Lee Jae-yong, do you think it will be possible for him to regain the leadership of the firm?
4. Do you think the Lee family will come apart following this court case?
5. Do you think that Chaebol leaders consider themselves are above the law in Korea?
6. Why do you think the new government of Korea is pushing for Chaebol reform?

(End of Part 3)