STUDIES ON INDEPENDENT DIRECTORS AND CORPORATE GOVERNANCE REFORMS IN TAIWAN

BY

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DISSERTATION

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Abstract

Taiwan introduced the institution of independent directors in early 2000s in order to deal with the ill-designed internal governance system in its Company Act. Although such an institution has long been advocated as a good governance practice by the U.S corporate conventional wisdom, how it would work and how it has been working in Taiwan is very debatable. Generally, the concept of independent directors remains relatively unfamiliar to most Taiwanese companies. Statistics data indicate that majority of Taiwanese listed companies have never hired independent directors, and almost no companies have independent directors to comprise a majority of boards of directors. These facts imply that such an institution has not been so desirable in practice.

Theoretically, it is believed that independent directors will face some inherent limitations while carrying out their monitoring tasks. The most serious issue is true independence of independent directors from management, even with several mechanisms attempting to ensure their independence. Under Taiwan’s current laws and regulations, independent directors have few chances getting rid of controlling shareholders’ influence. Hence, it seems unrealistic to expect that independent directors will be able to work in a manner that detects and prevents the wrongdoing of controlling shareholders and their affiliates. In addition, some features of Taiwan’s capital market and the legal environment as a whole, will leave little hope for independent directors as effective monitors.

However, this dissertation conducts an empirical project finding significant correlation between the presence of independent directors and firm performance in Taiwanese listed electronic companies, which suggests that independent directors may make positive
contributions to companies on whose boards they serve. With the presence of block-holders, the regression results suggest that the presence of independent directors has significant and negative association with firm performance. This suggests that the coexistence of independent directors and block-holders may become a problem for companies. This is also consistent with the argument that independent directors are not likely to be effective monitors at the presence of controlling shareholders (or block-holders).

In short, the ubiquitous presence of controlling shareholders in Taiwanese companies remains a difficult problem for Taiwan’s corporate governance. After the introduction of independent directors, how to make them effectively function as expected with the presence of controlling shareholders will be tremendously important. Taiwanese policymakers should take this into consideration in making future policy of independent directors for Taiwan. Currently, Taiwan is in an experimental stage regarding this institution, and has been trying to create a friendly environment for independent directors. It is unclear whether this institution will function as an effective monitor in a satisfying manner in the future. Taiwan has not been struck by serious scandals since the Reba scandal. Politically speaking, policymakers may not have much pressure from the voters as a kind of momentum for a more ambitious policy with respect to corporate governance, and it is likely that current policy of independent directors will be sustained for a while, unless another harmful scandal strikes Taiwan again.
To my wife and parents
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Chapter One: Introduction

1.1 The Motivation Behind This Dissertation

In recent decades, Taiwan’s capital market had been tarnished by a number of corporate scandals. Most of these scandals involved false accounting reports and managerial embezzlements. These scandals occurred more frequently during the late 1990s, and they ultimately forced the government of Taiwan to take steps to improve corporate governance. Among these, the scandal involving Procomp Informatics Ltd. (Procomp) in 2004 was the most shocking in Taiwanese history.

Procomp filed for reorganization because the company was unable to pay its debts. Investigations revealed that Procomp’s president at the time, Sophia Yeh, had committed embezzlement and filed false financial reports for the purpose of defrauding investors. In addition, Procomp’s management allegedly committed several fraudulent sales to overseas buyers (i.e., dummy companies in Hong Kong set up by Procomp) so that the illusion of stable performance could be maintained. Procomp avoided detection by making misrepresentations in its financial statements and by converting their accounts receivable into deposits with financial institutions (which co-conspired with Procomp), so that Procomp could show deposits on their balance sheets that were not truthful. In fact, Procomp’s assets and cash were misappropriated by the company’s management. Unfortunately, these forms of illegal behavior had been going on for a very long time, without being noticed. It was believed that the internal monitoring device

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(i.e., “supervisors”) did little or nothing during the period of time that these crimes were being committed.

Another serious scandal unfolded in 2007. The Reba Group (Reba) filed an application for reorganization in court. Reba’s major shareholders, the Wang family, controlled every member of the boards of directors in all of Reba’s affiliates, which were heavily influenced by Reba and the Wang Family. The Wang family received assistance from their affiliated accountants, who helped the family falsify their trading and financial statements. The family even attempted to manipulate the stock prices of the affiliates through insider trading. Some members of the Wang family were prosecuted and sentenced, but the main perpetrators (the chairman of Reba and his wife) fled to the United States (the U.S.) before the scandal was detected by the government. The Reba scandal attracted a great deal of attention from the public and investors because the scandal produced huge losses for investors. A total of $2.21 billion dollars had been embezzled from the Wang family. In terms of monetary loss, the Reba scandal was the largest one that had occurred in Taiwan. In addition, the number of people involved in this scandal amounted to 107, and all of whom had been indicted on charges of embezzlement and violations of banking, accounting, and securities laws.

It is no question that both the Procomp and Reba scandals have seriously injured the credibility of the Taiwanese capital market. Contemporary Taiwanese corporate scandals have revealed that the internal checks and balances system designed by the Taiwan Company Act

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3 John S. Liu & Chyan Yang, Corporate Governance Reform in Taiwan: Could the Independent Director System Be an Effective Remedy?, 48 ASIAN SURVEY 816 (2008).
4 Id.
5 Id. at 817.
[GONG SI FA](TCA) was extremely vulnerable and dysfunctional to the extent that company managers enjoyed numerous opportunities to defraud investors. supervisors (i.e., the statutory monitoring device) were usually uninformed about managerial misconduct and, in some cases, had even become the accomplices of those who engaged in misconduct.

Many Taiwanese commentators have suggested that Taiwan develop a more effective internal monitoring device. However, there is no universal agreement regarding how to improve the current form of internal governance system. Some argue that Taiwan should introduce the institution of independent directors which exists in the U.S. because conventional supervisors have been proven to be unsuccessful in performing their monitoring tasks. Others contend that Taiwan should consider reinforcing the functions of the current statutory monitoring mechanism (i.e., supervisors), instead of introducing an institution from another jurisdiction, which may not mesh with the legal and business environment in Taiwan.

There may be no absolute right answer in this debate. As a matter of fact, in response to several scandals that have occurred in recent years, Taiwan adopted several reforms intended to improve corporate governance by building a robust internal corporate monitoring system. Taiwan’s competent authority and legislature have chosen not to go to either extreme and have instead decided to develop a new system that combines both of these suggestions. First, some

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6 The English version of the TCA is available at [http://eng.selaw.com.tw/FLAWDAT0201.asp](http://eng.selaw.com.tw/FLAWDAT0201.asp) (last visited May 15, 2011). Under the TCA, only four statutory types of companies can be incorporated, and non-statutory forms are not allowed. The four types of companies are “Unlimited Company,” “Limited Company,” “Unlimited Company with Limited Liability Shareholders,” and “Company Limited by Shares.” The “Company Limited by Shares” is the type of company that is suitable for large or publicly-held companies that raise capital from the public. Only companies incorporated in this form can go public or be listed afterwards. These types of companies are the most important types of business organizations in Taiwan, and are usually the focus of practical and academic discussions by corporation law experts. It should be noted, under the TCA, only the “Company Limited by Shares” type of company can legally have a board of directors as the necessary executive organ that is responsible for all of the affairs of the company. This type of company is the focus of this dissertation, which will refer to a “Company limited by Shares” as a “company” when referring to Taiwanese companies, unless otherwise indicated.
new provisions seek to enforce stricter qualifications regarding who can be elected as supervisors. The issue is finding people who cannot be easily controlled by the management and/or controlling shareholders as in the past. There are also some provisions that expand supervisors’ span of monitoring authority allowing them to carry out more effective monitoring. Such reforms have been proposed for the purpose of institutionalizing more powerful and independent supervisors.

Furthermore, Taiwan has introduced the institution of independent directors using U.S. laws as one part of the solutions to the problem of supervisors’ long-term failures. In 2002, the Taiwan Stock Exchange (TWSE) (with support from the competent authority) introduced the concept of independent directors by promulgating its modified listing rules (Listing Rules) that mandated all new applicants (Newly-Listed Companies) appoint at least two independent directors when applying to be listed. The Listing Rules specified that non-compliance with this requirement regarding the appointment of independent directors would automatically result in rejection from listing. The TWSE also recommended that currently listed companies, which were not subject to the Listing Rules, should voluntarily hire independent directors as they saw fit. The Listing Rules, thus, formally defined and established Taiwan’s independent directors for the first time. The appointment of independent directors has since been deemed an indicator of good corporate governance practice that can benefit companies.

Taiwan’s introduction of the institution of independent directors evolved rapidly. In addition to the TWSE’s Listed Rules with respect to the mandatory appointment of independent directors for Newly-Listed Companies, an amendment to the Taiwan Securities and Exchange Act [CHENG JUN GIAO YI FA] (TSEA) in 2006 legally introduced the institution of
independent directors and the institution of audit committees. Additionally, Article 14-2 and Article 14-3 of the TSEA provide legal authority regarding eligibility, election procedures, and the authority of independent directors. Furthermore, companies can set up audit committees to replace conventional supervisors, according to Article 14-4 and Article 14-5 of the TSEA.

The introduction of the institution of independent directors may be the most important corporate governance reform in the history of Taiwan’s corporate laws. The concept of independent directors is a whole new legal idea in Taiwan that fundamentally changes the original intention behind the internal corporate governance system in the TCA, which allows supervisors to take charge of oversight and to take action against boards of directors and management.

Traditionally, the original Taiwanese corporate laws imported most ideas from Germany and Japan. The institution of supervisors is the mechanism under Germany’s two-tier board system and has been modified by Japan. As Taiwan has been struggling with the failures of supervisors and many reforms in this regard seem futile, the U.S. laws are gradually becoming more and more important, especially in terms of corporate governance. About two decades ago, many Taiwanese scholars chose to study corporate laws in the U.S. instead of in Germany or Japan. These scholars tend to advocate U.S. laws replacing some of Taiwan’s flawed regulations, especially after the failures of recent reforms regarding supervisors. The developments of

8 For more details of provisions in the TSEA regarding independent directors and audit committee, please see 3.1.4.
10 The supervisor system in both Taiwan and Japan is weaker than in Germany. In Germany, the supervisory board has the right to elect and dismiss directors, but Japanese and Taiwanese supervisors have no right to nominate directors who must be elected by the shareholder meetings.
independent directors in the U.S., thus, have had a great deal of influence on Taiwan’s corporate governance policy.\textsuperscript{11}

The U.S. corporate conventional wisdom believes that the institution of independent directors can help companies because independent directors can significantly reduce the agency costs that arise out of the separation of ownership and control typically found in modern companies. It is the case that most U.S. listed companies have boards of directors primarily consisting of independent directors, and insiders have lost their dominance on most corporation boards. The appointment of independent directors in U.S. companies is optional and companies have freedom to choose their own governance practices at their discretion. However, the examples of Enron and other corporate scandals forced the U.S. Congress to enact the Sarbanes-Oxley Act (SOX) in 2002. This act requires public companies to establish audit committees consisting exclusively of independent directors. Self-regulatory organizations such as the NYSE and NASDAQ have also set up mandatory listing requirements that require the majority of the members of boards of directors be independent directors.

Such legal developments in the U.S. regarding independent directors have not been ignored in Taiwan, whose capital markets have suffered from many corporate scandals. One common characteristic in the corporate scandals is the lack of internal monitoring to the extent that managers were not worried about being detected and caught. Wrongdoers normally file for bankruptcy or just flee the country, and the procedures for recovering damages usually turn out to be fruitless.

\textsuperscript{11} For more details of why the U.S. laws have increasing influence on Taiwanese corporate laws, please see 4.1.3.
Independent directors have evolved in different ways in the U.S. and Taiwan. In the U.S., the concept of independent directors has become statutory in SOX, at a time when most listed companies have long-term experience with independent directors. Most U.S. companies have voluntarily chosen to have independent directors without regulations forcing them to do so. When SOX was officially enacted, the presence of independent directors was already pervasive in practice.\textsuperscript{12} In contrast, when the TWSE’s Listing Rules of 2002 and the TSEA’s amendment of 2006 were made, most listed companies did not have experience with or knowledge of independent directors, and the presence of independent directors was uncommon in practice.

In comparison with the U.S., the introduction of independent directors in Taiwan requires a thorough plan to alleviate possible shocks to companies that might result from such a legal transplantation. This dissertation seeks to provide a comprehensive study of the institution of independent directors and will discuss whether or not independent director reforms in Taiwan would solve the current corporate governance problems.

\subsection*{1.2 Academic Contributions to the Corporate Laws in Taiwan}

Taiwanese corporate laws have been deemed weak and many commentators have called for reforms to build a more robust internal governance system. Taiwanese policymakers have sought some solutions for dealing with the corporate governance problems. The introduction of independent directors is regarded as an important reform of the corporate governance system.

\textsuperscript{12} For example, according to the 2004 Korn/Ferry report, targeting 904 boards in publicly-held Fortune 1000 companies, indicated that SOX and relevant regulations had not impacted the board composition of these companies which averagely have 9 outside/independent directors (because the same number had been reported since 1990). Scholars argue that SOX appears to mirror the corporate governance trends and its impact had been fairly minimal. See Lisa M. Fairfax, \textit{Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards}, 31 OHIO N.U.L. REV. 381, 395 (2005). [hereinafter Fairfax, \textit{Corporate Federalism}]
However, the concept of independent directors is relatively new in Taiwan. This unfamiliarity has led to concerns about whether this concept would work in Taiwan.

The existing body of literature in Taiwan does not offer any comprehensive studies on the institution of independent directors; instead, it usually focuses on very specific issues. The institution of independent directors can be understood from several perspectives, and current studies have been insufficient for the purpose of providing a complete understanding of independent directors. Taiwan is currently in the experimental stage regarding the legal transplantation of the institution of independent directors. This dissertation seeks to offer a comprehensive analysis of the institution of independent directors and provide some insights relevant to Taiwan’s reforms taken in the last decade.

This dissertation will focus on theoretical studies and will examine several critical issues regarding Taiwan’s current policies concerning independent directors. The concept of independent directors was developed in the U.S., so a comparative research and analysis will be an important part of this dissertation. There will be an empirical project to examine how Taiwanese independent directors have functioned so far. In short, this dissertation is expected to provide a strong theoretical and empirical basis for Taiwan to consider whether its current independent director policy should be sustained or modified.

1.3 Main Questions to be Explored in This Dissertation

The introduction of independent directors has a great deal of potential to impact Taiwan’s corporate governance system, and Taiwanese policymakers should develop reasonable and practicable governance structures as models for use by Taiwanese companies. This dissertation will attempt to answer three main questions below.
1. Given the failures of supervisors, what specific corporate governance problems exist in Taiwan?

2. How do independent directors solve corporate governance problems in theory?

3. How have independent directors functioned in Taiwan since their introduction from the empirical point of view?

1.4 Definition of Independent Directors to be Used in This Dissertation

The definition of independent directors can vary when the term is used in different contexts. Different stock exchanges around the world have their own definitions that they use to determine who will qualify or be disqualified. For example, the NYSE disqualifies people who have material relationships with a listed company from being categorized as independent directors. NASDAQ generally defines an independent director as “a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.” Delaware cases consider independent directors to be those who do not have conflicts of interest in alleged transactions in the litigations. Notwithstanding the differences, it is universally agreed that inside

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14 Section 303A.02 in NYSE LISTED COMPANY MANUAL (as of Nov. 15, 2009): “(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company),” available at http://nysemanual.nyse.com/LCM/ (last visited Sep. 28, 2011).
directors, directors who are current employees of the company on whose board they serve, cannot be independent directors.\textsuperscript{16}

Although there is a dichotomy between independent directors and non-independent directors, there are other ways to categorize directors using other characteristics of directors. For instance, corporate literature usually categorizes directors as inside, outside, and affiliated (gray) directors. There is general agreement that inside directors mean those who are officers and employees of the company on whose board of directors they serve; otherwise, they are outside directors. Affiliated directors are outside directors who have some types of business relationship with the company.\textsuperscript{17}

Independent directors and outside directors usually have similar, but different, meanings, although these two terms are sometimes used interchangeably. Independent directors are normally outside directors who meet the prescribed criteria of independence according to laws, regulations, or the listing rules of a given stock exchange. Most the scholarly literature refers to independent directors in the sense that such directors have no financial, employment, or business ties with the company, the company’s officers, or major shareholders.

This dissertation focuses on independent directors in Taiwan, where the term “independent directors” ("Duli Donse" in Chinese) refers to those who meet the standards of independence set by the TSEA and other relevant regulations regarding Taiwanese independent directors. Basically, the term “independent directors” has the same or a similar meaning, as defined in the scholarly literature.

\textsuperscript{16} Fairfax, \textit{Inside Director}, \textit{supra} note 13, at 133.
\textsuperscript{17} Donald E. Pease, \textit{Outside Directors: Their Importance to the Corporation and Protection from Liability}, 12 Del. J. Corp. L. 25, 29 (1987).
1.5 Methodology Used in This Dissertation

This dissertation will analyze the practicality of the institution of independent directors by exploring the questions presented above. Much of the research in the dissertation will involve comparative studies of Taiwan and the U.S.

Three research methods that will be used in the dissertation are citation analysis, data collection and analysis, and empirical study. Citation analysis focuses on a theoretical foundation primarily consisting of the existing body of research literature in the U.S. involving independent directors. Taiwanese literature concerning independent directors will also be included. This dissertation will examine the benefits that independent directors are able to offer to companies from certain theoretical perspectives.

The data collection and analysis requires an understanding of certain information regarding Taiwanese independent directors, and this is in the form of data compiled by this dissertation or by some research institutes. This data can provide some facts about Taiwanese independent directors and such facts can lead to some implications about the policy of independent directors for Taiwan.

The final approach is the empirical study. The empirical project is expected to explore whether independent directors would make economic contributions to the companies on whose boards they serve. The most straightforward benefits would involve improvements of firm performance. Evidence regarding whether, and how, independent directors have positive or negative influence on firm performance is crucial in Taiwan, because it may help point Taiwan in a better direction for reforming its corporate governance practices. This dissertation is expected to offer empirical evidence that aims to examine how independent directors have
worked out in practice. The empirical section of this dissertation will attempt to explore the correlation between independent directors and firm performance, and this will be accomplished by running OLS regressions.

1.6 The Structures of This Dissertation

This dissertation is organized as follows.

Chapter Two “Corporate Governance Structures in Taiwan and the Governance Problems” begins with an introduction to the corporate governance structure designed by the TCA as the research background of this dissertation. There will also be descriptions that point out the characteristics and problems of Taiwan’s capital market.

Chapter Three “The Introduction and Evolution of Independent Directors in Taiwan” will offer a basic and comprehensive legal background review regarding Taiwan’s introduction and evolution of institution of independent directors.

Chapter Four “The Fundamental Questions Regarding Independent Directors in Taiwan” will explore the fundamental questions regarding Taiwanese institution of independent directors; they are: Why does Taiwan want independent directors? What problems will Taiwan’s independent directors face? Why do companies need independent directors?

Chapter Five “An Empirical Analysis of the Effectiveness of Independent Directors in Taiwan—Do Independent Directors Matter on Firm Performance?” will run an empirical analysis that examines the correlation between the presence of independent directors and firm performance.
Finally, Chapter Six “Conclusion” will include the findings in this dissertation.
Chapter Two: Corporate Governance Structures in Taiwan and the Governance Problems

Introducing independent directors fundamentally changes governance structures in Taiwanese companies. This chapter features an introductory analysis of Taiwanese corporate governance systems that will serve as the foundation for further analyses in this dissertation. The beginning of this chapter focuses on internal governance mechanisms (the board of directors and supervisors) and their relationships within the context of internal governance. This dissertation will then present the facts regarding common types of supervisors’ dysfunctionality in recent decades and will offer explanations of such failures. This dissertation will also illustrate Taiwan’s recent reforms of the supervisor system and will seek to determine whether or not such reforms can cope effectively with Taiwanese governance problems. Finally, this dissertation will analyze the features of Taiwan’s capital markets and the problems the country currently faces.

2.1 Internal Governance Structures in Taiwanese Companies

2.1.1 General

Under the TCA, the internal governance system in Taiwanese companies has three primary organs: shareholder meetings, boards of directors, and supervisors. The shareholder meeting is the uppermost authority that has the power to decide matters regarding certain fundamental types of transactions such as mergers, dissolutions, and reorganizations. In addition, shareholder meeting is the only organ that can elect and dismiss directors and supervisors. Thus, both the board of directors and supervisors are responsible to the shareholders at the shareholder meetings. The board of directors, except in cases involving matters reserved for the shareholder meetings by the TCA or the articles of incorporation of a given company, has absolute authority over the business operations of companies. Supervisors are the statutory monitoring organ and
must regularly oversee the conduct of the board of directors and the board-appointed officers (refer to Figure 1 for details).

Figure 1: Three Primary Organs of Taiwanese Companies

Source: Author

Taiwan has essentially adopted a modified two-tier board system. Unlike the German two-tier board system, supervisors have no real authority to elect or dismiss board members. Board of directors and supervisors are instead parallel, and both are responsible to the shareholders during the shareholder meetings. However, it is impossible for those in attendance at shareholder meetings to exercise regular oversight of board performance. The TCA provides that supervisors engage in monitoring responsibilities to oversee the legality and appropriateness
of the conduct of executive boards in the interest of all of the shareholders. Execution and monitoring are conducted separately using different devices, and ideally the monitoring device can function effectively without interference from those involved in execution. However, the reality is that supervisors are usually too weak to detect ongoing wrongdoing in time and sometimes are entrapped into becoming the accomplices of wrongdoers. The result has been universal admission by Taiwanese commentators that supervisors generally fail to function as desired in the role of providing effective and robust monitoring on boards of directors and officers.

Note that legal sources of Taiwan’s corporate laws consist of several codes. In addition to the TCA, the TSEA also has certain provisions that preempt articles of the TCA with respect to public companies. Thus, although the primary goal of the TSEA is the regulation of the issuance and exchange of securities, the TSEA also offers legal resources for public companies. Additionally, the TCA and TSEA authorize competent authorities to issue supplemental regulations to these two statutes.\(^\text{18}\)

### 2.1.2 The Board of Directors

Under the TCA, a board of directors has statutory power with respect to all of the affairs of a given company, including all of the powers necessary to appoint and dismiss company officers, prepare financial reports, convene annual or provisional shareholder meetings, and resolve material and fundamental transactions prior to the review during shareholder meetings.\(^\text{19}\) In other words, the board of directors generally has unlimited power regarding the operations of

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\(^{18}\) Taiwan’s Ministry of Economic Affairs (“MOEA”) is the competent authority of the TCA, and Financial Supervisory Committee (“FSC”) is the competent authority of the TSEA.

\(^{19}\) Article 202 of the TCA.
the company. The primary exceptions involve specific matters that are proscribed by the TCA or the articles of incorporation of the company. Such matters are reserved for the approval by the shareholders during shareholder meetings. Proscribed items include fundamental transactions such as mergers, reorganizations, liquidations, dissolutions, and powers of electing and dismissing directors.\(^{20}\)

### 2.1.2.1 The Minimum Number of Seats on Boards

There are a statutory minimum number of directors that should comprise the membership of a board of directors. The TCA provides that no fewer than three directors should comprise the board of directors, and shareholders should elect these members during shareholder meetings with the cumulative voting as the default rule (the articles of incorporation can provide otherwise).\(^{21}\) If the company has “managing directors” who are statutory sub-organs under the board of directors, and regularly exercise the power and authority of the board of directors when the board of directors is in recess, there should be at least nine directors on board.\(^{22}\) There is another requirement that public companies must have at least five directors on their boards.\(^{23}\)

### 2.1.2.2 How Boards Exercise Power

The board of directors convenes meetings to discuss and pass important matters as necessary. Unless otherwise provided for in the TCA, resolutions made by the board of directors

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\(^{20}\) According to Article 202 of the TCA, business operations of a company shall be executed pursuant to the resolutions to be adopted by the board of directors, except for the matters the execution of which shall be effected pursuant the resolutions of the shareholder meeting as required by laws or the articles of incorporation of the company.

\(^{21}\) Article 198 of the TCA.

\(^{22}\) According to Paragraph 2, Article 208 of the TCA, the managing directors shall be elected from among the directors, and the number of managing directors shall not be less than three persons but not more than one-third of the total number of directors.

\(^{23}\) Paragraph 1, Article 26-3 of the TSEA.
shall be adopted by a majority of the attendees at meetings attended by a majority of the directors.\textsuperscript{24}

Senior officers (i.e., CEOs) are appointed by the board of directors and are the people who actually handle the company’s daily affairs and the business operations of the company. The board of directors has the authority to dismiss managers at any time without cause if they are dissatisfied with their performance.\textsuperscript{25} Thus, the board of directors is also responsible for monitoring managers.

2.1.2.3 Qualifications and Disqualifications for Directors

Under the TCA, any individuals (i.e., “natural persons”) with legally disposing capacity can be elected as directors.\textsuperscript{26} In addition, a director must not be a supervisor and must not have any disqualifications of the types specified by the TCA; a director will be automatically dismissed as a result of the operation of the law, if he or she has any disqualifications.\textsuperscript{27}

It should be noted that institutional shareholders (e.g., government and corporate shareholders) can be elected as directors or supervisors in their own capacity, but they should

:\textsuperscript{24} Article 206 of the TCA.
:\textsuperscript{25} Article 29 of the TCA.
:\textsuperscript{26} Before the amendment of Nov. 12, 2001, only shareholders were eligible to be elected as directors. This elective qualification was deleted in a later amendment.
:\textsuperscript{27} Such disqualifications include (Article 30 of the TCA):
1. Having committed an offence as specified in the “Statute for Prevention of Organizational Crimes” and subsequently adjudicated guilty by a final judgment, and the time elapsed after he has served the full term of the sentence is less than five years;
2. Having committed the offence in terms of fraud, breach of trust or misappropriation and subsequently punished with imprisonment for a term of more than one year, and the time elapsed after he has served the full term of such sentence is less than two years;
3. Having been adjudicated guilty by a final judgment for misappropriating public funds during the time of his public service, and the time elapsed after he has served the full term of such sentence is less than two years;
4. Having been adjudicated bankrupt, and having not been reinstated to his rights and privileges;
5. Having been dishonored for unlawful use of credit instruments, and the term of such sanction has not expired yet;
6. Having no or only limited disposing capacity.
appoint representatives to exercise the powers of directors and supervisors for them. In addition, institutional shareholders can have their representatives elected to act as directors or supervisors. Thus, an institutional shareholder may have two or more different representatives concurrently elected as director(s) and supervisor(s). Finally, as is the case with individual directors, their representatives must not have any of the disqualifications spelled out in Article 30 of the TCA. During their representatives’ terms of office as directors, institutional shareholders have the absolute right to have new representatives take office at any time for the remainder of their term. This phenomenon severely undermines the effectiveness of internal checks and balances within a company; as such, so many Taiwanese commentators have suggested deleting Article 27 of the TCA. While this Article provides flexibility for closely held companies, it may create corporate governance problems, as explained, for public companies. However, this Article remains in place for political reasons. The 2006 amendment to the TSEA has made this Article inapplicable to public companies, but this Article remains applicable to non-public companies (refer to Table 1 for more details).

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28 Paragraph 1, Article 27 of the TCA.
29 Paragraph 2, Article 27 of the TCA.
30 Paragraph 3, Article 27 of the TCA.
31 Article 26-2 of the TSEA. When the government or a juristic person is a shareholder of a public company, then except with the approval of the Competent Authority, the provisions of Article 27, paragraph 2 of TCA shall not apply, and a representative of the government or juristic person may not concurrently be selected or serve as the director or supervisor of the company.
Table 1: Qualifications and Disqualifications for Directors

<table>
<thead>
<tr>
<th>Qualifications</th>
<th>Individuals</th>
<th>Institutional Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualifications</td>
<td>No need to be shareholders; Any individual with disposing capacity (e.g., over age 20, or married)</td>
<td>Hold at least one share.</td>
</tr>
</tbody>
</table>

| Disqualifications | Not a supervisor; Items listed in Article 30 of the TCA. | Representatives have items listed in Article 30 of TCA, but the legal person or government can reappoint other representatives at any time and take over predecessors’ offices for the remainder of their terms; In public companies, an institutional shareholder and their representatives who have been elected as supervisor(s) cannot become a director. |

Source: Author

2.1.2.4 Methods of Electing Directors

All directors shall be elected at shareholder meetings, and these are usually held annually. The most frequently-used election method in practice is the cumulative voting, which computes the number of exercisable votes by multiplying the number of shares and the number of directors to be elected, and the total number of votes may be consolidated to support one candidate or may be split up for the purpose of supporting two or more candidates. The cumulative voting was the mandatory rule for the election of directors before 2001, because the legislation at that time was of the opinion that if there should arise conflicts of interest between several groups of shareholders, they could monitor each other. Under the cumulative voting

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32 Article 192 of the TCA. Boards of directors in Taiwanese companies cannot appoint a new director to fill a vacancy. Every director should be elected in shareholder meetings.

33 Article 198 of the TCA.
system, minority shareholders or their representatives have more opportunities to be elected as directors and could, thus, act as watchdogs for the interests of all of the shareholders.

However, this mandatory rule has been criticized, because it may unduly interfere with the internal affairs of the company. Additionally, boardroom harmony is also essential for efficient decision-making on the part of boards. Thus, the 2001 amendment to the TCA makes this election method the default rule. Companies can get it around by specifically adopting another election method as set forth in their articles of incorporation. As a matter of fact, cumulative voting remains the most frequently adopted practice.

In addition to cumulative voting, the 2005 amendment to the TCA also introduced the so-called “candidates nomination system,” which allows only certain types of eligible persons to enjoy the right to propose the slate of director candidates from which shareholders shall pick candidates to elect.\(^\text{34}\) Such a system can only be adopted by public companies, and such a form of adoption shall be expressly stipulated in the articles of incorporation. Under this system, only shareholder(s), individually or aggregately, who hold 1% or more of the total number of outstanding shares of the company and the board of directors have right to propose a slate.

Directors can serve up to three years, according to the articles of incorporation. Most Taiwanese companies stipulate in their articles of incorporation that directors (and supervisors) shall enjoy three-year terms. Such terms of office should be fixed for each director unless the

\(^{34}\) Article 192-1 of the TCA.
shareholder meeting amends the articles of incorporation. Unlike U.S. corporate laws, staggered boards are not permissible in Taiwan.\(^3^5\)

### 2.1.2.5 The Role of the Boards of Directors in Taiwan

Generally, the boards of directors in Taiwanese companies tend to be executive (managing) boards, rather than the monitoring (supervisory) boards that are usually seen in U.S. companies. Most Taiwanese companies are family-founded and mid-size companies. The founding shareholders usually maintain their shareholdings even after the companies go public so that they can keep dominance in managing business by electing themselves or their favorable persons as directors and managers. As a result, most Taiwanese boards of directors are comprised of inside directors. It is also common that a person serves as the board chairman (also the president of a Taiwanese company) and CEO within a company and such person normally is the controlling or big shareholder who has dominant power in the boardroom (see 2.4 for details).

The boards of directors in Taiwanese companies are also responsible for monitoring managers, because the boards are authorized to dismiss disqualified or underperforming managers. However, the main board function is still management. The monitoring function is assigned to a statutory monitoring device – supervisors.

2.1.3 Supervisors

2.1.3.1 Statutory Monitoring Device

Boards of directors are powerful in business operation in Taiwanese companies. Therefore, establishing a checks and balances system within a company requires a statute-required monitoring organ known as “supervisors,” which has been designed to monitor the legitimacy and appropriateness of the conduct of board of directors and board-appointed officers.\(^{36}\) Supervisors are generally expected to monitor conduct that may be in violation of laws, regulations, or the articles of incorporation, and they must also examine and verify the financial reports of the company to ascertain that the interests of all of the shareholders have been satisfied.\(^{37}\) Effective monitoring by supervisors of the behavior of board of directors and officers should maximize shareholder interests and decrease opportunities for the board of directors and officers to breach the fiduciary duties they owe to the company and shareholders.

2.1.3.2 Minimum Number of Supervisors and Method of Electing Supervisors

Every company must appoint at least one supervisor within that company, because this statutory monitoring device is required by statute. Public companies must have at least two supervisors in order to be in accordance with the TCA. Article 9 of the Listing Rules requires Newly-Listed Companies to appoint at least three supervisors when they apply to become listed.

\(^{36}\) For example, according to the Article 218 of the TCA, supervisors shall supervise the execution of business operations of the company, and may at any time or from time to time investigate the business and financial conditions of the company, examine the accounting books and documents, and request the board of directors or managerial personnel to make reports thereon.

\(^{37}\) According to Article 23 of the TCA, both directors and supervisors shall owe duty of care and duty of loyalty to the company and shall be responsible for damages incurred by breaches of such duties.
Supervisors shall be elected by shareholder meetings under the cumulative voting as the default rule (articles of incorporation can stipulate otherwise). Companies also can opt to adopt the candidate nomination system as their method of electing supervisors.

2.1.3.3 Monitoring Powers of Supervisors

Supervisors can individually exercise their supervisory powers without obtaining the consent of all of the supervisors or the consent of the majority of all of the supervisors, which can eliminate the collective action problem, particularly when the majority of supervisors are controlled by, or unduly influenced by, controlling shareholders or management. However, if there are different ideas regarding whether or how to exercise monitoring power among several supervisors, then that can lead to conflicting and inefficient monitoring. For example, each supervisor has the discretionary right to exercise his or her authority on the behalf of the company to hire legal consultants or accountants as necessary to help them review and verify corporate financial reports, though inefficiency may result from repeatedly hiring consultants and accountants.

One important weapon of supervisors is the right to verify financial reports prepared by the board of directors. Examining financial reports provides supervisors with opportunities to uncover hidden misconduct on the part of management. Supervisors are empowered to enjoy representation rights regarding the company in certain specific situations involving conflicts of interest between directors and the company. In situations such as “self-dealings” or company

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38 Article 216 of the TCA.
39 Article 221 of the TCA.
40 Paragraph 2, Article 218 of the TCA.
41 According to Article 213 of the TCA, in case of a lawsuit between the company and a director, the supervisor shall act on behalf of the company, unless otherwise provided by law; and the meeting of shareholders may also appoint some other person to act on behalf of the company in a lawsuit.
litigation against director(s), supervisors shall be the representatives for the company as the default rule so as to avoid potential breaches of the duty of loyalty in cases involving conflicts of interest.

2.2 Dysfunctions of Supervisors

Supervisors have monitoring power and representation rights, and they are expected to robustly and effectively monitor the board of directors and its appointed officers. However, these theoretical functions are rarely practiced in reality, and numerous corporate scandals have occurred in Taiwan in recent decades. The classic types of scandals have usually involved embezzlement by management (board of directors and senior officers) or illegal appropriations for unauthorized investments that have served only the interests of management. In the meantime, false financial reports have been used to disguise such illegal behavior. If supervisors do their jobs properly, they can review financial reports and attempt to uncover irregularities. Unfortunately, they usually fail to do their jobs and such failures can sometimes lead to massive financial damage being inflicted on investors.

Many Taiwanese corporate commentators agree that supervisors have not functioned as originally anticipated in the TCA. Sometimes the supervisors became the accomplices of those who committed crimes. The primary reasons why Taiwanese supervisors fail to do what they should do include:

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42 According to Article 223 of the TCA, in case a director of a company that transacts sales with, or borrows money from, or conducts any legal act with the company, on his own account or for any other person, the supervisor shall act as the representative of the company.
2.2.1 Lack of Independence

The TCA seeks to maintain objective monitoring by supervisors. The TCA, thus, provides that a supervisor cannot act concurrently as a director, a managerial officer or other staff/employee of the company.43 Supervisors should exercise power for the benefit of all shareholders. In an ideal world, they should not be controlled or influenced by the management or any other groups or individuals when they exercise their monitoring powers. Independence is required by the TCA, but the current election mechanism for supervisors actually weakens the independence of supervisors. According to the TCA, directors and supervisors shall be elected at shareholder meetings, and elections for directors and supervisors must be held separately. Therefore, shareholder votes should be computed separately for each election. Shareholders can manipulate their votes during two different elections so as to secure as many directors and supervisors as they desire. Due to the separate elections requirement, it is likely that the controlling shareholders or those who hold large blocks of stock will be able to control the majority of the board of directors and the majority of supervisors in certain situations. The result is that contradictions can occur within the system of checks and balances.

Even with cumulative voting as the default rule, in which minority shareholders could have their favorite candidates elected, and controlling shareholders or those who hold blocks of stock could still control the board of directors. Since supervisors are supported by the same groups of shareholders, it is difficult to expect them to effectively monitor directors who have been captured by the large shareholders. The concentrated nature of ownership structures in most Taiwanese companies (even listed companies) has led to the common belief that supervisors can be controlled by controlling shareholders and block-holders in certain circumstances.

43 Article 222 of the TCA.
This situation can become even worse. Article 27 of the TCA allows the institutional shareholders to have several representatives elected as directors and supervisors. Therefore, some directors and supervisors may be elected with the support from the same institutional shareholders. It would be unrealistic to expect such supervisors to robustly monitor directors with whom they are affiliated.

In certain extreme cases, a controlling shareholder can control the majority of seats on the board of directors and control all of the supervisors, which means that a true system of checks and balances does not exist. In practice, the election methods and the concentrated ownership structures of Taiwanese companies dictate that supervisors usually have close family or social ties with controlling shareholders who support them in elections. Thus, in practice, they tend to be figureheads instead of watchdogs for the interests of shareholders. 44

2.2.2 Lack of Adequate Power

Most commentators agree that supervisors do not have the supervisory power necessary to perform their monitoring duties. For example, Article 218-2 of the TCA stipulates that supervisors can ask the board or the director(s) whose conduct is allegedly in violation of the law, articles of incorporation, or shareholder meetings resolutions to discontinue such conduct. However, this will not effectively prevent the board or director(s) from continuing to engage in such misconduct. The only method available to supervisors is to claim damages on the behalf of the company, but this can be done only after actual damages have resulted from misconduct. In some situations, doing this may be too late, because wrongdoers often abscond with money.

44 OECD Corporate Governance in Asia, supra note 1, at 21.
2.2.3 Asymmetry of Information

Another difficulty that obstructs supervisors is the asymmetry of information between the boards of directors and supervisors. Supervisors are not board members, and they are usually sealed off from important information that could otherwise become the basis for launching necessary investigations.

To sum up, the TCA equips supervisors with some monitoring capabilities.\textsuperscript{45} When the board of directors violates laws, regulations or company’s articles of incorporation, supervisors may request that the board terminate engaging in such acts. Supervisors also can convene special shareholder meetings for the purpose of dismissing directors. Avoiding conflicts of interest between directors and the company requires that supervisors, instead of the president, shall act as the representatives of the company. Finally, when eligible shareholders (meaning those who have continuously held 3% of the company’s shares for more than one year) make a request to particular director(s), a supervisor can take legal action against a director of the company. However, supervisors usually lack adequate information, independence from directors and shareholders, and have insufficient supervisory power. As a result, supervisory failures occur in public and private companies, small and large, in Taiwan.

2.3 Recent Reforms Concerning Supervisors in Taiwan

Reforms have recently been made in Taiwan for the purpose of remedying supervisors’ failures. These reforms fall into three categories: (1) enhancing independence, (2) additional supervisory powers, and (3) alleviating asymmetry of information.

\textsuperscript{45} Corporate Governance in Taiwan, supra note 2, at 14-15.
2.3.1 Enhancing Independence

The 2001 amendment to the TCA requires public companies to have more than two supervisors.\textsuperscript{46} When there is a minimum of two supervisors, any controlling shareholder is less likely to be able to secure all of the seats for supervisors, except for certain types of extreme situations in which shareholders hold substantial percentages of shares. In such cases, minority shareholders with different interests may have more opportunities to have their candidates elected. Therefore, there can be supervisors who represent the interests of splinter groups of shareholders, instead of supervisors who work exclusively to promote the interests of controlling shareholders. Conflicts of interest among different groups of shareholders should encourage them to watch each other, which would allow checks and balances to be maintained for most shareholders. The minimum requirement that there be at least two supervisors can allow supervisors to share their monitoring workloads, and it better equip them to detect wrongdoing.

Article 26-3 of the TSEA stipulates that, except when approval from a competent authority has been given, a company shall have at least one supervisor who does not have relationships with other supervisors and directors, including: (1) spousal relationship; or (2) familial relationship within the second degree of kinship. The laws require that ineligible supervisors be automatically dismissed. Taiwan’s legislature hopes to enhance supervisors’ independence from other supervisors and directors. Requiring that companies hire one qualified supervisor with no close family ties to other supervisors and directors is one part of an effective checks and balances system. Unfortunately, Taiwanese law ignores the ties with controlling shareholders, which has long been a serious problem.

\textsuperscript{46} Paragraph 2, Article 216 of the TCA.
Section 2 of Article 26-3 of the TESA preempts Article 27 of the TCA. This means that representatives of the institutional shareholders may not be concurrently selected to act as directors and supervisors in a public company. Therefore, shareholders are eligible for election as either directors or supervisors. Institutional shareholders who have their own representatives elected as directors are unlikely to support their representatives to be elected as supervisors. It should be noted that this article is applicable only to public companies. This means that in non-public companies the institutional shareholders are allowed to have their representatives elected to become directors and supervisors.

Overall, the lack of independence from controlling shareholders and management has led Taiwan to reforms to enhance the independence of supervisors by requiring a mandatory minimum number of supervisors in a public company, by demanding at least one supervisor who has no close familial ties with directors and/or other supervisors, and by making Article 27 of the TCA inapplicable to public companies.

2.3.2 Additional Types of Supervisory Power

Recent amendments to the TCA provide supervisors with certain types of power, and constitute an attempt to develop a more effective form of monitoring. Situations such as directorate elections and lawsuits against directors typically require a resolution by shareholder meeting as matter of law. Boards of directors can, thus, avoid potential dismissal and lawsuits against themselves by not convening shareholder meetings. The TCA has attempted to deal with this problem by providing that when the board of directors refuses to, or is unable to, convene
shareholder meeting, supervisors may call a meeting when they deem it necessary for the benefit of the company.\textsuperscript{47}

Supervisors are not board members. They usually have no knowledge of the topics the board of directors discusses in the boardroom. Article 218-2 of the TCA specifies that supervisors can attend board meetings and deliver their opinions to the board. Attending the board meetings provides supervisors with opportunities to detect management misconduct.

2.3.3 Alleviating Asymmetry of Information

Article 218-2 of the TCA allows supervisors to obtain access to the agendas discussed in boardrooms. The law also requires directors to report to supervisors in certain situations. Article 218-1 of the TCA specifies that when a director discovers that the company is likely to suffer substantial damages, he or she shall report to the supervisors immediately. The director, thus, has the legal obligation to report to supervisors and provide them with the necessary information immediately in order to allow them to take precautionary steps to prevent possible wrongdoing.

2.3.4 Other Proposals for Supervisor System Reforms

2.3.4.1 Independent Supervisors

In 2002, the Listed Rules began requiring Newly-Listed Companies to appoint not only at least two independent directors, but also at least one independent supervisor. Supervisors may be subject to the influence of controlling shareholders, so the idea of independent supervisor was introduced to enhance independence of supervisors and thereby allow them to engage in objective, effective monitoring. However, Taiwanese policymakers have never adopted this

\textsuperscript{47} Article 220 of the TCA.
concept. When independent directors were to be codified into the TSEA, independent supervisors lost their importance. In 2006, the Listing Rules abandoned the concept of independent supervisors as a listing requirement for Newly-Listed Companies.

2.3.4.2 Supervisory Boards

Any Taiwanese supervisor can exercise monitoring power in an individual capacity, without interference from their fellow supervisors. Hence, when there are multiple supervisors in one company, they do their monitoring jobs on their own, and coordination between the supervisors may be insufficient to the extent that monitoring efficacy may be reduced. Free-rider problems may exist among uncoordinated supervisors. Also, monitoring by individual supervisors may be insufficient to fight against the board of directors as a whole.

Some Taiwanese scholars argue that Taiwan should consider introducing “supervisory boards” to replace the current institution of supervisors. The supervisory board system would operate in a manner that each supervisor would not exercise power individually, and supervisors would instead convene meetings to make resolutions by the majority of supervisors. Just as is the case with independent supervisors, supervisory boards have never drawn much attention from Taiwanese policymakers. The probable reason is that Taiwanese policymakers have lost confidence in conventional supervisors or other similar institutions.

2.3.4.3 Conclusion

Several methods have been utilized to reinforce supervisory monitoring, but drawbacks remain for the institution of supervisors in the TCA. The standards of independence for supervisors are too loose, given that controlling shareholders remain capable of capturing
supervisors. For example, even under Article 26-3 of the TSEA, having ties to controlling shareholders does not disqualify supervisors. The current disclosure rules for Taiwanese listed companies require companies to disclose relevant information in their annual reports in cases where supervisors have close blood relationships with major shareholders who hold 1% or more of the outstanding shares (or are top-ten shareholders). The law does not prohibit controlling shareholders from using “bubbleheads” acting on their behalves if they want to avoid compliance with disclosure rules.

Despite recent supervisor system reforms, many commentators still have serious reservations regarding the effectiveness of supervisors, and continue to call for additional reforms that require companies to appoint independent directors to replace supervisors. Because there are concerns about the legal transplantations of independent directors, Taiwanese policymakers have not completely abandoned supervisors.

2.4 Features of Taiwanese Capital Markets and Corporate Governance Issues

This section of the dissertation will describe certain features of the Taiwanese capital market, in order to facilitate an analysis of Taiwanese corporate governance issues. Such features include family-controlled companies, cross-holdings and affiliated companies, concentrated ownership structures, and the passive role of institutional investors.

2.4.1 Family-Controlled Companies

Small- and medium-sized companies comprise over 90% of all of the companies (closely-held and publicly-held) in Taiwan.48 Board members in such companies tend to be family

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48 Corporate Governance in Taiwan, supra note 2, at 5.
members and outsiders typically do not exert a substantial degree of control over the board of directors.\textsuperscript{49} Even after such companies go public or become listed companies, family members in some of these companies will retain boardroom dominance by having numerous family members and affiliates elected to the boards. Even though family members fail to keep dominance in the company after it goes list, they usually keep a substantial amount of shares that can ensure their representatives present in the boardroom.

In general, both advantages and disadvantages exist in such family-controlled companies (there is no official definition of family-controlled companies in Taiwanese laws. Here, a family-controlled company refers to a company whose board of directors is directly or indirectly dominated by a given group of family members). On one hand, family members can exert a strong leadership style and develop cohesive management teams, and they can run such businesses more smoothly than a company that must deal with various factions of shareholders. In addition, the presence of a large group shareholder can serve as a governance mechanism for policing management.\textsuperscript{50}

One the other hand, the controlling shareholders in a family-controlled company may exploit the interests of minority shareholders if no effective monitoring exists. Family-controlled companies have aroused concerns about corporate governance, because they have the potential for allowing controlling shareholders to gain benefit at the expense of non-controlling shareholders.\textsuperscript{51} In Taiwanese family-controlled companies, family members usually do not allow outsiders to become supervisors who can interfere with their control of the companies. The absence of internal monitoring does not necessarily mean that illegal activities are taking place.

\textsuperscript{49} Id.
\textsuperscript{51} Id.
However, if family members experience financial difficulties, they are likely to have fewer
inhibitions about exploiting their positions for personal gain. The Reba scandal provides an
example of this. All of the supervisors in the affiliates were family members or close relatives.
When the Wang family faced financial difficulties, they misappropriated corporate assets without
being monitored.\textsuperscript{52}

In short, a tradeoff can arise when controlling shareholders are present; benefits of
reducing managerial agency costs, and costs of controlling shareholders’ exploitations.\textsuperscript{53} Non-
controlling shareholders may welcome the presence of controlling shareholders only when the
benefits exceed the costs.\textsuperscript{54} However, the presence of controlling shareholders is usually less
admirable in Taiwan, because numerous scandals have turned out to involve controlling
shareholders.

\textbf{2.4.2 Pervasive Cross-Holdings and Affiliated Companies}

Taiwanese companies like to use cross-shareholdings of affiliated companies to
strengthen their control in the companies. Prior to 2001, the TCA had no provision that
prohibited cross-shareholding between parent companies and subsidiary companies.\textsuperscript{55} Subsidiary
companies have been set up as investment companies that buy large amounts of their parent
companies’ shares, a form of manipulation of the cross-holdings of shares. The directors of the
parent company usually elect themselves or their affiliates as directors of subsidiaries. This
allows them to influence how the subsidiaries vote in elections of parent company directors and

\textsuperscript{52} See Chapter One for the Reba scandal.
\textsuperscript{53} Gilson & Gordon, supra note 50, at 786.
\textsuperscript{54} Id.
\textsuperscript{55} \textit{Corporate Governance in Taiwan}, supra note 2, at 6.
supervisors. This method allows directors of the parent company to entrench themselves and prevent replacement regardless of how poorly they run the company (see Figure 2).

**Figure 2: Entrenchment of the Incumbent Directors of Parent Companies Through Cross-Shareholdings**

![Diagram showing entrenchment through cross-shareholdings](image)

Source: Author

The TCA was amended to deal with this problem by prohibiting subsidiaries from purchasing shares of their parent companies.\(^{56}\) In addition, subsidiary companies shall have no voting power vested in the shares issued by their parent companies.\(^{57}\) However, companies can bypass such prohibitions by setting up several indirectly affiliated companies or by failing to

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\(^{56}\) According to Paragraph 4, Article 167 of the TCA, where the holding company and its subordinate company jointly hold or possess a majority of the total number of outstanding shares or of the total amount of the capital stock of another company, the shares of the said holding company and its subordinate company shall also not be purchased nor be accepted as a security in pledge by the said another company.

\(^{57}\) According to Article 179 of the TCA, the shares shall have no voting power under any of the following circumstances:
1. the share(s) of a company that are held by the issuing company itself;
2. the shares of a holding company that are held by its subordinate company, where the total number of voting shares or total shares equity held by the holding company in such a subordinate company represents more than one half of the total number of voting shares or the total shares equity of such a subordinate company; or
3. the shares of a holding company and its subordinate company that are held by another company, where the total number of the shares or total shares equity of that company held by the holding company and its subordinate company directly or indirectly represents more than one half of the total number of voting shares or the total share equity of such a company.
reach the legal threshold (i.e., 50% of the voting shares or the total number of shares of a company).

As a result, there is no generally effective way to avoid such arrangements, and the government offers the alternative of choosing to request that, under certain conditions, companies disclose whether they have cross-holdings in the affiliated companies. However, a controlling company can get around these disclosure rules. Figure 3 shows that E can indirectly control Listed Company D through multiple investments. B and C can be elected as D’s directors and supervisors under Taiwanese laws, and E can have substantial control over D.

**Figure 3: Investment Arrangements to Control a Company**

![Investment Arrangements Diagram](image)

Source: Author

2.4.3 Ownership Structures

In comparison with U.S. companies, ownership structures of Taiwanese companies tend to be relatively concentrated. The block-holders (meaning those who control more than 5% of the outstanding shares) in listed companies are commonplace in the market. For example, among Taiwanese listed electronics companies that on average have appointed more than one
independent director on a monthly basis during 2005-2008, as shown in Table 2, the mean numbers of block-holders among the companies are around 1.8. Such ownership concentration is rarely seen in U.S. public held companies.

Table 2: Numbers of Block-Holders in Taiwanese Electronics Listed Companies with at Least One Independent Director (2005-2008)

<table>
<thead>
<tr>
<th>Year</th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>151</td>
<td>0.00</td>
<td>9.00</td>
<td>1.9801</td>
<td>1.51644</td>
</tr>
<tr>
<td>2006</td>
<td>157</td>
<td>0.00</td>
<td>9.00</td>
<td>1.9299</td>
<td>1.47246</td>
</tr>
<tr>
<td>2007</td>
<td>160</td>
<td>0.00</td>
<td>8.00</td>
<td>1.7313</td>
<td>1.37691</td>
</tr>
<tr>
<td>2008</td>
<td>175</td>
<td>0.00</td>
<td>8.00</td>
<td>1.7771</td>
<td>1.40669</td>
</tr>
</tbody>
</table>

Source: Taiwan Stock Exchange

The concentrated ownership structures of many Taiwanese companies raise concerns about Taiwanese corporate governance. One, or a small number of, controlling shareholder(s), who directly or indirectly control the boards of directors and supervisors, can easily capture some companies. When minority shareholders pay more attention to the stock price than to the firm’s performance, the controlling shareholders may take advantage of opportunities to defraud investors.

In Taiwan’s capital market, most of the capitalization of listed companies comes from individual investors who tend to focus on the stock price fluctuations of their holdings rather than corporate governance issues. In a manner consistent with “rational ignorance,” they believe that the expected financial benefits of making informed shareholder voting decisions are
outweighed by the expense of becoming informed. They prefer to sell the shares of companies that underperform or experience financial crises, but they usually suffer financial losses in the corporate scandals.

2.4.4 Passive Institutional Investors

In Taiwan, individual investors constitute almost 80% of trading volume, and are the major participants in the stock market, with institutional investors owning only a minor portion of shares. For example, Table 3 shows that in 2009, foreign institutional investors held an average of 16.4%, and domestic institutional investors held an average of 11.6%, of the overall stock market. As mentioned above, when making investment decisions, individual investors are swayed by market sentiments to a greater extent than institutional investors. They often care little about the business activities of the companies in which they invest and often fail to vote in elections of directors and supervisors.

In Taiwan, institutional investors are restricted by regulations regarding the shareholding limit on the total number of shares they are allowed to own or hold during a certain period. As is the case with individual investors, Taiwanese domestic institutional investors are more interested in stock prices than in governance issues. Taiwan’s government recently initiated a policy of increasing the role of institutional investors with regard to corporate governance. Unfortunately, their ownership remains too limited to advocate in favor of changes in corporate

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59 CORPORATE GOVERNANCE IN TAIWAN, supra note 2, at 7.
60 Id. at 8.
61 Id.
governance. Also, in the absence of institutional mechanisms to protect interests of foreign investors, they will likely have short-term investments rather than long-term investments.

Table 3: Types of Investors and Trading Value Ratios in the Stock Market

<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic institutional investors</th>
<th>Foreign Institutional Investors</th>
<th>Domestic Individual Investors</th>
<th>Foreign Individual Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>9.4</td>
<td>2.4</td>
<td>88.2</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>10.3</td>
<td>3.6</td>
<td>86.1</td>
<td>0</td>
</tr>
<tr>
<td>2001</td>
<td>9.7</td>
<td>5.9</td>
<td>84.4</td>
<td>0</td>
</tr>
<tr>
<td>2002</td>
<td>10.1</td>
<td>6.7</td>
<td>82.3</td>
<td>0.9</td>
</tr>
<tr>
<td>2003</td>
<td>11.5</td>
<td>9.4</td>
<td>77.8</td>
<td>1.3</td>
</tr>
<tr>
<td>2004</td>
<td>11.6</td>
<td>10.9</td>
<td>75.9</td>
<td>1.6</td>
</tr>
<tr>
<td>2005</td>
<td>15.4</td>
<td>14.5</td>
<td>68.4</td>
<td>1.7</td>
</tr>
<tr>
<td>2006</td>
<td>11.0</td>
<td>16.2</td>
<td>70.6</td>
<td>2.2</td>
</tr>
<tr>
<td>2007</td>
<td>13.0</td>
<td>17.6</td>
<td>67.3</td>
<td>2.1</td>
</tr>
<tr>
<td>2008</td>
<td>14.0</td>
<td>22.1</td>
<td>61.7</td>
<td>2.3</td>
</tr>
<tr>
<td>2009</td>
<td>11.6</td>
<td>16.4</td>
<td>72</td>
<td>0</td>
</tr>
<tr>
<td>2010.01-2010.08</td>
<td>13</td>
<td>19.2</td>
<td>67.8</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: CORPORATE GOVERNANCE IN TAIWAN, supra note 2, at 8.

Table 4 shows that because appointing independent directors is viewed as a good governance practice, foreign corporate/institutional investors generally become more interested in investing companies that have independent directors than companies that have no independent directors. However, domestic corporate/institutional investors see the appointment of independent directors as a minor factor when they make investment decisions.

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62 Id.
63 Wang & Pang, supra note 9, at 3.
64 CORPORATE GOVERNANCE IN TAIWAN, supra note 2, at 8.
Table 4: Percentages of Average Shareholdings Among Foreign and Domestic Corporate/Institutional Investors in Taiwanese Electronic Listed Companies (2005-2006)

<table>
<thead>
<tr>
<th>Year</th>
<th>Electronic listed companies with independent directors</th>
<th>Electronic listed companies without independent directors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Foreign corporate/institutional investors</td>
<td>Domestic corporate/institutional investors</td>
</tr>
<tr>
<td>2005</td>
<td>10.79%</td>
<td>25.22%</td>
</tr>
<tr>
<td>2006</td>
<td>12.86%</td>
<td>20.55%</td>
</tr>
</tbody>
</table>

Source: Taiwan Stock Exchange

2.5 Corporate Governance Problems in Taiwan

Different ownership structures will lead to different corporate governance problems. These features in Taiwan (including family-controlled companies, cross-shareholdings, affiliated companies, passive institutional investors, etc.) can facilitate a controlling shareholder to acquire a substantial degree of control over boards of directors and supervisors in certain situations.

The presence of controlling shareholders is often found in Taiwanese companies, even in the listed companies. When there are no feasible challenges for the control of controlling shareholders and when this control is attained without sufficient equity investment to the extent that aligns their interests with the company in which they invest, agency problems arises. In such circumstances, controlling shareholders may potentially exploit other shareholders.

In such circumstances, the primary Taiwanese governance question is how to build internal governance systems that minimize the possibility of exploitations by controlling shareholders.

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65 Wang & Pang, supra note 9, at 1.
66 Id.
shareholders and their fellow directors, supervisors, and senior officers. The ownership structures and other capital features create many opportunities for controlling shareholders to secure excess control (i.e., the difference between control [voting] right and cash-flow right), which facilitates potential wrongdoing at the expense of minority shareholders.  

As shown in Table 5, on average, the largest shareholders in the Taiwanese non-financial companies control 62.69% of the board seats and 49.55% of the supervisors. Additionally, a gap exists between control rights and cash-flow rights in Taiwanese companies. In case a controlling shareholder has major shareholdings that align him or her with interests of the company, they may actively monitor the management as a corporate governance mechanism that can reduce agency costs. However, when a controlling shareholder’s control right exceeds his or her cash-flow right, his or her interest may deviate from minority shareholders’ interests, which could be exploited by the controlling shareholder. The discrepancy between control right and cash-flow right provides an incentive and/or opportunity for controlling shareholders to exploit the interests of minority shareholders. This endangers the corporate governance in Taiwan.

67 YU-HSIN LIN, WEAK INDEPENDENT DIRECTORS, STRONG CONTROLLING SHAREHOLDERS: DO INDEPENDENT DIRECTORS CONSTRAIN TUNNELING IN TAIWAN?, J.S.D. DISSERTATION, STANDARD LAW SCHOOL (April, 2010), 52. [hereinafter YU-HSIN LIN, INDEPENDENT DIRECTORS]

68 Id.

69 Id. at 54.
Table 5: Board Composition and Ownership Structure in Taiwanese Listed Companies

<table>
<thead>
<tr>
<th></th>
<th>Financial Industry</th>
<th>Non-Financial Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Composition</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of Largest Shareholder Serves as Director (%)</td>
<td>59.18</td>
<td>62.69</td>
</tr>
<tr>
<td>Percentage of Largest Shareholder Serves as Supervisor (%)</td>
<td>57.48</td>
<td>49.55</td>
</tr>
<tr>
<td>Number of directors (average)</td>
<td>11.80</td>
<td>7.13</td>
</tr>
<tr>
<td>Number of supervisors (average)</td>
<td>3.29</td>
<td>2.57</td>
</tr>
<tr>
<td><strong>Ownership Structure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A)Control Right of Largest Shareholders (average) (%)</td>
<td>24.95</td>
<td>29.81</td>
</tr>
<tr>
<td>(B)Cash-Flow Right of Largest Shareholders (average) (%)</td>
<td>17.17</td>
<td>22.13</td>
</tr>
<tr>
<td>Excess Control (=A-B) (%)</td>
<td>7.78</td>
<td>7.68</td>
</tr>
<tr>
<td>Pyramidal Structure</td>
<td>0.46</td>
<td>0.18</td>
</tr>
<tr>
<td>Cross-Shareholding</td>
<td>0.34</td>
<td>0.33</td>
</tr>
</tbody>
</table>

Source: YIN-HUA YEH & CHEN-EN KO, DE RI MEI HAN GEGUO DULI DONGSHI, SHENJI WEIYUAN HUI JI JITA ZHUANMEN WEIYUAN HUI FAZHI GUIFAN JI SHIWU YUNZUO QINGKUANG [THE LAW AND PRACTICE OF INDEPENDENT DIRECTORS, AUDIT COMMITTEES AND OTHER FUNCTIONAL COMMITTEES IN GERMANY, JAPAN, UNITED STATES, AND KOREA], 294-95 (TAIWAN FSC, 2006).

Take Procomp, for example; Chairwoman Yeh and her brother held 7.83% of Procomp’s shares by the time the Procomp scandal broke out, but they secured all of five directors. This situation will create an incentive for them to exploit minority shareholders’ interests. In conclusion, in addition to the traditional agency problem that arises out of the differences in interests between management and shareholders, the presence of controlling shareholders can lead to another serious agency problem for Taiwanese companies. Even when non-controlling shareholders support supervisors, the weakness of Taiwan’s current supervisory institution appears to be insufficiently reliable in preventing possible exploitations by controlling shareholders. In contrast, the institution of independent directors has been deemed an effective

70 Id. at 55.
solution for dealing with Taiwan’s corporate governance problems, at least in the minds of most corporate commentators and policymakers.

Taiwan’s ownership structure has formed many business groups that make important contributions to Taiwan’s economy.\textsuperscript{71} It is possible for a controlling shareholder in a given business group to tunnel out corporate assets of one of the affiliated companies.\textsuperscript{72} Through cross-shareholding, a controlling shareholder (e.g., a parent company) can control most or all of the directors and supervisors in its subsidiary and commit wrongdoing that harms the company’s interests, without any internal oversight.

It is a common practice that major shareholders in Taiwanese companies borrow money from banks by pledging their shares. When prices of the pledged shares plummet, such shareholders will need money to maintain the prices of the pledged shares to avoid recourse from banks. Such pressure usually provides some controlling shareholders in Taiwan with reasons to embezzle corporate assets.

2.6 Summary: History of Taiwan’s Corporate Governance Reforms Regarding the Supervisor System

2.6.1 A Brief History About Politics in Taiwan and Corporate Governance Reforms

Basically, the calling for corporate governance reforms did not put too much pressure on Taiwanese policymakers and legislation to take actions to deal with corporate governance problems until the 1990s. For some historical and political reasons, both the administrative and legislative powers were monopolized by the ruling party, Kuomintang (KMT), and people in Taiwan were not allowed to elect their legislators three decades ago. In 1991, Taiwan dismissed

\textsuperscript{71} \textit{Id.} at 55-56.
\textsuperscript{72} \textit{Id.} at 56-57.
all then-legislators (who were elected when the KMT government ruled Mainland China) in the Legislative Yuan, and in 1992 a whole new group of legislators was elected. Henceforth, there was an election for legislators every three years (currently, every four years).

From 1992, more and more Taiwanese listed companies have suffered financial distress and most of them have gone bankrupt or ended up in liquidation. The number is more than 20 times that from the previous decade (there were eight cases from 1980 to 1991). This kind of incident usually results in huge losses for investors. Taiwanese legislation began to feel pressure from their voters. However, the policymakers are often conservative when considering the reforms.

Even though Taiwanese voters can elect the president (highest administrative agency) and legislators, KMT keeps dominance in both administration and legislation sectors. The voters’ anger might not be taken into serious consideration while the policy is made.

The KMT’s political dominance no longer existed when the Democratic Progressive Party (DPP) won the presidential election in 2000. Since then, Taiwan has had two major parties (KMT and DPP) in political competition, and the voices of voters draw more and more policymakers’ attention.

As previously mentioned, most Taiwanese corporate commentators believe that the weakness of supervisors is one of the reasons leading to many corporate failures and scandals. To carry out monitoring tasks effectively, supervisors need strong monitoring power and a mechanism that can ensure their independence from the management and controlling

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73 Liu & Yang, supra note 3, at 822.
74 Id.
shareholders. Prior to 2000, there was almost no reform to deal with these issues. Since 2001, Taiwan has launched some reforms to address this matter. For example, in order to maintain independence of supervisors, laws require the minimum seats of supervisors for public companies (Article 216 of the TCA in 2001 amendment). Additionally, there are laws that have established disqualifications regarding supervisors and that ban institutional shareholders’ representatives from being directors and supervisors in public companies (Article 26-3 of TSEA in 2006 amendment). Furthermore, with an aim at providing supervisors with stronger monitoring power, they are allowed to attend board meetings (Article 218-2 of the TCA in 2001 amendment) and can convene shareholder meetings in emergencies (Article 220 of the TCA in 2001 amendment). In 2002, TWSE even introduced independent supervisors for Taiwanese listed companies.

During the ruling period by DPP, several shocking scandals (including the Procomp scandal) occurred, and the policymakers quickly responded and sought to restore investor confidence and soothe voter anger before the next election. The corporate reforms since then have been happening faster than before. The voices from voters are becoming more and more powerful. For example, after the Reba scandal, lawmakers from the ruling party and opposition parties in Taiwan called for then-Prime Minister Su Tseng-chang to take responsibility and resign.⁷⁵

2.6.2 The Discussions of Supervisor System Reforms

Generally, there are debates about how to improve the supervisor system, and there are many choices from which to choose (for example, “supervisory board” and “independent

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⁷⁵ Financial Times, Taiwan PM Under Pressure To Quit, available at http://www.ft.com/cms/s/0/17fe75c8-a3fd-11db-bec4-0000779e2340.html#axzz1dDz0W7Ku (last visited Nov. 9, 2011).
supervisor”). Probably concerned about the new institution that will bring shocks to companies; Taiwanese policymakers prefer reforming the traditional supervisor system. There have been a few reforms of the supervisor system, but several corporate scandals (including Procomp) have proven the failure of such reforms, so policymakers turn to consider the institution of independent directors. Having the same concerns as the supervisor system reforms, the institution of independent directors is essentially optional for companies (this will be discussed further in Chapter 3).
Chapter Three: The Introduction and Evolution of Independent Directors in Taiwan

This chapter will offer a basic and comprehensive legal background review regarding Taiwan’s introduction and evolution of institution of independent directors.

3.1 The Introduction and Evolution of Independent Directors in Taiwan

3.1.1 2001 Amendment to the TCA

With regard to corporate scandals, Taiwanese commentators argue that insufficient supervisory power is the primary cause of the failures of supervisors, and have advocated giving supervisors more powers. For example, it is necessary to provide supervisors with adequate information prior to inappropriate or illegal decisions being made by boards, so the TCA provides that supervisors can attend board meetings and deliver their opinions.76 Article 220 of the TCA also gives supervisors an expanded range of discretionary power to decide whether provisional shareholder meetings should be held in case of emergencies. It is unfortunate that these additional powers still cannot preclude bad board decisions or misbehavior from occurring. Supervisors can, at best, function as an alarm system for the interests of shareholders.

In addition to the 2001 amendment to the TCA, Taiwan has developed various corporate reforms that offer supervisors expanded powers, but such reforms ultimately lead to nowhere. The non-stop corporate scandals have shown that supervisors are usually unable to prevent wrongdoing by boards of directors, managers, and controlling shareholders, and are often unable to even warn shareholders before such wrongdoing occurred. Some corporate scandals have

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76 Article 218-2 of the TCA.
attracted a great deal of attention from the public and from corporate scholars who remain dissatisfied with the institution of supervisors, even after the 2001 amendment to the TCA.

Instead of retaining supervisors, many Taiwanese scholars have suggested that Taiwan introduce the practice of making use of independent directors, an idea imported from the U.S. legal regime, whose corporate governance and internal checks and balances system are deemed to be better than those in use in Taiwan. Prior to the 2001 amendment to the TCA, holding shares was a prerequisite for election as a director or supervisor. This requirement was deleted in the TCA, and some scholars believed that meant that the TCA had officially introduced independent directors. However, many commentators disagreed with this argument. Finally, the competent authority clearly stated that the concept of independent directors was not an official part of the TCA.

3.1.2 First Initiative—TWSE’s Listing Rules and Recommendations for Best Governance Practice

On Feb. 12, 2002, the TWSE officially introduced the institution of independent directors by promulgating Listing Rules requiring Newly-Listed Companies to appoint at least two independent directors when they apply for listing reviews, and their applications will be rejected for non-compliance. The requirement regarding the appointment of independent directors is an important initiative in Taiwan’s recent corporate governance reforms during the last decade,

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77 Some commentators argued that “for non-shareholding professionals to become independent directors, the shareholder constraint in the [TCA] was lifted.” Liu & Yang, supra note 3, at 827.
78 According to Article 9 of the TWSE’s Listing Rules Governing Review of Securities Listings (Feb. 12, 2002), TWSE may disagree to its listing if the issuing company has any of the events listed below, except for any of those in Subparagraphs 10 or 12 under which the TWSE shall disagree to its listing, and is deemed by the TWSE to be inappropriate for listing: […] 12. If a company applying for listing has less than five members on its board of directors, or less than two independent directors. […] At least one of them must be a professional in accounting or finance.
because it fundamentally changes the traditional governance system that was specified in the TCA, which does not have any relevant provisions regarding independent directors. Even more important, most of Taiwan’s companies were unfamiliar with, or lacked knowledge of, this institution. Newly-Listed Companies are subject to the Listing Rules, and have no option but to hire at least two independent directors for their boards in order to pass a listing review by the TWSE.

However, mandatory appointments of independent directors apply only during listing reviews, and Newly-Listed Companies may choose to not retain independent directors afterwards at their own discretion. Also, the Listing Rules are not applicable to companies listed before Feb. 12, 2002, but such companies can voluntarily opt to appoint independent directors and set up special committees as they see fit.  

Since 2002, both appointment of independent directors and establishment of special board committees have been recommended by the TWSE and competent authority. Under the instructions of the competent authority (i.e., FSC), TWSE and GreTai Securities Market (a Taiwan OTC exchange) (GTSM), in 2002, jointly issued “Corporate Governance Best-Practice Principles for TWSE/GTSM Listed Companies (Best Practice Principles)” recommending that a listed company appoint independent directors and set up special committees. In the meantime, the FSC amended the regulations governing the annual reports and the public reports of listed

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79 The TWSE was hesitant to request all listed companies to appoint independent directors due to a fierce opposition from companies. However, the TWSE adopted a “comply or disclose” policy requiring disclosure of “independence” of directors and supervisors.

80 According to Article 28 of the Best Practice Principles, for the purpose of developing monitoring functions and strengthening management mechanisms, the board of directors of a TWSE/GTSM listed company may, taking into account the basis of the size of the board and the number of the independent directors, set up special committees of various functions to be stipulated in the articles of incorporation. Article 29 of the Best Practice Principles provides that it is advisable that a TWSE/GTSM listed company make it the first priority to set up the audit committee. The 2002 edition of the Best Practice Principles is available at [http://eng.selaw.com.tw/ShowHistory.asp](http://eng.selaw.com.tw/ShowHistory.asp) (last visited Oct. 31, 2011).
companies and required companies to disclose information of independent directors and supervisors. The information disclosed will be sufficient for investors to determine whether a company has appointed independent directors in accordance with TWSE’s Listing Rules or Best Practice Principles.

### 3.1.3 Taiwan Government’s Policy of Introducing Independent Directors

Taiwan’s Executive Yuan (i.e., highest administrative department) sought to build a better governance system in Taiwan, and passed a 2003 resolution called “Accountability of Companies in Taiwan: Policy Agenda and Action Plan to Strengthen Corporate Governance (Governance Policy).” This resolution declared a plan to introduce independent directors by amending the TSEA. The Governance Policy declared that one of Taiwan’s important policies was to strengthen corporate governance mechanisms. Such mechanisms included: gradually establishing a system of independent directors and supervisors; allowing the establishment of a one-tier board structure; allowing public companies to form permanent functional committees to replace boards of managing directors; expanding the introduction of nominees for independent directors and supervisors; and, promoting the procurement of liability insurance for directors and supervisors. Based on the Governance Policy, it was clear that Taiwan’s government decided to introduce independent directors as a method of developing better corporate governance systems in Taiwanese companies.

Furthermore, in August 2005, Taiwan’s Executive Yuan demonstrated its determination to improve corporate governance by requesting that all “state-run companies” (government is the...

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81 Article 10 of “Regulations Governing Information to be Published in Annual Reports of Public Companies (Mar. 13, 2003).”
83 *Id.* at 7-8.
sole or controlling shareholder) appoint independent director(s) as good models for other companies in Taiwan.

### 3.1.4 Codification of Independent Directors—2005 Amendment to the TSEA

After the Procomp scandal, other similar scandals were uncovered in 2004. One Taiwanese commentator thus concluded that “2004 seemed like the year of fraud.” These scandals emerged years after the promulgation of the Listing Rules and induced Taiwan to further codify independent directors in the 2005 Amendment to the TSEA. This Amendment has become the primary legal source concerning Taiwanese independent directors.

Article 14-2 of the TSEA provides that a public company may amend its articles of incorporation to appoint independent directors. The competent authority (i.e., FSC), if necessary, can require companies to appoint independent directors, not less than two in number and not less than one-fifth of the total number of directors, after reviewing the company’s scale, equity structure, type of operations, and other relevant factors. Thus, the appointments of independent directors are not mandatory in most public companies. Public companies can legally have independent directors by voluntarily amending their articles of incorporation or by mandatory orders from the competent authority. It should be pointed out that independent directors appointed prior to the enactment of the TSEA do not automatically become independent directors.

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84 In Taiwan, many businesses of electricity, water, and gasoline service are monopolized by state-run companies. The government usually is the sole or largest shareholder that can control the whole company.
85 *OECD Corporate Governance in Asia, supra* note 1, at 49.
86 The Amendment regarding independent directors and audit committee took effect on Jan. 1, 2007.
87 According to a directive issued by FSC on Mar. 28, 2006, financial corporations (including financial holding companies, banks, securities dealers, insurers) and public corporations with paid-in capital exceeding 50 billion New Taiwan Dollars (approximately 1.66 billion US dollars) must have independent directors in accordance with Article 14-2 of the TSEA. On Mar. 22, 2011, this directive was replaced by a new directive which requires financial corporations and public corporations with paid-in capital exceeding 10 billion New Taiwan Dollars (approximately 0.33 billion US dollars) must have mandatory independent directors.
under the TSEA unless they are reelected in compliance with independent standards and election procedures set by the TSEA.

Unless being requested by the competent authority, the appointments of independent director are optional for most Taiwanese public companies. Once a company opts to appoint independent directors, some election procedures and eligibilities must be applied in accordance with Article 14-2 of the TSEA. Specifically, the company should expressly add a clause regarding the appointment of independent directors to its articles of incorporation. The “nomination candidate system” is mandatory for electing independent directors.

A candidate must have either professional expertise (legal, accounting, financial, or the like) or working experiences related to the business with which the company involves. A candidate must not have any sorts of proscribed “ties” with company or its affiliates and the insiders.

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88 Article 2 of Regulations Governing Appointment of Independent Directors and Compliance Matters for Public Companies (Independent Directors Regulations) (Mar. 28, 2006), an independent director of a public company shall meet one of the following professional qualification requirements, together with at least five years work experience:
1. An instructor or higher in a department of commerce, law, finance, accounting, or other academic department related to the business needs of the company in a public or private junior college, college, or university;
2. A judge, public prosecutor, attorney, certified public accountant, or other professional or technical specialist who has passed a national examination and been awarded a certificate in a profession necessary for the business of the company.
3. Have work experience in the area of commerce, law, finance, or accounting, or otherwise necessary for the business of the company.


89 Article 3 of Independent Directors Regulations: During the two years before being elected or during the term of office, an independent director of a public company may not have been or be any of the following:
1. An employee of the company or any of its affiliates.
2. A director or supervisor of the company or any of its affiliates. The same does not apply, however, in cases where the person is an independent director of the company, its parent company, or any subsidiary in which the company holds, directly or indirectly, more than 50 percent of the voting shares.
3. A natural-person shareholder who holds shares, together with those held by the person's spouse, minor children, or held by the person under others' names, in an aggregate amount of one percent or more of the total number of issued shares of the company or ranking in the top 10 in holdings.
4. A spouse, relative within the second degree of kinship, or lineal relative within the fifth degree of kinship, of any of the persons in the preceding three subparagraphs.
However, appointing independent directors does not involve replacing supervisors. Unless a company sets up an audit committee, supervisors remain necessary. Thus, some Taiwanese companies may concurrently have supervisors and independent directors and both are monitoring devices. Article 14-3 of the TSEA states that when a company selects independent directors, the legal effect is that some proscribed matters shall be submitted to the board of directors for approval by resolution (unless approval has been obtained from the competent authority).

Attending board meetings, in which the proscribed matters are to be resolved, gives independent directors opportunities to review whether such matters are contrary to the interests of shareholders. Once they determine that they have some concerns about a particular matter, they can deliver a dissent opinion or qualified opinion that shall be noted in the minutes of the board meetings, in accordance with the TSEA. The result of having separate monitoring devices is that independent directors and supervisors may have their own primary monitoring responsibilities.

5. A director, supervisor, or employee of a corporate shareholder that directly holds five percent or more of the total number of issued shares of the company or that holds shares ranking in the top five in holdings.
6. A director, supervisor, officer, or shareholder holding five percent or more of the shares, of a specified company or institution that has a financial or business relationship with the company.
7. A professional individual who, or an owner, partner, director, supervisor, or officer of a sole proprietorship, partnership, company, or institution that, provides commercial, legal, financial, accounting services or consultation to the company or to any affiliate of the company, or a spouse thereof.
90 The matters include:
1. Adoption or amendment of an internal control system;
2. Adoption or amendment of handling procedures for financial or operational actions of material significance, such as acquisition or disposal of assets, derivatives trading, extension of monetary loans to others, or endorsements or guarantees for others;
3. A matter bearing on the personal interests of a director;
4. A material asset or derivatives transaction;
5. A material monetary loan, endorsement, or provision of guarantee;
6. The offering, issuance, or private placement of any equity-type securities;
7. The hiring or dismissal of an attesting CPA, or the compensation given thereto;
8. The appointment or discharge of a financial, accounting, or internal auditing officer;
9. Any other material matter required by the competent authority;
Independent directors who are also board members can function in different ways than supervisors within the context of monitoring. For example, prior notices must be sent to independent directors before board meetings, so if the company fails to do so and absentee directors fail to attend meetings, any resolutions that are arrived at during such meetings should be void. Additionally, independent directors can vote in the boardroom and are supposed to be provided with sufficient information prior to making decisions. Independent directors can at least have their opinions recorded in the board minutes so as to alert shareholders when the board of directors makes any suspicious decisions (see Figure 4).

**Figure 4: Two Monitoring Devices Exist Within a Company Which Appoints Independent Directors**

- **Board of directors**
  - Matters specified in Article 14-3 of TSEA
  - Should be approved by majority of board
  - Independent directors can deliver dissent or qualified opinions

- **Supervisors**
  - May monitor all conduct of board and officers;
  - May attend the board meetings;
  - May request information from the management;
  - May stop the board and its members from proceeding with misconduct;
  - May convene shareholder meeting in emergencies.

Source: Author
3.1.5 Codification of Audit Committee—2005 Amendment to the TSEA

In addition to independent directors, the 2005 amendment to the TSEA also introduced the “audit committee,” which could completely supplant supervisors. The audit committee should consist of a minimum of at least three independent directors, and one of them should have a professional background in finance or accounting. Companies are free to have an audit committee if they deem it appropriate, unless requested to do so by the competent authority.\(^9\)

A company with an audit committee should no longer have supervisors, legally speaking. This indicates that Taiwanese policymakers believe that the functions provided by both an audit committee and supervisors may completely overlap and be interchangeable, and the audit committee can assume all of the tasks that supervisors are supposed to handle.

Article 14-5 of the TSEA stipulates that if a company establishes an audit committee, the proscribed matters shall be subject to the consent of one-half or more of all audit committee members and be submitted to the board of directors for a resolution.\(^9\) Therefore, a member of the audit committee who is also an independent director can both deliver opinions regarding proscribed matters, and can also vote on such matters. The proscribed matters relate to conflicts

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\(^9\) At present, no Taiwanese company is required to establish the audit committee.
\(^9\) According to Paragraph 1, Article 14-5 of the TSEA, the matters include (same as matters in Article 14-3 of the TSEA, except for items 2 and 10):
1. Adoption or amendment of an internal control system;
2. Assessment of the effectiveness of the internal control system;
3. Adoption or amendment of handling procedures for financial or operational actions of material significance, such as acquisition or disposal of assets, derivatives trading, extension of monetary loans to others, or endorsements or guarantees for others;
4. A matter bearing on the personal interests of a director or supervisor;
5. A material asset or derivatives transaction;
6. A material monetary loan, endorsement, or provision of guarantee;
7. The offering, issuance, or private placement of any equity-type securities;
8. The hiring or dismissal of an attesting CPA, or the compensation given thereto;
9. The appointment or discharge of a financial, accounting, or internal auditing officer;
10. Annual and semi-annual financial reports;
11. Any other material matter required by the company or the competent authority.
of interest, fundamental transactions, or financial report integrity. An audit committee should be the gatekeeper who can review the legality or appropriateness of these matters.

However, except for annual or semi-annual reports, even if such matters fail to be approved by the audit committee, they can be ratified by two-thirds or more of all directors, but the resolution of the audit committee shall be recorded in the minutes of the board meetings\(^9\) (see Figure 5).

**Figure 5: Legal Procedural Requirements for Board Decision-Making for Companies with Audit Committees**

![Diagram](image)

Source: Author

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\(^9\) According to Paragraph 2, Article 14-5 of the TSEA, with the exception of subparagraph 10 (i.e., Annual and semi-annual financial reports), any matter under a subparagraph of the preceding paragraph that has not been approved with the consent of one-half or more of all audit committee members may be undertaken upon the consent of two-thirds or more of all directors, without regard to the restrictions of the preceding paragraph, and the resolution of the audit committee shall be recorded in the minutes of the directors meeting.
3.1.6 Mandatory Establishment of Remuneration Committee

Article 14-6 of the TSEA was added in 2010 and required all listed companies to establish remuneration committees.\(^94\) Given the authorization derived from that Article, the FSC issued the “Regulations Governing the Appointment and Exercise of Powers by the Remuneration Committee of a Company Whose Stock is Listed on the Stock Exchange or Traded Over the Counter (Remuneration Rules),” in order to set the legal standards for corporate compliance.\(^95\)

Note that remuneration committee members are not directors but are instead appointed by the board of directors. The committee shall consist of not fewer than three members. Committee members must meet certain legal requirements regarding professionalism,\(^96\) disqualifications,\(^97\) and standards of independence.\(^98\) When the board of directors declines to adopt, or seeks to

\(^{94}\) This Article will take effect on Jan. 01, 2012.
\(^{96}\) According to Article 4 of the Remuneration Rules, a remuneration committee member shall meet one of the following professional qualification requirements, together with at least 5 years work experience:
1. An instructor or higher in a department of commerce, law, finance, accounting, or other academic department related to the business needs of the company in a public or private junior college, college, or university.
2. A judge, public prosecutor, attorney, certified public accountant, or other professional or technical specialist who has passed a national examination and been awarded a certificate in a profession necessary for the business of the company.
3. Have work experience in the area of commerce, law, finance, or accounting, or otherwise necessary for the business of the company.
\(^{97}\) According to Article 4 of the Remuneration Rules, a person to whom any of the following circumstances applies may not serve as a remuneration committee member; if already serving in such capacity, the person shall be dismissed:
1. Any of the circumstances in the subparagraphs of Article 30 of the TCA.
2. Any violation of the remuneration committee member qualification requirements set out in the Rules.
\(^{98}\) According to Article 6 of the Remuneration Rules, during the 2 years before being appointed or during the term of office, a remuneration committee member shall not have been or be any of the following:
1. An employee of the company or any of its affiliates.
2. A director or supervisor of the company or any of its affiliates. The same does not apply, however, in cases where the person is an independent director of the company, its parent company, or any subsidiary in which the company holds, directly or indirectly, more than 50 percent of the voting shares.
3. A natural-person shareholder who holds shares, together with those held by the person's spouse, minor children, or held by the person under any other's name, in an aggregate amount of 1 percent or more of the total number of issued shares of the company or ranking in the top 10 in shareholding.
modify, a recommendation made by the remuneration committee, it shall require the consent of a majority of the directors in attendance at a meeting attended by two-thirds or more of the entire board. The board shall specifically explain whether the remuneration passed by the board exceeds in any way the recommendation of the remuneration committee. If the remuneration passed by the board of directors exceeds the recommendation of the remuneration committee, the circumstances and causes for the difference shall be specified in the board meeting minutes and shall be disclosed within two days after the resolution by the board of directors. Note that the remuneration committee members are neither directors nor independent directors. However, according to the Remuneration Rules, when a company appoints independent directors, at least one independent director shall participate in the remuneration committee, and the entire membership shall unanimously elect the independent director to serve as the chairman on the committee.99

3.1.7 Supplements to the Institution of Independent Directors in Taiwan

3.1.7.1 Database for Independent Directors and Independent Supervisors

After the introduction of the institution of independent directors, Taiwan should consider whether there is sufficient number of qualified candidates on the market. The TSEA’s limitation on the number of companies on whose boards independent directors can serve raises concerns

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4. A spouse, relative within the second degree of kinship, or lineal relative within the third degree of kinship, of any of the persons in the preceding three subparagraphs.
5. A director, supervisor, or employee of a corporate shareholder that directly holds 5 percent or more of the total number of issued shares of the company or ranks in the top 5 in shareholding.
6. A director, supervisor, managerial officer, or shareholder holding 5 percent or more of the shares, of a specified company or institution that has a financial or business relationship with the company.
7. A professional individual who, or an owner, partner, director, supervisor, or managerial officer of a sole proprietorship, partnership, company, or institution that, provides commercial, legal, financial, or accounting services or consultation to the company or to any affiliate of the company, or a spouse thereof.
99 According to Article 8 of the Remuneration Rules, when a company has selected independent directors, at least one independent director shall participate on the remuneration committee, and the entire membership shall unanimously elect the independent director to serve as the convener and meeting chair.
about whether or not there is a sufficient supply of qualified personnel.\(^{100}\) For example, the number of currently TWSE-listed companies is 774, and there are 590 GTSM (OTC) companies (as of Sep., 2011). The Governance Principles suggest that every listed or GTSM company should have at least two independent directors. Assuming that each director serves at only one company, there exists a need for more than 2,700 independent director candidates. Furthermore, public non-listed companies may also require independent directors on their board for better internal governance.

In order to deal with this issue, the SFI, at the request of the FSC, established a database called “Independent Directors/Independent Supervisors Registry.”\(^{101}\) The qualifications for being registered in the database include both independence and professionalism in accordance with the standards of independence set forth by the TSEA and the relevant regulations. Therefore, public companies may choose to select appropriate independent directors from those in the database, without having to examine the qualifications of every single candidate. There is currently information about 2,677 qualified candidates in the database.\(^{102}\)

### 3.1.7.2 Legal Incentives

The separation of ownership and operational control is common in modern companies. However, the TSEA requires that directors as a group must hold a minimum percentage of company’s shares that ranges from 0.2% up to 1.5%, based on the amount of a company’s paid-in capital, and the same rule applies to supervisors. Directors and supervisors are subject to fines if they fail to maintain the proscribed minimum ownership requirements. The Rules and Review

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100 According to Article 4 of Independent Directors Regulations, no independent director of a public company may concurrently serve as an independent director of more than three other public companies.


102 **CORPORATE GOVERNANCE IN TAIWAN**, *supra* note 2, at 15.
Procedures for Director and Supervisor Share Ownership Ratios at Public Companies (Ownership Rules) was amended in 2006 in order to lower the minimum requirements for companies that appoint more than two independent directors. This is accomplished by applying a discount on the number of shares that directors and supervisors are required to maintain. If a public company sets up an audit committee, the requirements for the shares held by supervisors shall not apply. In addition, if the number of independent directors in a non-financial company exceed one-half of the total number of director seats and establish an audit committee, the minimum requirements for both directors and supervisors shall not apply.

3.1.8 Current Policy

There are three levels of influence on Taiwanese corporate governance, in terms of legal compliance. First, the TCA and TSEA set out the basic governance system with which companies must comply. Most of provisions in the TCA or the TSEA are mandatory, but some are optional for companies that want to develop the best possible governance practices. As will be explained later, Taiwanese companies have four statutory governance models from which to choose, and each company can decide which model is best for compliance with related provisions. The TCA or TSEA basically provide rigid configurations of four models that offer companies little room for accommodating their particular needs. For example, non-public companies cannot appoint independent directors; even when the majority of the board of

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104 According to Paragraph 2 of Article 2 in the Ownership Rules, the shareholdings of independent directors elected by a public company shall not be counted in the total referred to in the preceding paragraph; if a public company has elected two or more independent directors, the share ownership figures calculated at the rates set forth in the preceding paragraph for all directors and supervisors other than the independent directors and shall be decreased by 20 percent.
105 Paragraph 3, Article 2 of the Ownership Rules.
106 Paragraph 4, Article 2 of the Ownership Rules.
directors are independent, supervisors are still necessary; an audit committee and supervisors cannot coexist within one company; and, every listed or GTSM companies must establish a remuneration committee.

Second, the TWSE has listing requirements that apply to listed companies. Most of the listing requirements are mandatory. However, a few of them are suggestions. Listing Rules regarding independent directors should be mandatory, but are only applicable when companies apply for listings. Therefore, in terms of internal governance system, Taiwan’s listing rules are basically suggestive in nature.

Third, there exists a voluntary code of recommended practices, particularly for listed companies. Article 27 of the Best Practice Principles suggests that listed companies can set up audit, nomination, risk management and other functional committees based on their beliefs concerning corporate social responsibility and sustainable operations or set up committees for environmental protection or other types of activities.

When there is no legislation governing “nominations,” “risk management,” and “environmental protection” board committees, the Best Practice Principles provide listed companies with guidance that can help them develop optimal governance practices. Such Principles, however, have a little impact in practice. For example, as of October 2011, only two listed (and one GTSM) companies have established nomination committees, and only four listed companies have set up the governance committee.

As noted above, the current types of corporate governance structures commonly found among Taiwanese companies can be classified as follows: (1) regarding non-public companies, the only choice is to have supervisors, but such companies can still have unofficial independent
directors at their discretion, because the TSEA is not applicable to these companies; (2) public companies subject to the TSEA can have independent directors in legal capacities, and regardless of whether they have independent directors on a mandatory or voluntary basis, necessary procedures and requirement must be complied with in order to make such appointments legally meaningful. In the meantime, supervisors remain necessary; (3) public companies that have audit committees, whether on a mandatory or voluntary basis, cannot legally have supervisors under the TSEA. Companies in such circumstances adopt so-called “one-tier boards” (Table 6 for details).

Table 6: Companies Categorized by Types of Internal Governance Systems

<table>
<thead>
<tr>
<th></th>
<th>Board of directors</th>
<th>Independent Director(s)</th>
<th>Supervisor(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Non-public company</td>
<td>Required (more than 3 directors) (Paragraph I of §192 of the TCA)</td>
<td>N/A</td>
<td>Required (more than 1 supervisor) (Paragraph I of §216 of the TCA)</td>
</tr>
<tr>
<td>(2) Public company w/o independent directors</td>
<td>Required (more than 5 directors) (Paragraph I of §26-3 of the TSEA)</td>
<td>N/A</td>
<td>Required (more than 2 supervisors) (Paragraph II of §216 of the TCA)</td>
</tr>
<tr>
<td>(3) Public company w/ independent directors</td>
<td>Required (more than 5 directors) (Paragraph I of §26-3 of the TSEA)</td>
<td>Not less than two in number and not less than one-fifth of the total number of directors (Paragraph I of §14-2 of the TSEA)</td>
<td>Required (more than 2 supervisors) (Paragraph II of §216 of the TCA)</td>
</tr>
<tr>
<td>(4) Public company w/ audit committee</td>
<td>Required (more than 5 directors) (Paragraph I of §26-3 of the TSEA)</td>
<td>Not less than three and at least one of whom has accounting or financial expertise (Paragraph II of §14-4 of the TSEA)</td>
<td>N/A (Paragraph I of §14-4 of the TSEA)</td>
</tr>
</tbody>
</table>

Source: Author
3.2 Summary

In Taiwan, there was a constitutionality issue regarding TWSE’s mandatory policy of independent directors. Some argue that TWSE’s Listing Rules may be unconstitutional and violate the freedom of Newly-Listed Companies to run business because of the mandatory appointment of independent directors as requested by the Listed Rules. To avoid that dispute, Taiwan’s competent authority decided to create legal sources for appointing independent directors by amending the TSEA. A total of 4.46% of listed companies were involved in financial distress in the year 2001. Most of these companies ended up in liquidation or bankruptcy. A total of 41 companies out of the 919 listed companies recorded having financial troubles. Corporate governance reform was urgently needed, and an independent director system was believed by Taiwanese authorities to be one of the solutions to the problems.

Under the circumstances in which supervisors are disappointing to policymakers, independent directors seem to be the only hope for Taiwan. Especially after the Procomp scandal, it was agreed upon by most commentators and policymakers to introduce independent directors. The voices against independent directors existed, but they were weak. The policy of the introduction of independent directors has been confirmed several times in the government’s documents such as the Governance Policy. The question here is not whether Taiwan should introduce independent directors, but how Taiwan will go about introducing independent directors.

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109 However, Liu argues that the mandatory appointment of independent directors required by the Listing Rules has no constitutionality issue at all. Id.
Taiwanese policymakers appear to favor independent directors, so it is no question that independent directors should be introduced. But how? Most discussions are related to the inherent limitations of independent directors, such as lack of adequate time, lack of incentive, and lack of expertise. For example, during the legislation of provisions regarding independent directors in the TSEA, the legislators expressed concern about the effectiveness of independent directors. No one can be certain whether independent directors will devote their time to monitoring in a satisfactory manner. Another question is whether there are adequate candidates who can carry out the monitoring tasks so that possible wrongdoing can be prevented. The introduction of independent directors in the TSEA is greatly motivated by the Procomp scandal, which involves fake overseas accounts. Assuming 1,000 companies need to appoint two independent directors and an independent director can serve up to five companies, there should be at least 400 eligible independent directors. It is doubtful that there are 400 candidates who have professional abilities to detect wrongdoing such as those that take place in the Procomp scandal.

Whether to adopt a mandatory policy is also a hot topic. In the initial bill proposed by Taiwan’s FSC, all public companies were required to appoint independent directors comprising one-fourth of board seats. In the meantime, some important board decisions need to be approved by half of independent directors. However, this bill encountered great opposition from the private sector, which put a great deal of pressure on legislation not to pass the bill. To most Taiwanese companies which never appoint independent directors, the appointment of independent directors seems very burdensome because they are concerned about additional seeking and hiring costs of independent directors and the possible maladjustment working with independent directors who have veto power.
To reduce such concerns, the FSC re-proposed a bill that required public companies to hire two independent directors and deleted the provision authorizing independent directors’ veto power in major board decisions. However, companies remained concerned about the mandatory appointment of independent directors, and opposed the bill. Finally, the FSC gave up the mandatory policy and presented a watered-down bill forming current setting that made the appointment of independent directors optional for public companies.

Likewise, the first tentative draft of the Principles of Corporate Governance by the American Law Institute (ALI) adopted a mandatory policy to require independent directors to comprise a majority of the board of directors in publicly-held companies, but the ALI’s proposal regarding the board structure had been criticized by scholars.110 Finally, the drafters changed the mandatory proposal into recommendations of corporate practice. As a matter of fact, the emergence of independent directors is due to shareholder pressure.111 Shareholders have not encountered strong opposition from management.112 In the last three decades, U.S. boards became increasingly independent and such changes in board composition cannot be done without the acquiescence of incumbent inside directors and management.113

Currently, Taiwan’s policy of independent directors authorizes the FSC to request public companies to have independent directors if necessary. The plan is to call for independent directors step-by-step to avoid too many shocks to the companies. In 2011, the FSC issued an order requiring non-financial companies with paid-in capital of more than 10 billion New Taiwanese Dollars (NTD) to appoint independent directors (replacing an old directive of 2006

112 Id.
113 Id.
requesting companies with paid-in capital of more than 50 billion NTD subject to mandatory appointment of independent directors). It is very likely that the FSC will request more and more companies to appoint independent directors.
Chapter Four: The Fundamental Questions Regarding Independent Directors in Taiwan

This chapter will explore the fundamental questions regarding the Taiwanese institution of independent directors. These questions are: Why does Taiwan want independent directors? What problems will Taiwan’s independent directors face? Why do companies need independent directors? Finally, this chapter will present data to present the facts about independent directors in Taiwan, and reach some implications from the data.

4.1 Question One: Why Does Taiwan Want Independent Directors?

4.1.1 Serious Financial Distress and Corporate Scandals

As calculated in a research, from 1992 to 2005, a total of 211 listed companies suffered financial distress and most of them went bankrupt or ended up in liquidation.\(^{114}\) The number is more than 20 times that of the previous decade (there were 8 cases from 1980 to 1991).\(^{115}\) After several shocking scandals occurred, Taiwan sought to quickly restore investor confidence and soothe voters’ anger before the next election by introducing independent directors to deal with then severe corporate governance problems.\(^{116}\)

It appears that Taiwanese policymakers favor the institution of independent directors because they see it as a better governance mechanism for building an effective internal checks and balances system for Taiwanese companies. However, some interest groups oppose any aggressive policies of government that promote independent directors and put political pressure on legislation. Taiwanese legislators usually have friendly, close relationships with businessmen

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\(^{114}\) Liu & Yang, supra note 3, at 822.

\(^{115}\) Id.

\(^{116}\) Gerard Hertig, On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture (March 2005), available at SSRN: [http://ssrn.com/abstract=676417](http://ssrn.com/abstract=676417). In Taiwan, the Procomp scandal in fact pushed the institution of independent directors forward. See also OECD Corporate Governance in Asia, supra note 1, at 60.
who provide them with political donations and even bribes when legislators run elections.\textsuperscript{117} Such businessmen usually control several companies, and they tend to prefer traditional supervisors to independent directors with whom they are unfamiliar.

Pressure from businessmen and other concerns made Taiwanese legislation reject a bill that required at least one-fourth of boards to be comprised of independent directors in all listed companies and required audit committees consisting entirely of independent directors to replace supervisors.\textsuperscript{118} The next year, the FSC re-submitted a watered-down bill that became the current system of independent directors in the TSEA, in order to secure its passage through the legislation.\textsuperscript{119} The result of compromises between policymakers and the corporate sector (and their political allies) leads to the current set-up.\textsuperscript{120}

4.1.2 Dissatisfaction with Supervisors and Weaknesses of Other Governance Mechanisms

There is no doubt that the institution of independent directors is just one of several governance mechanisms dealing with the agency problem and other corporate governance issues. Other alternative mechanisms, however, are less likely to occur in Taiwan. Probably like independent directors in the U.S., Taiwanese institution of independent directors wins the position of monitor because policymakers believe that what independent directors can do better than other potential monitoring mechanisms.\textsuperscript{121}

\begin{flushleft}
\textsuperscript{117} Consider the Reba scandal for example, the Reba chairman was once the national party representative of “Kuomintang” (i.e., current ruling party of Taiwan), and one of his sons was a Taiwanese legislator.

\textsuperscript{118} ASIA CORPORATE GOVERNANCE ASSOCIATION (ACGA), ACGA WHITE PAPER ON CORPORATE GOVERNANCE IN TAIWAN 26 (2011). [hereinafter ACGA TAIWAN WHITE PAPER] Other concerns include the costs of hiring independent directors, a sufficient supply of eligible candidates, and the uncertain effectiveness of independent directors. This Chapter will discuss the concerns later.

\textsuperscript{119} Id.

\textsuperscript{120} Id.

\textsuperscript{121} James D. Cox, The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director’s Spine, 61 GEO. WASH. L. REV. 1233, 1237 (1993).
\end{flushleft}
There are several corporate governance mechanisms that have been discussed in the scholarly literature, including institutional investors, the presence of block shareholders, product market, and the takeover market. As explained in Chapter Two, institutional investors have been passive regarding governance issues of Taiwanese companies.\textsuperscript{122} Although shareholder activism has been advocated for several years, the functions that institutional investors seek to have as a governance mechanism remain weak. In addition, the presence of block shareholders is a greater concern than a governance mechanism in Taiwan. The product market may influence to the extent to which a company improves board effectiveness in order to maintain its competitive advantages, but such a mechanism would function in a very limited manner.

Finally, the market for control can be a mechanism that disciplines underperforming management. Poor managerial performance may lead to a hostile takeover or proxy contest that can replace the underperforming management.\textsuperscript{123} However, such mechanism is expensive, and the takeover and proxy contest are usually invoked only when the managerial underperformance or wrongdoing is so harmful to the firm that the firm’s shares are in trade at a substantial discount.\textsuperscript{124} In Taiwan, there are few cases of hostile mergers and acquisitions, which would operate to improve the effectiveness of board functions.\textsuperscript{125} Generally speaking, the takeover market in Taiwan is considerably inactive, so its function is very limited. Another possible mechanism is governmental monitoring in some forms. The current dominant policy around the world prefers deregulation, which makes reliance on a government agency to monitor managerial

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{122} \textit{ACGA TAIWAN WHITE PAPER}, supra note 118, at 26.
\item\textsuperscript{123} \textit{Cox}, supra note 121, at 1236.
\item\textsuperscript{124} \textit{Id}.
\item\textsuperscript{125} Solomon et al., supra note 107, at 240.
\end{enumerate}
\end{footnotesize}
performance politically not viable.\footnote{Id.} On the contrary, independent directors can be instruments of accountability that “will lessen the need for government to play a significant role.”\footnote{Irwin Borowski, \textit{Corporate Accountability: The Role of the Independent Director}, 9 J. CORP. L. 455 (1984).}

Like the U.S., SOX was enacted in the wake of Enron and WorldCom scandals, in order to improve the integrity of the corporate decision-making process in response to corporate scandals after Enron,\footnote{Jill E. Fisch, \textit{The New Federal Regulation of Corporate Governance}, 28 Harv. J.L. & PUB. POL'y 39, 42 (2004).} Taiwan should have a similar goal. In order to restore investor confidence, the role of independent directors in Taiwan’s listed companies should be strengthened to improve board decision-making and its oversight of management.\footnote{ACGA TAIWAN WHITE PAPER, \textit{supra} note 118, at 24.} Many scholars argue that such an institution is best enforced by the market rather than by legislation.\footnote{E.g., Roberta S. Karmel, \textit{The Independent Corporate Board: A Means to What End?}, 52 Geo. Wash. L. REV. 534, 556 (1984); Fisch, \textit{supra} note 128, at 44.}

The internal mechanisms seeking to reduce agency costs include contracts, the market for corporation control, and the managerial labor market. The more effectively these mechanisms function, the more limitedly independent directors can benefit companies.\footnote{Richard H. Fosberg, \textit{Outside Directors and Managerial Monitoring}, 20 Akron Bus. & Econ. Rev. 24, 24-25 (1989).} As mentioned above, unfortunately, the alternative corporate governance mechanisms are too weak and little should be expected in Taiwan. Taiwanese policymakers, thus, turn to emphasize the importance of independent directors.

\subsection*{4.1.3 U.S. Influence on Taiwanese Corporate Governance Reforms}

The governance system designed in the original version of the TCA imported many traditional ideas from Germany and Japan. The institution of supervisors is a mechanism derived from the mix of German and Japan’s supervisory board. Several decades ago, most Taiwanese
corporate scholars went to Germany and Japan for advanced studies. However, increasing numbers of Taiwanese scholars have chosen to study corporate law in the U.S. in recent years, instead of Germany and Japan.\textsuperscript{132}

When Taiwan struggled with the failures of the supervisor system and reforms of such system appear fruitless, the U.S. laws have gradually become more and more important. In the meantime, corporate scholars who studied in the U.S. have advocated that U.S. laws replacing flaws in Taiwanese corporate laws. In contrast, scholars who studied in Japan tend to oppose importing the concept of independent directors and advocate further reforms of the supervisor system.\textsuperscript{133} Prior to the official introduction of independent directors in the TSEA, Professor Huang (who studied in Japan) argued that Taiwan’s then-board of directors should be a managing device rather than monitoring device, and it would be confusing to introduce independent directors (monitors against management) onto the board of directors.\textsuperscript{134} Professor Lin (who studied in Japan) also contended that Taiwan transplanted its internal governance system primarily from Japan and it was inappropriate to introduce independent directors replacing supervisors.\textsuperscript{135}

Several failures of recent reforms on the supervisor system have led U.S. laws be able to attract greater attention from Taiwanese policymakers. Thus, the U.S. developments regarding independent directors have gradually influenced Taiwanese corporate governance policies. In

\textsuperscript{132} For example, the School of Law at Taiwan University and the School of Law at Chengchi University, two leading law schools in Taiwan, currently have 11 faculty members who specialize in corporations. 7 of them obtained their doctorates in the U.S., 1 in the U.K., and 3 in Japan.

\textsuperscript{133} Professors Ming-Jye Huang (School of Law of Taiwan University) and Kuo-Chuan Lin (School of Law of Chengchi University), both of whom studied in Japan, opposed the introduction of independent directors and instead proposed to strengthen the institution of supervisors.

\textsuperscript{134} Ming-Jye Huang, Gong Si Jan Kong yu Jan Cha Ren Jye Du Gai Ge Ren [Corporate Governance and Reforms of Supervisor System], 29 NATIONAL TAIWAN UNIV. L. J. 159 (2000).

addition, investment by U.S. institutional investors (e.g., Citigroup Global Markets, Goldman Sachs, Morgan Stanley, Merrill Lynch, etc.) recently accounted for more and more percentages of Taiwan’s capital market. Many investors suggest that foreign institutional investors should induce Taiwanese companies to develop better governance practices. Table 7 shows that Morgan Stanley Capital International (MSCI) has a division known as MSCI Taiwan which favors investments in Taiwanese listed companies that have appointed independent directors.

Table 7: Taiwanese Listed Companies (MSCI Taiwan)

<table>
<thead>
<tr>
<th></th>
<th>Companies with independent director(s)</th>
<th>Companies without independent director(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of invested companies</td>
<td>69</td>
<td>53</td>
</tr>
<tr>
<td>Percentage of investment</td>
<td>76%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: MSCI Taiwan

Independent directors in the U.S. are deemed a good governance practice by both corporate practice and academia, because they can help reduce agency costs and benefit shareholders. In addition, independent directors can be an effective mechanism for protecting shareholders.137

ALI suggests that “the board of every large publicly held corporation should have a majority of directors who are free of any significant relationship with the corporation's senior executives.”138 The primary U.S. stock exchanges, the NYSE and NASDAQ, have set up

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138 *ALI, ALI Principles of Corporate Governance* §3A.01(a) (1994).
mandatory listing requirements that the majority of the board of directors must be independent directors. Most big corporations have voluntarily appointed independent directors. For example, the “General Motors Company Board of Directors Corporate Governance Guideline” stipulates that there must be a majority of independent directors on the board. A large institutional investor, the California Public Employees’ Retirement System (CalPERS), states that independence is the cornerstone of accountability and independent boards are essential components of sound governance structures. CalPERS also suggests that boards consist of at least a majority of independent directors. This investor further suggests that “boards should strive to obtain board composition made up of a substantial majority of independent directors.” Likewise, many influential institutes have similar opinions regarding the importance of independent directors in the corporate governance context.

After major corporate scandals such as Enron and WorldCom, U.S. Congress enacted SOX in 2002, which requires publicly-traded companies to establish audit committees consisting exclusively of independent directors. Despite criticism by many corporate scholars, the enactment of SOX indicates the importance of independent directors. SOX attempts to prevent fraud by “leaving the audit committee comprised of independent directors as the last line of defense.”

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139 E.g., Section 303A.01 of NYSE LISTED COMPANY MANUAL: “Listed companies must have a majority of independent directors”; Rule 5605(b) of NASDAQ LISTING RULES: “A majority of the board of directors must be comprised of Independent Directors as defined in Rule 5605(a)(2).”
142 Id.
143 Id.
144 E.g., BUSINESS ROUNDTABLE 2010 PRINCIPLES OF CORPORATE GOVERNANCE (2010) suggests that “a substantial majority of the board’s directors should be independent, both in fact and appearance, as determined by the board,” available at http://businessroundtable.org/studies-and-reports/2010-principles-of-corporate-governance (last visited Sep. 29, 2011); the COUNCIL OF INSTITUTIONAL INVESTORS GOVERNANCE POLICIES even suggests that “at least two-thirds of the directors should be independent” and “companies should have audit, nominating and compensation committees, and all members of these committees should be independent,” available at http://www.cii.org/CouncilCorporateGovernancePolicies (last visited Sep. 29, 2011).
defense in circumstances where officers have conspired to falsify financial statements.”

The board compositions on Delaware companies continue to reflect the trend that the CEO is the only non-independent director on board.

Given the development of independent directors in the U.S., including policies requiring independent board majorities by the NYSE and NASDAQ, and the enactment of SOX, Taiwan introduced independent directors as an experimental solution to the governance problems that Taiwan has faced.

4.1.4 Regulation Competition in East Asian Countries

The institution of independent directors has been debated in recent decades in Taiwan and neighboring East Asian countries, including China, Japan, and Korea. After the financial crisis of 1997, corporate laws regarding corporate governance in East Asia have been converging with U.S. laws, which are seen as legal structures that offer investors better levels of protection. The quality of corporate governance may be likely to affect a country’s ability to attract international capital. Countries in East Asia like Japan, South Korea, and China all

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146 Jonathan H. Gabriel, Note, Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud, 38 SUFFOLK U. L. REV. 641, 643 (2005). However, the author indicated that independent directors had failed to monitor effectively in the past and could not “detect and prevent fraud committed by determined insiders.” Id.


149 Liu & Yang, supra note 3, at 817.
established the independent director system between 1999 and 2003. Following this development, Taiwan also began a series of actions to introduce independent directors.

4.1.4.1 China

On August 6, 2001, the China Securities Regulatory Commission (CSRC) issued the "Guiding Opinion on Establishing the Independent Director Institution in Listed Corporations (Guiding Opinion)," which recommended that all listed companies revise their articles of incorporation by appointing at least two independent directors by June 30, 2002, and establish boards of directors consisting of at least one-third independent directors by June 30, 2003. Most listed companies followed the recommendations, although the Guiding Opinion was not legally binding. The result is that there are two separate supervisory mechanisms in place in all listed companies: the supervisory board (i.e., the statutory monitoring device) and independent directors. The Guiding Opinion was simply an administrative mandate.

In 2005, China amended its Company Law (CCL) to provide legal enforceability. The CCL clearly stipulates “all listed companies should appoint independent directors.” Therefore, legally speaking, listed companies have no choice but to appoint two supervisory institutions:

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150 Id. at 818.
151 Id.
155 Article 123 of the CCL was revised in 2005 and took effect on Jan. 1, 2006.
independent directors on the board of directors and a supervisory board. The result was that although the institution of independent directors was formally codified, such codification had no additional legal effect, because all listed companies were already in compliance with the Guiding Opinion. The Guiding Opinion still governs matters related to independent directors until such time as the State Council, which is authorized by the CCL to issue rules, issues new regulations.

4.1.4.2 Hong Kong

The listing rules of Hong Kong Stock Exchange (HKSE) (1) require that every board of directors of a listed issuer must include at least three independent non-executive directors; and, (2) at least one of the independent non-executive directors must have appropriate professional qualifications or accounting or related financial management expertise. In addition, the HKSE also suggests that an issuer appoint independent non-executive directors representing at least one-third of the board.

4.1.4.3 Japan

In 2002, Japan introduced the institution of independent directors, and companies were allowed to choose between (1) US-style board with three committees (audit, nomination, and remuneration) that are composed mainly by independent directors (company with committees

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Japanese companies listed on the Tokyo Stock Exchange (TSE) are required to secure at least one independent director or one statutory auditor (i.e., a device responsible for auditing a company’s compliance with laws and regulations). They are permitted to attend board meetings, but do not have votes. Until now, most Japanese companies have chosen to retain the traditional statutory auditor system instead of adopting the board committee system.

It is worth to note that Taiwan’s reform regarding the introduction of independent directors in the TSEA basically resembles the reform adopted in Japan, because companies have the option to choose whether to have a U.S.-style board structure and traditional board structure and supervisor system.

4.1.4.4 Korea

The institution of outside directors was introduced in Korea in 1998 as part of the government’s corporate restructuring policies, after a financial crisis of 1997 occurred in East Asia. Article 542-8 of Korean Commercial Act stipulates that (1) listed companies shall ensure that outside directors make up not less than one-fourth of the total number of directors, except in cases determined by “Presidential Decree” in consideration of the magnitude of assets. Some listed companies, as requested by “Presidential Decree,” shall appoint at least three outside directors; and, (2) traditional statutory auditor (supervisor, also known as kensayaku) system without any independent directors.


Bruce E. Aronson, Learning from Toyota’s Troubles: The Debate on Board Oversight, Board Structure, and Director Independence in Japan, 15 J. JAPANESE L. 67, 82 (2010).

Yu-Hsin Lin, Independent Directors, supra note 67, at 95-96.
directors and the number of outside directors shall account for more than half of the total directors.162

Korea Exchange Listing Regulation provides that the number of outside directors of a listed corporation shall be at least one-fourth of the total number of directors. However, the number of outside directors of the listed corporations specified in Article 542-8(1) of the Commercial Act shall be at least three persons, which shall be the majority of the total number of directors.163

4.1.4.5 Summary

The illustrations above show that the convergence of corporate governance in the East Asia should have motivated Taiwan to launch reforms of the institution of independent directors. Given the trend in favor of independent directors, Taiwan seeks to maintain its competitive advantages in terms of corporate governance in the capital markets in East Asia and in the rest of the world as well.164 For example, a recent research targeting Korean large listed companies found that firms with 50% outside directors had a 40% increase in stock price.165 The authors

163 Id.
164 Most experts around the world agree that best governance practices “must include a trend toward more independent boards of directors.” See Robert A. Prentice & David B. Spence, Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?, 95 GEO. L.J. 1843, 1864 (2007). The authors also indicated that more than eighteen nations appointed public or private committees issuing reports that called for increased independence in boards of directors in the 1990s. Id.
suggest that the presence of a majority of outside directors (i.e., the board independence) predicts higher share prices in emerging markets.\textsuperscript{166}

Corporate governance practices worldwide are evolving gradually toward a similar pattern.\textsuperscript{167} Under the competition in the globalized financial markets, many Taiwanese companies hope to attract funds from international capital markets because investors tend to reward firms who appoint independent directors for better corporate governance.\textsuperscript{168} Also, creditors who recognize the value of independent directors are willing to extend credit on cheaper terms to firms that hire more independent boards.\textsuperscript{169} As described by Delaware Chancellor Allen, "[t]he evolution of a global market and the growth of institutional investors … are dynamic … They will, they are now, pushing in the direction of greater efficiency and greater accountability."\textsuperscript{170} As a result, better corporate governance would increase the competitiveness of Taiwanese corporations.\textsuperscript{171}

4.2 Question Two: What Problems Will Taiwan’s Independent Directors Face?

Theoretically, whether or not independent directors can serve as effective monitoring is an open question.\textsuperscript{172} Like independent directors in the U.S., Taiwanese independent directors also

\textsuperscript{166} Id.
\textsuperscript{168} Prentice & Spence, \textit{supra} note 164, at 1867.
\textsuperscript{169} Id. at 1868.
\textsuperscript{171} Liu & Yang, \textit{supra} note 3, at 826.
face the same limitations. In addition, Taiwanese independent directors should face other problems arising from Taiwan’s legal and business environment distinctive from those in the U.S. The beginning of this part will have a review of the debates in the U.S., and later there will be an analysis addressing problems that Taiwanese independent directors would face.

4.2.1 The Theory About the Weakness of Independent Directors

Some U.S. scholars argue that independent directors cannot provide effective monitoring of management based on the following inherent limitations.173

4.2.1.1 Lack of Adequate Time

Many independent directors are employed part-time by their companies and do not have enough time to do more than review business decisions.174 They do not have enough time to make business decisions. An independent director may also work as a full-time employee for another company, or may be concurrently hired by several companies.175 They usually cannot devote most of their time to one company on whose board they serve.176


174 Ribstein, supra note 145, at 26.


176 E.g., Professors Lipton and Lorsch argued that “the most widely shared problem directors have is a lack of time to carry out their duties […] In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors. Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance, 48 BUS. LAW. 59, 64-65 (1992); Professor Lin argued that “even if [independent directors] have the expertise, these directors' busy schedules may preclude them from devoting sufficient amounts of time to thoroughly review management's proposals. Laura Lin, The Effectiveness of Outside Directors as A Corporate Governance Mechanism: Theories and Evidence, 90 NW. U. L. REV. 898, 914-15

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To work effectively, independent directors must be willing to devote a substantial amount of time to the company. In the U.S., the lack of time has been a more serious problem for the effectiveness of independent directors, since the introduction of Sarbanes-Oxley in 2002. “The time required for audit committee meetings has at least doubled,” so “[t]he [independent] directors’ committee work usually cannot be completed in the allotted time, and their discussions often end up being truncated or spilling over into hastily arranged teleconferences.”

4.2.1.2 Lack of Important Information or Industry-Specific Knowledge

Effective monitoring is theoretically premised on accessibility and availability of the company’s information. Independent directors are outsiders who rely on information provided by insiders. If management refuses to provide important information to independent directors, or intentionally hides such information, it is difficult for them to effectively monitor the

(1996). In short, “outside directors presently lack the time to monitor, except during corporate crises, because they are either CEOs themselves or hold equally demanding full-time positions.” Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 884 (1994).

According to the Section 4 of “Independent Directors Regulations,” no independent directors can serve more than three companies. Taiwanese policymakers have same concern about the time constraints that independent directors usually face. However, setting a maximum number of companies on which an independent director can serve would not be enough to provide sufficient incentives for independent directors. Many commentators believe that “carrot and stick” approach should be utilized to provide independent directors with more incentives to stimulate the effectiveness of independent directors (this will be discussed later). Some research literature, however, argues that independent directors can best use their limited time by making business decisions. See Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 5 (1981).


Jay W. Lorsch & Robert C. Clark, *Leading from the Boardroom*, 86 HARV. BUS. REV. 104, 107 (2008). However, some scholars indicated that directors have been serving on fewer and fewer boards since SOX, and that would help boards maintain a performance advantage. Prentice & Spence, supra note 164, at 1865.


Ribstein, supra note 145, at 26.
company. Even though independent directors can actively collect information, unless they have
eough time to do so at a company, they usually have insufficient information to make
discriminating choices that can benefit shareholders.\textsuperscript{181} In addition to the lack of information, the
amount and complexity of the data independent directors receive may be another difficulty that
most independent directors would encounter.\textsuperscript{182}

Today, most directors of the U.S. listed companies are completely “independent.” Due to
current strict standards of independence, many directors lack industry-specific experience and
knowledge.\textsuperscript{183} Even if independent directors are provided with comprehensive, well-organized
data, they will still be unable to process such data.\textsuperscript{184} The current viewpoint of policymakers
regarding corporate governance is that independence is superior to working knowledge of the
company, and has become the principal criterion for appointing directors.\textsuperscript{185}

Finally, public companies are growing bigger and their businesses are more complex than
last decades.\textsuperscript{186} That may require independent directors “to keep up with various facets of their
businesses and industries.”\textsuperscript{187} As a matter of fact, expecting an independent director in an
automobile manufacturer to know the details of a new engine technology may be unrealistic.\textsuperscript{188}

\begin{footnotes}
\footnote{Lipton & Lorsch, \textit{supra} note 176, at 65.}
\footnote{Deakin, \textit{supra} note 173, at 537 (citing Leo E. Strine, Jr., The Role of Delaware in the American Corporate
Governance System, and Some Preliminary Musings on the Meltdown's Implications for Corporate Law at Utrecht
Univ. Molengraaff Inst. for Private Law Conference on Governance of the Modern Firm 2008, at 26 (Dec. 13,
2008).}}
\footnote{Lipton & Lorsch, \textit{supra} note 176, at 65.}
\footnote{Deakin, \textit{supra} note 173, at 541.}
\footnote{Lorsch & Clark, \textit{supra} note 178, at 108.}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
4.2.1.3 Structural Bias or Inclination in Favor of Management

"Structural bias" here can be defined as an inherent prejudice that results from the composition and character of the board of directors. In U.S. companies, candidates for independent director positions are often nominated by CEOs, and the elections of independent directors tend to be greatly influenced by management. For example, a CEO may invite favored outside independent directors onto the board by offering generous annual pay, insurance, and retirement benefits. Additionally, independent directors and CEOs are often friends and social acquaintances. Directors’ feelings of cordiality and friendliness may develop over the years in companies on whose boards they serve, and a bias problem may develop. CEOs may nominate directors who are unwilling or unable to monitor the managerial team. The bonds of friendship and collegiality among directors sometimes are powerful that independent directors are unlikely to show the qualities of independence and objectivity in monitoring their colleagues’ performance, especially when board culture calls for consistency in the boardrooms. The possible result is that directors may be reluctant to challenge management, in the absence of obvious evidence.

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192 Solomon, supra note 175, at 584.
193 Allen, supra note 191, at 2057.
The structural bias also can be explained by an implicit conspiracy theory that argues directors pursue group interests due to an implicit conspiracy among directors.\textsuperscript{196} Independent directors may be disinterested in some transactions in which they believe have no direct personal conflicts of interest, but their decisions might favor other interested directors.\textsuperscript{197} Individual directors may show favoritism for each other out of solidarity or in return for the expectation of similar treatment by other directors. They may do so in order to maintain their positions on the board.\textsuperscript{198} Independent directors may be reluctant to “reduce board cohesiveness by failing to be perceived as team players, or by reducing trust within the board.”\textsuperscript{199} Some literature also indicates that independent directors who can deliver dissenting opinions regarding certain suspect transactions may be excessively influenced by the leader of the group. Therefore, removing the CEO as a member of the board means that an independent board is more likely to engage in frank discord in dissent.\textsuperscript{200}

With regard to derivative litigation, it is critical that independent directors be able to perceive and represent corporate interests when they determine whether or not a shareholders’ demand or shareholders’ suit is in the best interests of the company.\textsuperscript{201} However, Professors Cox

\begin{itemize}
  \item \textsuperscript{196} Julian Velasco, \textit{Structural Bias and the Need for Substantive Review}, 82 WASH. U. L. Q. 821, 856 (2004).
  \item \textsuperscript{197} \textit{Id}.
  \item \textsuperscript{198} \textit{Id}. Research suggests that the market for independent directors functions in the interests of managers, not shareholders. Directors who have ousted a CEO will be hired by fewer companies than those who have not. Furthermore, companies on whose boards they serve tend to be significantly smaller and less reputable. As a result, “independent directors who overtly signal their alignment with shareholders by virtue of their actions on prior boards are penalized in the directorial market.” Mary-Hunter McDonnell & Brayden King, \textit{The Market Hates a Monitor: The Adverse Selection of Independent Directors Who Oust a CEO} (July 23, 2011), available at SSRN: \url{http://ssrn.com/abstract=1893713}.
  \item \textsuperscript{200} Z. Jill Barclift, \textit{Corporate Governance and CEO Dominance}, 50 WASHBURN L.J. 611, 620 (2011). [hereinafter Barclift, \textit{Corporate Governance}] The author also points out the proportion that the CEO serves simultaneously as chairman of the board, is decreasing in U.S. public companies. See \textit{Id} at 620-21.
  \item \textsuperscript{201} A shareholder should make a demand to the board of directors before bringing a derivative suit on behalf of a corporation, unless the shareholder can prove that such a demand is futile. Even in demand futility, a company,
and Munsinger concluded that “several psychological mechanisms can be expected to generate subtle, but powerful, biases which result in the independent directors' reaching a decision insulating colleagues on the board from legal sanctions.” There exists skepticism to the effect that independent directors might not be objective in derivative suit contexts. According to Zapata, decisions made by a special litigation committee consisting of independent directors receive greater scrutiny. A Delaware court has the discretion to apply its own business judgment and second-guess a special litigation committee's decision that has been made by disinterested independent directors.

In reality, as pointed out by Delaware Chancellor Strine, independent directors are usually managers of other corporations, and the social affinities often exist between independent directors and managers. Outside independent directors may be tied to management in several

\[\text{James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. 83, 84 (1985). Professor Rock also points out that “[t]o the extent that they are economically or psychologically dependent on management, they have significant incentives not to act as the shareholders' champion.” Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 505 (1991). However, some scholars disagree with the presumption of structural bias that independent directors are more willing to risk financial and reputational harm than deal with complaints against insider directors. Michael P. Dooley & E. Norman Veasey, The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared, 44 BUS. LAW. 503, 533-35 (1989).}

\[\text{Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).}

\[\text{Grover C. Brown et al., Director and Advisor Disinterestedness and Independence under Delaware Law, 23 DEL. J. CORP. L. 1157, 1190 (1998).}

\[\text{Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1375 (2002). [hereinafter Strine, Delaware Impact] More responsibilities being placed on independent directors will also be a concern about true independence, because independent directors may have “to spend so much time on issuer business that because of their increased fees and added work they will no longer be functioning as truly outside, independent directors.” Perry E. Wallace, Accounting, Auditing and Audit Committees After Enron, et al.: Governing Outside the Box Without Stepping Off the Edge in the Modern Economy, 43 WASHBURN L.J. 91, 115 (2003) (citing Roberta S. Karmel, Federalization of the Law Regarding Audit Committees, N.Y. L.J., Feb. 20, 2003, at 3).} \]
ways so that “it is delusion or pretense to expect them to represent shareholder views,” especially in conflict-of-interest transactions.\textsuperscript{206}

The independent directors may naturally give weight to the points of view of CEOs who usually have special knowledge and experience related to the operation of the company.\textsuperscript{207} In many situations, independent directors may be unable to identify and control their own biases. The idea of “bounded rationality,” meaning the inability of people to perceive their own ethical limitations, has demonstrated that people are unaware of their biases and how their biases affect their personal decision-making.\textsuperscript{208} Independent directors are human beings who are subject to this inability and are unable to avoid unconscious bias. The impact of unconscious bias may be tremendous to the extent to which the effectiveness of independent directors will be impaired.

In short, independent directors will face “significant personal costs, both financial and psychological, to serving an active, independent role in the boardroom,” and “the personal costs of fighting these financial and psychological constraints have been quite high.”\textsuperscript{209} Therefore, independent directors may “have an incentive to work closely and amicably with management and little incentive to challenge it.”\textsuperscript{210} With an eye on the true utility of independent directors, it is very essential to minimize these costs for them.\textsuperscript{211}

\textsuperscript{206} Allen, supra note 191, at 2056. See also Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence, 67 Tex. L. Rev. 1351, 1395-1412 (1989).

\textsuperscript{207} Haft, supra note 176, at 3.

\textsuperscript{208} Page, supra note 199, at 239-40.


\textsuperscript{210} Solomon, supra note 175, at 585.

\textsuperscript{211} Id.
4.2.1.4 Lack of Incentives

Independent directors are usually outsiders who have no ownership interest in a company.\textsuperscript{212} How well the firm performs normally does not have any financial impact on independent directors. Thus, they may not have any significant economic incentive to discipline company management.\textsuperscript{213} Outside independent directors also typically lack an affirmative incentive to monitor effectively, because they are rewarded with a flat monetary benefit for their work.\textsuperscript{214}

Assuming independent directors have enough incentives to provide active monitoring, these incentives will not always ensure optimal levels of monitoring, because boards must exercise power by collective actions that will likely raise a free-riding problem.\textsuperscript{215} Thus, even though faithful and active monitoring may be in line with individual director’s interest, she may assume that other colleagues will do the work.\textsuperscript{216} Therefore, the free-riding problem will likely lower the board’s capabilities to offer the optimal levels of monitoring.\textsuperscript{217}

4.2.1.5 Costs and Benefits

Adding independent directors to a board may be associated with costs and benefits in certain respects.\textsuperscript{218} Searching for, and hiring, desirable independent directors may be costly.

\textsuperscript{213} Rock, \textit{supra} note 202, at 505.
\textsuperscript{214} Lin, \textit{supra} note 176, at 916. For the insurance of independence and low possibilities of conflicting interests that affect the objectivities of independent directors, directors' fees must be the sole compensation for them, but these fees may vary due to responsibilities for each different director. Toda & McCarty, \textit{supra} note 179, at 196.
\textsuperscript{215} Bainbridge, \textit{ALI Governance Project, supra} note 191, 1060-61.
\textsuperscript{216} Id. at 1061.
\textsuperscript{217} Id.
\textsuperscript{218} But the problem is that there may be no good scientific mechanism for quantifying benefits or costs associated with the appointments of independent directors. See Donald C. Langevoort, \textit{The Social Construction of Sarbanes-Oxley}, 105 MICH. L. REV. 1817, 1827 (2007).
Benefits may be created by having independent directors if most of them are business experts or experienced officers who can provide valuable insights into the business strategies that can produce better company performance.\footnote{E.g., Pease, \textit{supra} note 17, at 33.} However, independent directors may be unable to create efficiency in terms of decision-making made by boards of directors. The board of directors is a collegial body that uses consensus-based decision-making, and consensus works best where team members are given equal access to information and have comparable interests.\footnote{Bainbridge, \textit{NYSE's Director Independence}, \textit{supra} note 110.} In comparison with independent directors who are outsiders, inside directors are more likely to have comparable access to information and have similar interests,\footnote{\textit{Id.}} so scholars argue that independent directors may be undesirable in terms of efficient decision-making by boards of directors.\footnote{\textit{Id.} Professors Lipton and Lorsch also argued that “if independent directors are to be more effective monitors, we need to find a means to strengthen the cohesiveness of boards and the process by which directors work together.” Lipton & Lorsch, \textit{supra} note 176, at 66.}

When boards of directors focus on monitoring, it can negatively impact productivity. There may be trade-offs for board members between the ability to manage the business and the ability to function as an effective monitor.\footnote{Professor Bainbridge contended that “[i]f the board is limited to monitoring management, and especially if it is limited to objective measures of performance, however, the board may be unable to differentiate between acts of god, bad luck, ineptitude, and self-dealing.” Bainbridge, \textit{NYSE's Director Independence}, \textit{supra} note 110.} Some argue that independence of independent directors will only function in the conflicts of interest between management and shareholder, so expecting independent directors to make better business decisions and run the company better is “to misconceive the role of the independent director and to fetishize independence.”\footnote{Usha Rodrigues, \textit{The Fetishization of Independence}, 33 \textit{Iowa J. Corp. L.} 447, 495 (2008).}
4.2.1.6 Other Factors

Even if independent directors are willing to be actively evolved in monitoring management, few board meetings are held during a year and most of them are short.225 A survey indicated that large U.S. manufacturing companies averagely had 14 board and committee meetings per year, and the board meeting on average lasted only three hours.226

4.2.1.7 Summary

Some scholars doubt the functions of independent directors, and argue that their inherent limitations are likely to lead to ineffective monitoring. A comprehensive study suggests outside directors, in fact, are faced with limited time and information, which hinders them from evaluating senior management adequately.227

Professors Gilson and Kraakman contend that good character and financial independence from management may be necessary, but insufficient, conditions for effective monitoring due to the inherent limitations of independent directors.228 The limitations include dependency, ideologies and social obstacles to monitoring.229 More specifically, a financially independent outside director depends on management in order to maintain tenure as directors.230 Many outside directors of public companies are CEOs of other companies, which makes it unlikely that such directors will monitor in a more energetic manner than they believe they should be.

225 Bainbridge, ALI Governance Project, supra note 110, at 1058.
226 Id. (citing The Conference Board, Membership and Organization of Corporate Boards 25 (1990).
228 Gilson & Kraakman, supra note 176, at 874-75.
229 Id. at 875.
230 Id.
monitored by their own boards. Finally, outside independent directors may be financially independent but not socially independent from management.

In conclusion, scholars point out the ineffectiveness of independent directors by pointing at the collapse of Enron, which had a majority of independent directors on its board of directors. Like what happened in Enron, “[n]o director can be expected to catch sophisticated fraud by company insiders. The head of Enron’s audit committee, Robert Jaedicke, is a professor of accounting at Stanford University, who could hardly have been more qualified for the job.”

4.2.2 The Theory About Effectiveness of Independent Directors

Most corporate scholars argue that although independent directors are constrained by inherent limitations, the institution is good for companies.

4.2.2.1 Professionalism and Business Experience

The board of directors has two basic functions: the advisory function and the monitoring function. Boards can produce value for companies in several ways, including providing advice, developing long-term business strategies, and offering expertise as needed by companies. Independent directors are usually business veterans or experts in some professional areas that the

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231 Id. E.g., Allen, supra note 191, at 2057.
232 Id.
233 E.g., Page, supra note 199, at 247. However, some scholars argue that “[t]he failings of Enron's directors…, should not suggest that proximate monitors [company's directors] can never be effective, or that reliance on the "objective" outside monitor is more appropriate.” Elson, supra note 212, at 502.
235 Fisch, supra note 128, at 43.
company needs. They help management develop business strategies that improve the competitive advantages of companies. Their insights can be valuable.

Compared to the advisory function, scholars suggest that the board’s monitoring or oversight function is paramount. An independent board consisted by a majority of independent directors will be able to prevent self-interested activities that may harm the interests of shareholders by offering a robust review of suspicious transactions. Independent directors equipped with professional abilities can help board monitoring by reducing the possibility of wrongdoing by management. A NYSE report claims that having a majority of independent board of directors increases the quality of board oversight and reduces the possibility of damaging conflicts of interest. For example, an independent director with accounting expertise could better detect irregularities in financial reports prepared by management than could non-expert directors. Furthermore, an independent director’s business experience could offer valuable comments regarding how to monitor management.

Independent directors who ask pointed questions can induce management to consider matters about which their staff members do not want to make them think. Hard issues are often filtered as they make their way up the line towards decision makers. During the information-filtering process, people can slant the facts, and the information may not be completely accurate.

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236 Most independent directors are current or retired CEOs and other senior officers of other public companies, in the viewpoints of incumbent management, because they are familiar with how boards of directors are working and the scope of CEOs’ obligations and duties. A second popular source of independent directors is retired high-level corporate management. See Robert W. Hamilton, Reliance and Liability Standards for Outside Directors, 24 WAKE FOREST L. REV. 5, 17 (1989).

237 E.g., Pease, supra note 17, at 33.

238 Eisenberg, Modernization of Corporate Law, supra note 179, at 205.


240 Lucian A. Bebchuk et al., supra note 177, at 1039.

241 Id.
by the time it reaches decision-makers.\textsuperscript{242} Therefore, an independent director must be willing to challenge managerial proposals and ask the critical questions that nobody else is asking.

\subsection*{4.2.2.2 Functions in Emergency}

Some scholars argue that independent directors can perform useful roles in emergencies, such as replacing ineffective CEOs, assuring an orderly transition in the event of the retirement or death of CEOs, and forming special litigation committees to investigate the merits of shareholder demands or lawsuits.\textsuperscript{243}

\subsection*{4.2.2.3 Conflicts of Interest}

Normally, compared to outsiders, inside directors with firm-specific expertise and adequate information are in better positions to exercise business judgment for the company. In some situations involved with conflicts of interest between insiders (and management) and shareholders, insiders’ judgment may be tainted by personal interest. For example, a hostile tender offer creates a conflict of interest between shareholders and managers, and independent directors can provide oversight to the extent that protects shareholders’ interests.\textsuperscript{244} Thus, independent directors can help prevent skewed judgment from being made.\textsuperscript{245} In the U.S., that is why there will be nearly insurmountable hurdles for shareholders to challenge board actions tainted by conflicts of interest through derivative litigation if independent directors have validated such actions.

\footnotesize
\begin{itemize}
\item \textsuperscript{242} Id.
\item \textsuperscript{243} Pease, \textit{supra} note 17, at 33-34. See also Jones, Promoting Accountability, \textit{supra} note 194, at 114. Some even argue that “one of the board's most important functions is to evaluate the performance of the CEO, and to replace an underperformer in a timely fashion.” Millstein, \textit{supra} note 170, at 1494.
\item \textsuperscript{244} E.g., James F. Cotter et al., \textit{Do independent directors enhance target shareholder wealth during tender offers?}, 43 J. FIN. ECON. 195, 196 (1997) (finding that tender offer targets with independent boards experience higher shareholder gains).
\item \textsuperscript{245} E.g., Noyes E. Leech & Robert H. Mundheim, \textit{The Outside Director of the Publicly Held Corporation}, 31 BUS. LAW. 1799, 1804 (1976).
\end{itemize}
Independent directors usually have substantial experience in making tough evaluative judgments, which can affect friends and business colleagues, including decisions such as arranging dividends among partners and dismissing long-time employees.\(^{246}\) Outside independent directors who have invested years in building their reputations, are likely to resign themselves to having to make tough, relationship-straining decisions.\(^{247}\) For example, the Delaware Court generally tends to give more credit to a board consisting of a majority of independent directors when assessing the reasonableness of a board’s defensive reactions to a hostile takeover.\(^{248}\) Another example is that executive compensation approved by independent directors will be more likely assumed reasonable.\(^{249}\)

Furthermore, independent directors can evaluate conflict-of-interest transactions within the company rather than in a court in the litigation.\(^{249}\) With the presence of independent directors, the board of directors will more likely accept an unsolicited takeover offer, because independent directors may not easily decide to reject the offer and a CEO’s tenure may already be less secure when the independent directors are present.\(^{250}\) Management may have to face more threatening discipline from the market.

Chancellor Strine argues that independent directors are subject to the desire to protect their positions. They are, thus, more likely to impartially decide whether or not a bid is in the shareholders' best interests,\(^ {251}\) as opposed to insider managers who usually have more at stake in

\(^{246}\) Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 Iowa L. Rev. 1305, 1316 (2005).

\(^{247}\) Id.


\(^{250}\) Kahan & Rock, *supra* note 111, at 897.

\(^{251}\) Strine, *Delaware Way, supra* note 248, at 677.
terms of financial investment and human capital. Therefore, Delaware law encourages boards to delegate the authority to independent directors in responding to takeover.\textsuperscript{252} Delaware Chancellor Allen also observed in the famous RJR Nabisco case, “in which a committee of structurally independent directors has appeared to function quite adversarily” and “the outside directors were seen as energetically exercising informed and independent judgment in the sale of the enterprise.”\textsuperscript{253}

4.2.2.4 Protecting Shareholders

Independent directors are anticipated to function in the interests of shareholders, and may be able to articulate shareholder concerns and push management towards the maximization of shareholder wealth.\textsuperscript{254} Robust monitoring of management can help preserve the interests of shareholders, and the management integrity can be maintained.\textsuperscript{255} Justice Veasey stressed that independent directors could function as an effective stockholder protection device.\textsuperscript{256}

Independent directors can also be securities monitors who protect securities investors.\textsuperscript{257} In some cases, the managers may prefer not to disclose bad news to the public, independent directors can provide a check on management who desires to avoid or prolong disclosing bad information and ensure the compliance with the disclosure rules.\textsuperscript{258} Generally, they can enhance the reliability of public disclosure made by companies and that will make “stock market prices a

\begin{footnotesize}
\textsuperscript{252} Id. Chancellor Alan also states that “use of outside directors to protect minority shareholders was specifically encouraged by the Delaware Supreme Court in its 1983 Weinberger opinion.” Allen, supra note 191, at 2058.
\textsuperscript{253} Id. at 2059.
\textsuperscript{255} Chandler & Strine, supra note 147, at 979. E.g., Prentice & Spence, supra note 164, at 1908. The authors argue that “audit committees be composed entirely of independent directors pays concrete benefits in terms of accurate financial reporting.”
\textsuperscript{256} Veasey, Rationale for Corporate Decision, supra note 137, at 687.
\textsuperscript{257} Hillary A. Sale, Independent Directors as Securities Monitors, 61 BUS. LAW. 1375, 1382 (2006).
\textsuperscript{258} Id.
\end{footnotesize}
more reliable signal for capital allocation and for the monitoring of managers at other firms as well as their own.”

4.2.2.5 Summary

Independent director advocates generally admit the inherent limitations that may impair their effectiveness, but are of the opinion that board independence is a worthwhile goal. Chancellor Allen states,

“Director independence does not assure that a director will make a better contribution on the board than an insider might make. Independent directors may have less information about the firm and may, in fact, tend to make less brilliant decisions over time than those with a close financial interest in the firm. Nevertheless, independence offers to investors some further assurance that the governance process has integrity. It is a very imperfect signal of integrity, of course. Independent directors can be imperfect in a number of ways, as can we all, but their lack of management bias does offer investors some protection.”

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259 Gordon, supra note 254, at 1469.
260 Veasey, Rationale for Corporate Decision, supra note 137, at 687-88.
261 Id. at 688. (citing William T Allen, Independence, Integrity and the Governance of Institutions, Speech to the National Association of Corporate Directors Annual Meeting, 7-8 (Oct. 27, 1997).
Whether the majority of the board of directors should be independent is debatable, but most academia and business researchers agree that independent directors can help the board function effectively,\(^{262}\) as long as some preconditions can be met.

### 4.2.3 Preconditions for Effectiveness of Independent Directors

Assume the theory acclaiming independent directors is accurate, most scholars agree that there should be some mechanisms to motivate independent directors to carry out their duties.

#### 4.2.3.1 Incentives: Carrot vs. Stick

Like inside directors, independent directors are also agents for shareholders. They may seek for their own interests and the agency cost may rise albeit little. In situation that they are granted other expansive powers over auditing, director nomination, and executive compensation, the costs certainly rise.\(^{263}\) Some scholars argue that independent directors should be compensated for time spent on monitoring in order to give them a monetary incentive that will motivate them to monitor in an effective manner.\(^{264}\) Independent directors who fail as monitoring watchdogs will probably suffer soiled reputations and negative labor market consequences,\(^{265}\) so they have incentives to carry out their tasks effectively and avoid colluding with managers to exploit shareholders.\(^{266}\) Some argue that independent directors should partially be compensated by the equity of the company, so they, as the equity owners, have interests aligned with interests of

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\(^{262}\) Pease, supra note 17, at 31. See also Borowski, supra note 127, at 455-56 (arguing the independent directors can play an important, albeit “limited,” role in improving corporate accountability).


\(^{265}\) Davis, supra note 246, at 146.

\(^{266}\) Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J. L. & Econ. 301, 315 (1983).
shareholders. Also, independent directors’ incentives to monitor management include a desire to protect their reputation and to maximize the value of their equity holdings in the company.

Independent directors have the same fiduciary duties to the company as other directors. Some scholars agree that imposing legal liabilities on directors can help motivate them to be attentive and careful in order to avoid adverse financial consequences that can result from the failures to measure up to legal standards. Likewise, liability encourages the independent directors to reject non-arms-length transactions and offers a powerful argument for independent directors when insiders propose a dubious transaction. However, the stick approach cannot be overstated because imposing heavy liabilities on directors has certain disadvantages.

For example, independent directors may be so apprehensive about shareholder lawsuits that they might back off from innovative decision-making, which would reduce their

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267 For example, granting directors stock options or restricted stock may successfully align independent directors with shareholders. A research indicates that there has been “a substantial increase in the use of incentive-based compensation for directors,” and suggests that incentive compensation would influence board’s monitoring efforts. See Tod Perry, Incentive Compensation for Outside Directors and CEO Turnover (June 2000), available at SSRN: http://ssrn.com/abstract=236033. However, some doubt if this method would work. See Rodrigues, supra note 224, at 460-61.

268 Lin, supra note 176, at 940.

269 Brian R. Cheffins & Bernard S. Black, Outside Director Liability across Countries, 84 Tex. L. Rev. 1385, 1387 (2006). Professor Sale contends that “[Independent directors] are potentially liable if they simply rubber-stamp the statements or information provided to them by the officers.” Sale, supra note 257, at 1381. See also Hamilton, supra note 236, at 5. But see Jones, Promoting Accountability, supra note 194, at 117 (noting that cumulative effect of protective devices normally used in practice, such as business judgment rule, demand requirement in derivative suits, exculpation, indemnification, and insurance lead to de facto “no liability” rule for directors. Thus, independent directors will face very infinitesimal risk of paying for damages caused by breach of fiduciary duty out of their own pockets).

However, Professor Stout argues that the deficiencies of directors’ external punishments (i.e., legal sanctions and social sanctions) are not seen as threats to directors because the punishment is inadequate, and does not explain why a purely self-interested director would take fiduciary duties seriously. She argues that some nonpecuniary reasons, such as “honor,” “integrity,” “trustworthiness,” and “responsibility,” can push directors to make altruistic decisions. See Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, What You Don’t Want to Invite Homo Economicus to Join Your Board), 28 Del. J. Corp. L. 1, 5-10 (2003).

effectiveness on behalf of the company.\textsuperscript{271} Furthermore, they may spend time collecting documents that can be utilized as part of the defense in future lawsuits, which would diminish their ability to function.\textsuperscript{272} Even independent directors are not in a better position than insiders to understand the relevant facts and make material decisions, such as mergers or hostile takeovers, in the best interests of the company and its shareholders. The courts do not hold them “to a lesser standard in being informed and in exercising requisite care in their decisions.”\textsuperscript{273} Thus, protecting independent directors from potential liabilities is an important issue.\textsuperscript{274} Imposing too heavy liability on them will provide less incentive for experienced or professional experts to be hired as independent directors.\textsuperscript{275}

The legal liability risks that independent directors face are higher in the U.S. than in other parts of the world.\textsuperscript{276} For example, even though independent directors in Taiwan are subject to various legal rules, they rarely can be liable due to high thresholds for shareholder suits (discussed later).

\textbf{4.2.3.2 True Independence}

The U.S. corporate conventional wisdom argues that independent directors are presumably able to function as an effective monitor because they have no family or financial ties

\textsuperscript{271} Pease, supra note 17, at 96.  
\textsuperscript{272} E.g., Id.; Cheffins & Black, supra note 269, at 1389.  
\textsuperscript{273} Pease, supra note 17, at 53.  
\textsuperscript{274} E.g., Haft, supra note 176, at 17-19. The author argued that “the law should encourage truly independent directors to serve and act as "monitors," but rather as "deciders." To promote these ends, courts can accord more certain, and probably greater, legal protection to business decisions reached by the truly independent board than does current law.”\textit{Id.} at 6. See also James M. Tobin, \textit{The Squeeze on Directors—Inside is Out}, 49 BUS. LAW. 1707, 1750-51 (1994); Pease, supra note 17, at 49-53; Marshall L. Small, \textit{The Evolving Role of the Director in Corporate Governance}, 30 HASTINGS L.J. 1353, 1370 (1979).  
\textsuperscript{276} Cheffins & Black, supra note 269, at 1387.
with big shareholders, company officers, and the company. In this sense, there is no question that true independence is critical in order for independent directors to function as expected.277

Independent directors are specifically assumed to be able to make fairer decisions on behalf of the company than inside directors, particularly in situations where conflicts of interest between inside directors and the company exist.278 In cases of shareholder lawsuits in which directors allegedly breach their fiduciary duties by engaging in transactions that involve their self-interest, independent directors are deemed to be the best parties to make the final decisions regarding the best interests of the company. If the alleged transactions are reviewed and agreed upon by independent directors, the court will not have a second guess on the legality of such transactions, which are usually presumed to be in the best interests of the company. Under the business judgment rule, which presumes that board decisions are made on a fair, informed, good-faith basis, decisions by independent directors will receive a great deal of deference by courts, and can avoid trivial lawsuits.

In order for independent directors to maintain true independence, some U.S. scholars suggest that there should be a stricter standard for independence.279 In fact, the standards have become increasingly stricter.280 There are two primary approaches used to determine which

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277 E.g., Tobin, supra note 274, at 1723. The author believes that it is “[c]ritical to an outside [independent] director's ability to successfully carry out his or her management oversight function is the ability of that director to exercise his or her business judgment, independent from management.” Id. at 1748; Professor Millstein also argues that “[t]rue independent oversight is the key to achieving accountability. At the board level this requires true independence of management to enhance the board’s credibility with the shareholders” Millstein, supra note 170, at 1494; see also Leech & Mundheim, supra note 245, at 1830 (noting that the benefits of a board dominated by outside directors can be achieved only by ensuring that such outsider is truly independent); Toda & McCarty, supra note 179, at 189 (suggesting that independence among directors is vital to effective corporate governance).

However, some argue that inducing both faithful and capable agents should be the goal of corporate governance. Even though independence can be a proxy, fetishizing the independence proxy sometimes is misguided and dangerous. See Rodrigues, supra note 224, at 451.

278 E.g., Strine, Derivative Impact, supra note 205, at 1375; Gilson & Kraakman, supra note 176, at 874-75.

279 Fairfax, Corporate Federalism, supra note 12, at 383.

280 Corporate Governance Issues, supra note 239, at 61; Clark, supra note 172, at 268.
director can be an independent director. The traditional approach used in U.S. litigations is a function-specific approach that is used to determine who would qualify as independent directors in litigation. Delaware courts tend to defer to business decisions made by the majority of the board of directors whose members have no direct and personal interest in the alleged transaction and are independent of the defendant directors. The business decisions made by independent directors are assumed in the best interest of shareholders. In general, the more independent directors are on board, “the more likely it is that board action will find a safe harbor from liability in many settings.” The approach used by Delaware courts to determine independence is situational. Specifically speaking, courts will determine whether a particular director is disinterested or independent on a case-by-case basis, without a bright-line rule. The primary questions that are most often asked by courts regarding independence concern what purpose and independence from whom. A director who is independent in one case may not be independent in another.

Instead of the traditional approach, the SOX and most stock exchanges around the world equates independence with outsider status by using a list of several conflicting relationships that will disqualify directors from being deemed independent. This approach contends that once a director is elected as an independent director, the label of independence automatically comes with that eligible director unless that director later fails to meet the independence standard. This approach, which includes full disclosure of information about directors, can give the public a

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281 Veasey, Good Governance Practices, supra note 137, 2182. But Delaware Vice Chancellor Chandler has a similar but slightly different opinion, and states that “not rely reflexively only on the status of a director as an inside director or an independent director to inform their determination of whether that director’s actions were right or wrong, proper or improper, informed or uninformed.” William B. Chandler III, On the Instructiveness of Insiders, Independents, and Institutional Investors, 67 U. Cin. L. Rev. 1083, 1088 (1999).
282 Rodrigues, supra note 224, at 447.
283 Veasey, Good Governance Practices, supra note 137, at 2182.
284 Id.
285 Fisch, supra note 128, at 45; Rodrigues, supra note 224, at 447.
clear and quick guide to understanding whom and how many independent directors are on board. In contrast, courts determine the independence of directors primarily by evaluating the practical constraints on a particular director’s ability to function effectively with respect to a specific issue.\textsuperscript{286}

Scholars have criticized the later approach,\textsuperscript{287} because this definition of independence can be over-inclusive or under-inclusive.\textsuperscript{288} This approach basically emphasizes the importance of business relationships between directors and the company, which have the potential to impair a director’s ability to function in the interest of the company, regardless of how minor such relationships might be. Most of current independence standards fail to address the conflict-of-interest situations in which independent directors will help to alleviate the agency problem.\textsuperscript{289} For example, in terms of executive compensation, the lacks of financial ties to the company and familial ties to the executives may not be sufficient to expect independent directors to solve the agency problem.\textsuperscript{290} Instead, whether the financial ties to the executives being compensated exist will be critical. It is unfortunate that current independence rules overlook this obvious hole.\textsuperscript{291} Additionally, this approach ignores social ties and friendships than can similarly have an adverse impact on board function.\textsuperscript{292} Scholars describe this type of director independence as “cosmetic

\begin{footnotesize}
\begin{enumerate}
\item Fisch, supra note 128, at 45.
\item Id.
\item Id.
\item Id.
\item Id. 289 Rodrigues, supra note 224, at 447.
\item Id.
\item Id. 291 Fisch, supra note 128, at 45; as Professor Brudney notes, “[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess.” Victor Brudney, The Independent Director -Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 613 (1982).
\end{enumerate}
\end{footnotesize}
independence,” arguing that current standards for independence are insufficient to remedy the corporate failures of recent years.\textsuperscript{293}

Even in the U.S., the related-party transactions involving controlling shareholders are subject to an entire fairness review, which “reflects a distrust of the statutory mechanisms of independent director.”\textsuperscript{294} The bottom line is that, theoretically speaking, regardless of how precise or strict the independence standard might be directors’ actual independence cannot be guaranteed simply by requiring directors to meet independence standards.\textsuperscript{295} That is to say, even using a precise definition of independence and rigorous enforcement does not ensure that independent directors will act in a completely independent manner and in the interests of shareholders.\textsuperscript{296}

\textbf{4.2.4 Problems That Taiwanese Independent Directors Will Face}

Independent directors in both the U.S. and Taiwan inevitably face the same inherent limitations, including insufficient time and information, inadequate incentives, structural biases, uncertain true independence, and so on. In addition to the above inherent limitations, Taiwanese independent directors can also face other problems that can arise in a legal and business environment, which differs from that of the U.S. in several critical respects.

\textsuperscript{293} Nicola Faith Sharpe, \textit{The Cosmetic Independence of Corporate Boards}, 34 Seattle Univ. L. Rev. 1435 (2011). Professor Sharpe argues that independent directors “frequently lack the time, information, and knowledge to properly monitor the CEO and other top-level management,” and current independence standards fail to take these factors into account. As a result, current adopted “definition of independence actually reduces the likelihood that independent directors will be able to act independently of the [CEO].”


\textsuperscript{295} Sharpe, supra note 293, at 1437.

\textsuperscript{296} OECD \textit{Corporate Governance in Asia}, supra note 1, at 50. See also Bainbridge, \textit{ALI Governance Project}, supra note 191, at 1082. Professor Bainbridge argued that “independent directors are not a perfect constraint on management self-dealing. Both actual and structural bias may affect their decisionmaking.”
4.2.4.1 Dominance by Controlling Shareholders

Controlling shareholders are pervasive in Taiwanese companies, in the sense that they usually dominate boardrooms. Therefore, in addition to independence from management, independence from big (or even controlling) shareholders also is critical for an effective board monitoring, particularly in Taiwanese companies.297 Ironically, Taiwan’s Independent Director Rules mandate that companies adopt the “candidate nomination system” in electing independent directors. Under such election system, only board of directors and big shareholders (who hold more than 1% of a company’s outstanding shares) can propose slates of independent directors. Thus, if the majority of incumbent directors and big shareholders have shared interests, truly independent directors are less likely to be nominated and elected.298

One primary reason why Taiwan introduced the institution of independent directors is to prevent the undue dominance of management and board of directors by controlling shareholders. Even in the case of dispersed ownership structures of the U.S. public companies, corporate scholars argue that the key to director independence is not the independence of directors from management but rather their dependence on shareholders.299 Therefore, in Taiwan, director independence from shareholders should be an important issue when it comes to independence of independent directors.

297 E.g., Black, Preconditions for Strong Securities Markets, supra note 270, at 808. The author contended that “nominally independent directors won't be very independent in fact, especially when a company has a controlling shareholder, at whose pleasure the directors serve.”
298 Liu & Yang, supra note 3, at 836. The authors contend that without support from the controlling shareholders or the block shareholders, it is nearly impossible for independent directors to garner sufficient votes to be elected.
299 Gilson & Kraakman, supra note 176, at 905. However, SOX “does not contain any overarching definition of independent director,” and the directors affiliated with big stockholders are qualified to serve as independent directors. Also, NYSE does not prohibit “a major but non-controlling stockholder from being considered an independent director.” Chandler & Strine, supra note 147, at 991.
However, the intentions of insiders can determine whether a company will appoint independent directors as part of their team (because the articles of incorporation need to be amended with support from board of directors and big shareholders). Current regulations regarding independence standards stipulate that incumbent directors and big shareholders can still appoint candidates who have close social ties to them, which means that they can nominate only those candidates whom they can ensure will not monitor them in a robust manner.

Hence, given these standards of independence, there is no guarantee that independent directors will turn out to be truly independent of management and controlling shareholders. Managers and controlling shareholders can bypass the independence standards, and the independent directors can be captured or influenced by controlling shareholders and management. The ownership structures of Taiwanese listed companies are relatively concentrated, so powerful shareholders are common in the market and true board independence is less likely to occur in reality.

Unfortunately, Taiwan has no good idea to deal with dominance of controlling shareholders. In the U.S., Delaware corporate laws tend to be suspicious of fiduciaries that are interested parties or controlled by controlling shareholders.\(^\text{300}\) It appears that independent directors may feel that they owe allegiance to the controlling shareholders who support them in the elections, rather than the company and its shareholders.\(^\text{301}\) Thus, when a controlling shareholder is involved in a deal with the company, the transaction should be reviewed to verify

\(^{300}\) Strine, *Delaware Way*, supra note 248, at 678.

\(^{301}\) *Id.*
that it is substantively fair even if independent directors negotiated the transaction.\textsuperscript{302} An approval by a special committee consisting of independent directors will be necessary.\textsuperscript{303}

### 4.2.4.2 Weak Enforcement of Corporate Laws

Regarding the enforcement of corporate regulations, Taiwan is heavily reliant upon the administrative agency in dealing with a company’s internal governance issues. In cases that arise from issues concerning the fiduciary duties of directors, shareholders must overcome high legal thresholds if they intend to bring an action on behalf of the company (i.e., a derivative suit). Such thresholds include holding a minimum of 3% of the outstanding shares of the company, a holding period of more than 12 months, demand an action against directors to supervisors, a waiting period of 30 days after demand, and rendering a security deposit when the court deems it necessary.\textsuperscript{304} In addition, the plaintiff shareholder may owe liabilities to the defendant directors if that shareholder loses the lawsuit.\textsuperscript{305}

The TCA, thus, sets up an almost impracticable dispute resolution mechanism for internal affairs issues. When all of the supervisors have been captured by management or controlling shareholders, or are involved in wrongdoing, the only method that shareholders (particularly minority shareholders) can use is enforcement by a public agency, meaning the MOEA and FSC, which are the competent authorities in Taiwan. However, it is unrealistic to expect too much from the public agencies, because an administrative agency as an outsider has difficulty detecting wrongdoing when it is in progress secretly. Inside and outside governance mechanisms can

\textsuperscript{302} Id.
\textsuperscript{303} A Delaware decision demonstrated the ability of independent directors to withstand the fear of a controlling shareholder and the power of independent directors to protect minority interests. \textit{Hollinger International v. Black}, 844 A.2d 1022 (Del. 2004). Haas, \textit{supra} note 294, at 2287.
\textsuperscript{304} Article 214 of the TCA.
\textsuperscript{305} Article 215 of the TCA.
supplement each other. However, internal Taiwanese governance mechanisms (i.e., supervisors and shareholders) have serious deficiencies and often fail to function effectively. Agencies such as the MOEA, FSC, and criminal prosecutors, subject to many limitations, currently do not aggressively enforce corporate governance regulations.

4.2.4.3 Majority of Board Members Not Independent

Scholars argue that effectuating a board’s monitoring function requires a majority of independent directors on board.\textsuperscript{306} Few companies in Taiwan have independent-majority-boards. The possible positive effects independent directors might bring to company would be waned because the majority of board members are not independent.

From 2005 to 2008, there were 106 Taiwanese listed companies, which, on average, continuously appointed at least one independent director on a monthly basis, as shown in Table 8. Here, assuming the board independence means number of independent directors/total number of directors, the average mean for board independence is about 0.3, which is far from a majority of independent director boards.

Table 8: Taiwanese Listed Companies That Have at Least One Independent Director (2005-2008)

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<th>Minimum</th>
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<td>Board independence (2005)</td>
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<td>.11</td>
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<td>.2938</td>
<td>.08193</td>
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<tr>
<td>Board independence (2006)</td>
<td>106</td>
<td>.11</td>
<td>.60</td>
<td>.2908</td>
<td>.08258</td>
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<tr>
<td>Board independence (2007)</td>
<td>106</td>
<td>.11</td>
<td>.60</td>
<td>.3025</td>
<td>.08850</td>
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<tr>
<td>Board independence (2008)</td>
<td>106</td>
<td>.13</td>
<td>.60</td>
<td>.3004</td>
<td>.08677</td>
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</tbody>
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Source: Taiwan Stock Exchange

Unless independent directors comprise the majority of the board of directors, their functions might be quite limited. Given that the board of directors usually needs the approval of more than half of the directors in order to exercise power, independent directors actually cannot prevent the board from making a mistaken or inappropriate decision. Instead, the only weapon that independent directors can use under the TSEA is to deliver the dissent or qualified opinions, which should be recorded in the board minutes. Under the TCA, every attending director is responsible for the decisions made at that board meeting, except for those who deliver dissenting opinions that are recorded in the board minutes with respect to the challenged decision. However, some of independent directors may choose to resign in order to avoid possible litigation that may arise from mistaken or inappropriate board decisions.

Given that independent directors are usually in the minority in boardrooms, independent directors are unlikely to challenge decisions made by their majority colleagues because they cannot determine whether or not decisions might go wrong. As scholars argue, a majority in a group is more likely to think and judge independently.\(^\text{307}\)

\(^{307}\) Liu & Yang, supra note 3, at 836-37.
Some scholars suggest that companies should select an independent lead director to chair meetings of independent directors, and the reasons why a company has a lead director, and the role that the lead independent director plays in the company should be publicly disclosed by the company.\textsuperscript{308} Disclosures are intended to inform investors of the facts about a company’s board leadership structure and the degree to which the board can exercise independent judgment.\textsuperscript{309}

The introduction of the institution of independent directors in Taiwan is primarily derived from the mistrust of boards that consist of insiders. Adding independent directors as watchdogs into boardrooms may reduce board harmony, and the adversary relationship between inside and outside directors can decrease the efficacy of board monitoring.\textsuperscript{310}

During a board meeting in presence of majority of inside directors, independent directors may not feel comfortable delivering their opinions, because they may be unwilling to offend or seem to threaten inside directors (and management), or to embarrass themselves due to their relative lack of knowledge.\textsuperscript{311} To discharge monitoring responsibilities, U.S. scholars argue that the board of directors will be active, primarily through committees of the board. At least some functional board committees (e.g., audit, nominating, and compensation) should be established and composed exclusively of such independent directors.\textsuperscript{312}

As compared with the U.S. independent directors, the presence of independent directors is uncommon in Taiwan and they rarely comprise majority of board of directors. That may

\begin{footnotes}
\footnotetext{308}{Z. Jill Barclift, \textit{The Battle for Control of Corporate Governance}, 15 \textit{CHAP. L. REV.} 1, 7 (2011).}
\footnotetext{309}{\textit{Id.}}
\footnotetext{310}{E.g., Leech & Mundheim, \textit{supra} note 245, at 1805. The authors argued that “the creation of a monitoring responsibility may lead outside directors to believe that their role requires them to assume an essentially adversary attitude toward management.”}
\footnotetext{311}{\textit{Corporations and Society, supra} note 209, at 2196.}
\footnotetext{312}{Eisenberg, \textit{Social Norms, supra} note 306, at 1278.}
\end{footnotes}
indicate that most Taiwanese companies do not recognize the value of independent directors in reconciling conflicts of interest matters.  

Finally, if boards are generally independent of management and controlling shareholders, and are actively involved in overseeing managerial behavior, “one might conclude that a board controlled by independent directors is a sufficient constraint on management shirking and self-dealing.”  

It appears that Taiwanese policymakers anticipate that the good theory of independent directors will materialize in Taiwan. However, most Taiwanese companies have boards of directors whose majorities are not independent. Furthermore, there are no supplemental rules or norms that technically help Taiwanese independent directors facilitate effective monitoring, such as a lead independent director, director oversight of legal compliance systems, and regular meetings of the independent directors without the presence of the inside directors and management.  

This leads to doubts about effectiveness of functions that independent directors could have. In order to avoid shocking companies, Taiwanese policymakers compromised to allow public companies to decide whether a majority of independent directors would be appropriate for their companies’ circumstances.  

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313 YU-HSIN LIN, INDEPENDENT DIRECTORS, supra note 67, at 172.  
314 Bainbridge, ALI Governance Project, supra note 191, at 1035.  
315 Chandler & Strine, supra note 147, at 956.  
316 This situation also happens in the U.S. Tentative Draft No. 1 of the American Law Institute's Principles of Corporate Governance (ALI Principles) required that independent directors comprise a majority of the board of directors in a large publicly held corporation. However, such requirement was abolished in the final version of ALI Principles.
4.2.4.4 No Strong Power Vested with Independent Directors

According to the TSEA, independent directors generally have no special investigative power without an audit committee. They usually rely on information provided by management to help them make proper decisions. With the presence of an audit committee, committee members can exercise investigative power, as do supervisors.\textsuperscript{317} However, weak monitoring power is partially blamed for supervisors’ failures. Investing supervisor-type powers in committee members may be inadequate. Furthermore, the board of directors still can veto the decisions of the audit committee with the approval of two-thirds of all of the directors.\textsuperscript{318} Because independent directors are not vested with any real investigative power, they are unlikely to operate as an effective monitoring device.

Informational asymmetry is a serious obstacle to the effectiveness of independent directors. Recent research indicates this difficulty exists and reduces the functionality of independent directors.\textsuperscript{319} The author of this research interviewed several independent directors of Taiwanese listed companies, and some of the interviewees expressed their concerns about informational asymmetry that exists between independent directors and management.\textsuperscript{320}

One interviewee pointed out,

“[I]f the company’s management team intentionally allows fraud to exist in the process, the independent director has very incomplete information. Because they (the management team) will not tell you (the independent director). If this deal occurs overseas, in this case

\textsuperscript{317} Article 14-4 of the TSEA.
\textsuperscript{318} Article 14-5 of the TSEA.
\textsuperscript{319} YU-HSIN LIN, INDEPENDENT DIRECTORS, supra note 67, at 137.
\textsuperscript{320} Id.
the independent director’s ability (to detect fraud) is very weak. In an intentionally-fraudulent deal, the independent director is at a very weak position. He does not have information, the management cannot tell you.”

Lin’s research shows that some interviewees found they were unable to “dig deeper” for information in the presence of controlling shareholders who dominate both management and the boardroom. Independent directors similarly may be unable to detect conflict-of-interest transactions when insiders have an incentive to intentionally hide information about such transactions in order to avoid being scrutinized by the competent authority, or are concerned about attracting too much public attention. Given the complex ownership structure of Taiwanese companies, which involves a variety of methods such as cross-holdings and pyramid structures, it may be difficult to identify whether or not the parties involved are “related parties” in the first place.

In the absence of sufficient material information, it may be unrealistic to expect independent directors to be able to determine and valuate suspect transactions in an effective manner. Given the presence of controlling shareholders, independent directors are likely to be kept in the dark when attempting to make decisions. Lin’s research concluded that Taiwanese independent directors, who are being deemed to be outsiders by controlling shareholders, in fact are ineffective “in overseeing controlling shareholders, especially in detecting unfair related-party transactions and fraud.”

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321 Id. at 137-38.
322 Id. at 139.
323 Id. at 140.
324 Id. at 143.
U.S. corporate scholars recommend that companies both appoint majorities of independent directors to their boards and establish some sub-committees consisting solely of independent directors, such as audit, compensation, and nominating committee in order to facilitate the effectiveness of independent directors.\textsuperscript{325} According to Lipton and Lorsch, the ideal U.S. board should be a monitoring board with three important committees composed solely of independent directors.\textsuperscript{326} In Taiwan, only audit committee and remuneration committee have been introduced by the TSEA. The company can voluntarily establish other types of committees, as recommended by the Best Practice Principles. At present, few listed companies have established sub-committees (but the remuneration committee is a necessary device for all listed companies in accordance to Article 14-6 of the TSEA).

4.2.4.5 Concerns Arising from Overlapping Monitoring Devices

Both independent directors and supervisors can legally coexist. According to the TSEA, independent directors cannot completely supplant supervisors, which continue to remain necessary. When two monitoring devices have been set up, concerns may arise about how to assign the powers and liabilities between two devices.

Hence, within a company that appoints both independent directors and supervisors, there are two different monitoring devices: independent directors and supervisors. Independent directors are essentially board members that have the same power as a non-independent director. Independent directors are responsible for monitoring some material business decisions, which are specifically itemized in Article 14-3 of the TSEA, such as reviewing a company’s internal control mechanism, fundamental transactions, and financial reports.

\textsuperscript{325} E.g., Veasey, *Good Governance Practices*, supra note 137, at 2190.
\textsuperscript{326} Lipton & Lorsch, *supra* note 176, at 59.
However, according to the literal meaning of the language of Article 14-3 of the TSEA, this does not mean that such business decisions are reserved exclusively for independent directors. As is the case for the conventional monitoring device in the TCA, theoretically speaking, the power of supervisors should include such business decisions, and they can request that the board of directors cease misconduct, regardless of whether such misconduct is directly related to the responsibilities of independent directors. Thus, the coexistence of two distinctive monitoring devices gives rise to at least two problems. One is the free rider problem to the effect that each device may have reasons to shirk when each assumes that the other device will do the job. In contrast, the other problem is inefficient repetitive monitoring by two monitoring devices. Therefore, the coordination between the two monitoring devices may be necessary. It is unfortunate that Taiwanese legislation has thus far failed to take such problems into consideration.

In comparison with supervisors, independent directors are vested with powers as regular directors except for the delivery of dissenting or qualified opinions. In fact, when there is no audit committee, one effect is that some fundamental decisions can be approved only by the board of directors, and cannot be delegated to subcommittees. The primary function that independent directors have is sounding the alert by delivering dissents or qualified opinions in the minutes of board meetings for public disclosure (see Table 9 for details).
Table 9: Independent Directors vs. Supervisors

<table>
<thead>
<tr>
<th>Authority and Functions</th>
<th>Independent Directors</th>
<th>Supervisors</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Monitor the proscribed matters set forth in Article 14-3 of the TSEA; Attend board meetings; Vote at board meetings; Deliver dissents or qualified opinions; Signal concerns by delivering dissents or qualified opinions, or even resigning.</td>
<td>Monitor all board and managerial conduct; Attend board meetings; Deliver opinions at board meetings; Convene provisional shareholder meetings, as necessary; Request board to refrain from continuing illegal conduct; Examine the accounting books and documents, and request that board of directors or managerial personnel make reports.</td>
</tr>
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</table>

Source: Author

In Taiwan, supervisors should be taken into account when developing corporate governance policies. With regard to internal monitoring, both independent directors and supervisors serve similar functions in the context of internal control. Taiwan appears to have lost confidence in the effectiveness of supervisors’ monitoring functions, given the introduction of independent directors. The TSEA does not require supervisors meet standards for independence, as is the case for independent directors. To put it differently, if independence is the key to solving governance issues in Taiwan, what difference could independent directors make? If the independence theory is correct, why does current law not require supervisors to have identical, or similar, standards of independence?

One may argue that independent directors have advisory functions, because they have certain types of expertise that companies need. However, independent directors are empowered to object to important items, so the monitoring function should be the focus of Taiwan’s recent independent director reforms. Thus, independent directors are expected to function primarily as a
monitoring device instead of an advisory role. In order to make sure the scope of responsibility of independent directors, Article 26 of the Best Practice Principles suggests that a listed company stipulate the scope of duties of their independent directors.\(^{327}\)

### 4.2.4.6 Mandatory Nature of Taiwanese Corporate Laws

Why does Taiwan need to codify the institution of independent directors? In the U.S., the development of the institution of independent directors emerged from the marketplace without formal regulations. Companies voluntarily appoint independent directors to suit their governance needs for a variety of reasons, including the benefits of better performance and greater deference from courts.\(^{328}\)

The Taiwanese government prefers to codify such an institution, and has left little room for companies to develop individually desirable governance practices. The mandatory rules stipulate that the term “independent directors” refers exclusively to independent directors appointed under procedural rules proscribed in the TSEA (see Table 10). The nomination and election procedures are also mandatory, with no room for modifications.\(^{329}\) Hence, Taiwanese companies have little room to build their own governance systems freely.

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327 Such Principles are not mandatory and only for purposes of recommendation.
328 Chandler & Strine, *supra* note 147, at 977-78.
329 One Taiwanese corporate commentator suggests companies may opt to appoint either supervisors or independent directors, but once they choose independent directors, they are mandatorily subject to the all set of the independent director rules prescribed by the laws. See Wallace Wen-Yeu Wang, SELI DULI TUNGSEI DE GONGSHI CHILI DE YINGSHAN [*THE IMPACT OF APPOINTMENTS OF INDEPENDENT DIRECTORS AND SUPERVISORS ON CORPORATE GOVERNANCE*] 40 (TAIWAN EXECUTIVE YUAN, March 2004).
The TSEA stipulates that prior to the appointment of independent directors a company must add a clause concerning independent directors into the articles of incorporation. Such an amendment needs a resolution during a shareholder meeting, which needs a quorum of at least two-thirds of the voting shares and approval by at least 50 percent of such a quorum. Given the concentrated ownership structures, and the fact that many individual investors are not interested in attending shareholder meetings, such an amendment usually fails without the support of stock block-holders. Independent directors are expected to provide effective monitoring function of management, without undue influence from other groups or individuals, particularly in situations where controlling shareholders exert control over the board of directors and supervisors. It is difficult to expect large shareholders to support an amendment adopting independent directors.

In addition, given that the institution of independent directors is an unfamiliar notion to many Taiwanese companies, companies might have reservations about them and might stop hiring independent directors if they believe that they do not fit in with the company culture. However, once the clause regarding independent directors becomes effective, the company should elect independent directors in accordance with the articles of incorporation. That means

<table>
<thead>
<tr>
<th>Procedures</th>
<th>Requirements</th>
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<tbody>
<tr>
<td>Amending articles of incorporation</td>
<td>Need to convene shareholder meeting and need a quorum and two-thirds of voting shares</td>
</tr>
<tr>
<td>Independence Standard</td>
<td>Need to comply with rulings issued by the competent authority</td>
</tr>
<tr>
<td>Nomination and election procedures</td>
<td>Need to use candidate nomination system</td>
</tr>
<tr>
<td>Authority</td>
<td>Matters specified in Article 14-3 of the TSEA should be absolved by the board of directors and independent directors’ opinions should be recorded in board minutes</td>
</tr>
</tbody>
</table>

Source: Author
that the costs for companies to relieve themselves of independent directors would require another amendment to the company’s articles of incorporation.

Companies that want to appoint independent directors or an audit committee should comply with the procedures established by law and regulations. In addition to a clause concerning independent directors, independent directors should be elected through the candidate nomination system, a procedure in which only board of directors and big shareholders (those with more than 1% of all outstanding shares) have the right to submit a slate of independent directors. After the elections, the only power that independent directors have would be the right to file objections regarding important items that have been specified in Article 14-3 of the TSEA.\footnote{330} However, independent directors’ objections cannot invalidate items that have been approved by the majority of the board of directors, and the only effect is that such objections are recorded in the minutes of the board meeting. In comparison with non-independent directors, the right to object to particular items appears to be the only privilege vested in independent directors. In fact, a non-independent director also can express their opinions about a particular item. Therefore, whether or not the objection should be recorded in the minutes is the only different privilege that distinguish independent directors from non-independent directors.

Reviews and discussions with the board of directors give independent directors opportunities to discover irregularities and illegalities when they attend the board meetings. The TCA stipulates that if any director is not given prior notice before a board meeting, resolutions made at such meetings are void. Hence, management has no way to avoid being monitored by independent directors when important items need to be taken up at board meetings.

\footnote{330} Article 14-3 of the TSEA.
Professors Lipton and Lorsch argue “changes in board practices [shall] be implemented by individual boards, with no changes in laws, stock exchange rules, SEC regulations, or new court decisions. Trying to change regulations or laws will be politically difficult and at best very time consuming.”\textsuperscript{331} Taiwanese policymakers may need to think about this statement seriously.

4.2.4.7 Un-Examinable Independence

In Taiwan, the independence issue is critical. Attempts to build an effective system of checks and balances have made it clear that independent directors are expected to deliver dissenting quality opinions in board meetings when the prospective transactions appear suspicious. Within the system, it is assumed that board decisions made without hearing the voices of independent directors are likely to be appropriate. The institution of independent directors would theoretically have a bonding function for quality of board decisions, which do not involve self-interested deals or other illegal activities.\textsuperscript{332}

In Taiwan, the controlling shareholders can usually elect the majority of the board of directors, or even the entire board, which means that “the real objectivity and independence, and therefore the real value, of nominally independent directors can be undermined.”\textsuperscript{333} Taiwan had adopted legislation that assumes that independent directors avoid being unduly influenced by management and make objective decisions that are in the interest of shareholders. However, determining what constitutes true independence remains an open question.\textsuperscript{334}

\textsuperscript{331} Lipton & Lorsch, supra note 176, at 64-65.
\textsuperscript{332} Dooley & Veasey, supra note 202, at 503.
\textsuperscript{333} OECD Corporate Governance in Asia, supra note 1, at 57.
\textsuperscript{334} As Taiwanese scholars argue, “[m]any newly appointed independent directors and supervisors seem to be closely associated with the controlling shareholders.” Liu & Yang, supra note 3, at 836.
As explained previously, derivative suits tend to not be exercised by shareholders in Taiwan. Thus, there are few or no opportunities to review the true independence of independent directors in litigations. In the absence of effective judicial reviews, shareholders and investors can hardly challenge the credibility of independent directors. In other words, ex post judicial review of director independence determining true independence of directors is almost unavailable in the Taiwan’s legal system. Taiwanese independent directors currently are only subject to formality checks that will be performed by companies’ self-compliance, stock exchange, and the competent authority.

The reputation of each independent director may be the only way to ensure his or her independence. Independent directors who want to maintain their reputations may avoid compromises with management and controlling shareholders regarding suspicious transactions that are likely to harm the interests of shareholders.

Many U.S. companies have nomination committees consisting entirely of independent directors, and the committee has power to propose the slate. This is done in order to avoid undue influence on the nominations of independent directors. Such a method can protect the independence of independent directors from undue influence by management. To help ensure

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335 There are very high legal barriers that militate against bringing a derivative suit against director(s), which is designed for the purpose of avoiding potential abuses by shareholders. These include the minimum number of shares held by plaintiff shareholder or shareholders (more than 3 % of outstanding shares), the minimum holding period (in excess of one year), the written demand made to supervisor(s) requesting an action and a 30-day waiting period, litigation securities upon defendant’s request, and the potential liabilities after losing cases. In addition, attorney’s fees are not allowed even when the plaintiff wins or settles with defendants. Therefore, there is little incentive offered, and the derivative suits have been rarely come about in practice. See also OECD Corporate Governance in Asia, supra note 1, at 22-23.
336 YU-HSIN LIN, INDEPENDENT DIRECTORS, supra note 67, at 110.
337 Id.
338 Rock, supra note 202, at 505.
the true independence and objectivities of directors, a nominating committee consisting entirely of independent directors should be responsible for nomination of directors.\(^{339}\)

In Taiwan, there is no similar legal notion regarding the nomination committee, and most Taiwanese companies do not have such committees. In contrast, the “candidate nomination system” allows management and major shareholders to manipulate their favorite candidates into being elected as independent directors. The result is that the independence of Taiwanese independent directors remains in doubt.\(^{340}\)

Corporate literature indicates that the dominant leader of the group may heavily influence independent directors who can deliver dissenting opinions on certain suspect transactions.\(^{341}\) In most Taiwanese companies, the CEO (or general manager) and board chairman are often the same person (or several individuals supported by the same controlling shareholders), so independent directors are less likely to engage in frank discord against management.

As proposed in the initial draft of TSEA that requires mandatory appointment of independent directors, such requirement can be a way to promote independent director review of self-dealing transactions.\(^{342}\) However, such requirement cannot do much to make the directors truly independent.\(^{343}\) The bottom line is that even if independent directors are truly independent,

\(^{339}\) The nomination committee can provide “an independent locus of responsibility for the composition of the board” and “screen out candidates who lack objectivity toward the senior executives by virtue of elements that cannot be adequately captured by an objective test.” Eisenberg, Modernization of Corporate Law, supra note 179, at 205.

\(^{340}\) In the U.S., both NYSE and NASDAQ require that director-nomination decisions must be made (or at least recommended to the board) by independent directors only. “The NYSE mandates that such decisions (or recommendations) must be made by standing independent committees, while NASDAQ gives companies the option of using either independent committees or a majority vote of all independent directors.” Corporations and Society, supra note 209, at 2192.

\(^{341}\) E.g., Barclift, Corporate Governance, supra note 200, at 620.

\(^{342}\) Black, Preconditions for Strong Securities Markets, supra note 270, at 826.

\(^{343}\) Id.
restoring investor confidence in the integrity of the Taiwanese system of corporate governance, given recent scandals, requires objectivity and judicial intervention. \textsuperscript{344}

\textbf{4.2.4.8 Passive Institutional Investors and Apathetic Taiwanese Shareholders}

One reason for the rise of independent directors in the U.S. companies is the advocacy by institutional investors. \textsuperscript{345} Along with addition of independent directors to the board, institutional shareholders will continue to monitor directors and their performance. \textsuperscript{346}

Unlike the U.S. institutional investors who hold majority of equity in the listed companies, \textsuperscript{347} institutional investors in Taiwan tend to be passive regarding governance issues, so companies feel little pressure to adopt better governance practices. Share prices are the primary concern of institutional investors. Individual investors contribute most of the capital in Taiwan, and the governance issues may not interest them. Taiwanese shareholders may have little interest in whether or not directors are independent, but they do rate managerial performance by voting using the “Wall Street Rule” if the management fails to meet their standards of performance. \textsuperscript{348}

The U.S. institutional shareholders have long been advocating to push boards have a majority of independent directors. \textsuperscript{349} Also, institutional investors may help companies to identify

\textsuperscript{344} Delaware Court also notes that "even when the transaction is negotiated by a special committee of independent directors, no court could be certain whether the transaction fully approximated what truly independent parties would have achieved." \textit{Kahn v. Tremont Corp.,} 694 A.2d 422, 428 (Del. 1997). In absence of “a strong and independent judiciary … that will equitably decide on lawsuits that may be filed to vindicate shareholder or director abuses,” the effectiveness of independent directors remains doubtful. See Ong, Allan Verman Yap, \textit{Minimum Requirements for True 'Independence' for Independent Directors: Learning from the Chinese System} (March 30, 2010), available at SSRN: \textit{http://ssrn.com/abstract=1581229}.

\textsuperscript{345} “[T]he primary pressure is on outside [independent] directors and comes from advocacy by institutional investors.” Tobin, \textit{supra} note 274, at 1707.

\textsuperscript{346} \textit{Id.} at 1729.

\textsuperscript{347} “[T]he equity ownership by all types of public and private institutions is between 50% and 60% of the total value of stock-exchange-listed companies.” Lipton & Lorsch, \textit{supra} note 176, at 60.


qualified candidates of independent directors whose “specific charge of being independent of management and accountable for advancing shareholder interests.”

4.2.4.9 Summary

In addition to the U.S. debate associated with the effectiveness of independent directors, some Taiwanese commentators also show their concerns in this regard. First, the independence matters but the independence is very difficult to be ensured in Taiwan’s society. Most leaders of Taiwanese companies generally prefer to hire independent directors with whom they are familiar. A controlling shareholder, of course, will look for good candidates according to their personal preference. They will judge the candidates primarily based on their prior “Guan Xi (i.e., relationship)” with candidates. The Guan Xi generally provides reliable information as primary resource letting people know others in Chinese (and Taiwanese) society. The best strategy for a controlling shareholder is to invite someone who has the Guan Xi with her if possible. As mentioned, the presence of controlling shareholders is common and they normally can decide who will be elected as independent directors. It is less likely that the favorable candidates will monitor against their supporters.

Taiwan has a different internal governance system in which the board of directors is a managing device rather than a monitoring device. Independent directors in nature are deemed as monitors against management, so it may raise questions when independent directors (monitors) are introduced into the board of directors (management) because an independent director is responsible for both management and monitor. How independent directors can monitor decisions and behavior by them is quite doubtful.

350 Gilson & Kraakman, supra note 176, at 905.
351 Yu-Hsin Lin, Independent Directors, supra note 67, at 150.
It is no doubt that substance is more important than form when speaking of independent directors. Directors who are labeled as independent directors may have significant importance in corporate governance but they must be utilized responsibly.\(^352\) However, due to any reasons, when independent directors are not truly independent, the label will be meaningless. It may raise a problem for investors of Taiwanese companies who have given these prima facie labels weight in making investing decisions. Similarly, courts will confront the same problem when the transaction in question has passed by the independent directors. Delaware courts have distinguished the concept of an "interested" director from that of an "independent" director\(^353\) and have realized labeling could have an unfair effect without appropriate sensitivity.\(^354\) By the same token, Taiwanese courts may have to develop a legal standard to determine the legality of behavior involved with monitoring by independent directors.

A research on Taiwanese independent directors of listed companies conducts a survey in order to explore a question as to what independent directors consider to be the most important key to effective function. The survey contains pre-specified choices: “the lack of sufficient time,” “the difficulties in accessing information,” “the colleague relationships,” “insufficient pecuniary incentives,” “the lack of certain types of professionalisms for effective monitoring,” “expectations for re-nomination,” and “no difficulties to effectively execute powers.” “Insufficient time” and “the difficulties in accessing information” are ranked as the first (28%) and second (18%) most important factors in the effective functioning of independent directors.\(^355\) That survey indicates that even in situations where independent directors have true independence

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\(^352\) Chandler & Strine, \textit{supra} note 147, at 997.

\(^353\) \textit{Id.}

\(^354\) \textit{Id.} at 998.

\(^355\) In that survey, there are effective 585 questionnaires with 276 returns (returns-ratio of 47%). See Len-Yu Liu, \textit{A Study of the Regime of Independent Directors of Listed Companies in Taiwan—An Empirical Approach}, 114 CHENGCHI L. REV. 53, 127 (2010).
from management and controlling shareholders, they may have insufficient time and information to make decisions. In addition to the lack of time and information, Taiwanese independent directors face other challenges when trying to be effective monitors. Of the respondents, 57% responded that they did not experience any difficulties when they effectively executed their powers.356

However, that survey may not have revealed the complete picture regarding the difficulties that Taiwanese independent directors face. Whether or not they are truly independent remains uncertain (and can remain unchallengeable through derivative suits in Taiwan). Basically speaking, Taiwan’s society has emphasized Guan Xi rather than the rule of law, and that characteristic will be serious detriment to the effectiveness of Taiwanese independent directors.357 Taiwan’s current legal system states that the FSC, MOEA, and Taiwan’s stock exchanges are probably the only mechanisms that might ascertain truly independence of independent directors.

4.3 Question Three: Why Do Companies Need Independent Directors?

4.3.1 Costs and Benefits

U.S. scholars suggest that one reason for the rise of independent directors since the 1960s is judicial deference to decisions made by independent-majority-boards,358 and companies (and the management of such companies) have incentives to hire additional independent directors for

356 Id.
357 Lawrence Liu, Financial Reform and Constitutional, supra note 108, at 125.
358 “The key to upholding an interested transaction is the approval of some neutral decision-making body...[A] transaction will be sheltered from shareholder challenge if approved by either a committee of independent directors, the shareholders, or the courts.” Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) See also Lin, supra note 176, at 907.
their boards in order to avoid trivial and strike lawsuits brought by shareholders.\textsuperscript{359} Saving on costly litigation expenses is an inducement for companies seeking to avoid being harassed by legal actions by shareholders to appoint independent directors.\textsuperscript{360} In contrast, costs will be incurred in searching for candidates who meet certain eligibility and expertise.

Most Taiwanese companies are accustomed to having supervisors as a monitoring device, and having two monitoring mechanisms would incur more expenses. Thus, unless the expected benefits exceed the expected costs, companies may often prefer to not hire independent directors.

Economical rationality is an essential consideration with regard to whether the policy of independent directors will work in Taiwan. Companies may attempt to use whatever corporate governance practices they prefer, even in the face of legal constraints. For example, companies subject to mandatory policies may have ways to get around such legal constraints, such as recruiting nominally independent directors instead of truly independent directors. Thus, if most companies assume that independent directors are inappropriate for their companies, this may indicate that a mandatory policy should not be maintained.

Some companies may hire independent directors not because of economic considerations but rather as the result of legal pressures. Encouraging companies to voluntarily appoint independent directors involves the competent authority loosening legal requirements, which ask that all directors and supervisors have a certain ownership percentage of their company’s shares,


\textsuperscript{360} Dooley \\& Veasey, \textit{supra} note 202, at 503.
and will be fined if they fail to maintain a prescribed percentage.\textsuperscript{361} As a result, some companies have noneconomic incentives to hire independent directors. The TWSE’s Listing Rules require Newly-Listed Companies to appoint independent directors when they apply for listing. This mandatory policy arbitrarily decided which governance practices should be applied to such companies without allowing them to develop individual versions of economic rationality. Unlike larger firms, it is likely that small firms do not want to have independent directors because they may have smaller budgets that do not allow them to pay the expenses incurred by a larger board of directors.\textsuperscript{362}

The first question relates to whether or not benefits exceed expenses. If they do, then the second question should be whether the overall costs of having independent directors offset their effectiveness. The answers to these two questions are not self-evident. The truth is that the costs and benefits vary from company to company, and it is difficult to arrive at a universal conclusion that is applicable to all companies.

Recruiting independent directors can cause problems for smaller, more specialized companies, due to the potential liabilities and risks they face. Smaller companies with specialized operations face difficulties in searching for, and hiring, eligible candidates with the requisite knowledge in specific industries.\textsuperscript{363}

\textsuperscript{361} According to Article of 2 of Ownership Rules, if a public company has elected two or more independent directors, the share ownership figures are calculated at the rates set forth in the preceding paragraph for all directors and supervisors other than the independent directors, and shall be decreased by 20 percent.

\textsuperscript{362} Professor Romano pointed out that the expenditures incurred by complying with SOX may be insignificant for large firms but may be significant for smaller firms. See Roberta Romano, \textit{Does the Sarbanes-Oxley Act Have a Future?}, 26 YALE J. ON REG. 229, 241 (2009).

\textsuperscript{363} \textit{Corporate Governance Issues}, supra note 239, 63. See also Chandler & Strine, \textit{supra} note 147, at 981.
Like SOX, the TSEA and TWSE’s Listing Rules create a need for additional independent director candidates.\(^{364}\) However, the increased demand for independent directors may face a supply diminished by the increasingly stricter independence standards, and it may make difficult for more companies to hire capable independent directors.\(^{365}\) As a matter of fact, after the TSEA, more than half of existing Taiwanese listed companies have merely reappointed their existing board outsiders as independent directors or independent supervisors.\(^{366}\)

### 4.3.2 Value of Inside Directors

Insider directors admittedly can contribute to shareholders’ interests. They usually have industry knowledge or company-specific knowledge that can help them craft a business strategy for a company. One may argue that some firms whose boards are dominated by insiders may be better because insiders have more time devoted to the company and can use their company-specific knowledge to perform better than outside directors. For public companies, that should not be the norm. In some cases, a blended board composition consisting of independent directors and knowledgeable insiders may be optimal. In addition to contributions by insiders, having a majority of independent directors can provide some assurance of integrity of management.\(^{367}\)

An inside director who is also a full-time senior employee is supposed to have more informational advantages than outside independent directors who usually devote small portion of their time and effort to the company. Thus, the decisions made by those inside directors are more likely to be informed than decisions made by independent directors.\(^{368}\) Those inside directors

\(^{364}\) Id. at 966-67.

\(^{365}\) Id. at 967; Bainbridge, *NYSE's Director Independence*, supra note 110.

\(^{366}\) Liu & Yang, *supra* note 3, at 838.

\(^{367}\) E.g., Veasey, *Good Governance Practices*, supra note 137, at 2184.

\(^{368}\) Bainbridge, *ALI Governance Project*, *supra* note 191, at 1056.
may have made significant investments in the firm-specific human capital.\textsuperscript{369} To be a senior employee in one company, she has to invest considerable time to learn how to do her jobs more effectively than others.\textsuperscript{370} Much of this knowledge may be very specific to her company.\textsuperscript{371} Such an inside director is in a better position to make quality decisions than an outsider is.\textsuperscript{372}

Some companies may maintain the current number of inside directors whose expertise they need.\textsuperscript{373} To meet the majority of independent directors as suggested by many U.S. corporate scholars, a company may increase its board size in order to maintain desirable numbers of inside directors and independent directors.\textsuperscript{374} The increased board size may be beyond its optimal size.\textsuperscript{375} Also, the growing demand for independent directors will likely increase the costs of hiring directors.\textsuperscript{376} Due to the presence of independent directors who may have adversary attitude against non-independent directors, many valuable directors may be dissuaded from serving on the board.\textsuperscript{377} Thus, boards might perform more effectively if they contain a mix of independent directors and inside directors.\textsuperscript{378}

Inside directors supported by controlling shareholders have benefits in some aspects. First, they can help company access to financing in emergencies in which arm’s length financing is limited. Second, they can provide monitoring on management if there are no shareholders whose

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\textsuperscript{369} Id.
\textsuperscript{370} Id.
\textsuperscript{371} Id.
\textsuperscript{372} Id.
\textsuperscript{373} Lin, supra note 176, at 966.
\textsuperscript{374} Id.
\textsuperscript{375} Id.
\textsuperscript{376} A research indicated that after the enactment of SOX U.S. boards were larger and had more workloads, and there were “significant increases in director pay and overall director costs, particularly among smaller firms.” James S. Linck et al., \textit{The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors}, 22 \textit{Rev. Fin. Stud.} 3287 (2009), available at SSRN: \url{http://ssrn.com/abstract=1443058}.
\textsuperscript{377} E.g., Leech & Mundheim, supra note 245, at 1805.
\end{flushleft}
ownership is not big for them to monitor management (instead, they will walk away with selling their shares). For some companies, these benefits regarding financing and monitoring provided by controlling shareholders may be more valuable than benefits produced by monitoring of independent directors. This is also an example that independent directors do not fit all companies.

4.3.3 Conclusion

The above rationale shows that even though corporate commentators suggest “there should be a heavy majority of purely independent directors on every board” for public companies, a mandatory rule may not be appropriate for all types of companies. Companies should instead consider adopting independent directors on a voluntary basis and develop their own governance practices as they see fit. After all, “what is a proper board for one company may not be good for another,” so each company should have free hand to decide what is best for its needs.

This dissertation will show that the number of listed companies that appoint independent directors remains relatively low (e.g., 293 out of 758 in 2010). It appears that the market does not desire independent directors so much.

379 Veasey, Good Governance Practices, supra note 137, at 2190.  
380 Pease, supra note 17, at 34. Delaware Chancellor Strine also states that “Delaware's approach recognizes that what works for one corporation might not be optimal for another.” See Strine, Delaware Way, supra note 248, at 686. See also Veasey, Good Governance Practices, supra note 137, at 2184.
4.4. Statistics Data

4.4.1 Numbers of Taiwanese Listed Companies with Independent Directors

This section focuses on the statistics data about the numbers of independent directors and audit committees in Taiwanese listed companies, which may be able to offer implications of how desirable independent directors are in practice.

Figure 6: The Numbers of Listed Companies with Independent Director(s) and the Numbers of All Listed Companies from 2005 to 2010

Source: Taiwan Stock Exchange

Figure 6 shows that the number of listed companies with at least one independent director was 224 (32.41% of all listed companies) in 2005 and the number increased to 293 (38.65% of all listed companies) in 2010. There may be some explanations for the increase. The obvious one should be attributed to the mandatory policy of the Listing Rules that requires Newly-Listed Companies appoint at least two independent directors while apply for listing. The increase also may indicate that the importance of independent directors have gradually been emphasized by the market so they become more and more desirable to the listed companies.
It may be possible to know whether or not a company voluntarily has an independent director, by looking at its listing date (before or after the Listed Rules). Some of the companies listed after the Listed Rules may already have independent directors at its own discretion. As can be seen in this Figure, the number of overall listed companies is increasing year by year (from 691 in 2005 to 758 in 2010), which means 67 Newly-Listed Companies are subject to the Listing Rules. Compared with the increase of the number of companies with independent directors (69), it indicates that most of the Newly-Listed companies keep hiring independent directors for the next term, even though they are no longer subject to the Listed Rules, which is applicable only at the listing review. However, this also could be explained from other perspective. This may be costs and difficulties that they should face (for example, amending articles of incorporation according to TSEA) if they want to get rid of independent directors. In fact, this probably is the reason why few companies opt to hire independent directors if they did not do so when going listed. For example, in comparison with 2005, only 9 additional listed companies opt to hire independent directors in 2006. Even so, companies will get rid of independent directors if necessary. Take listed companies which had independent directors in 2005 for example, 15 companies stop hiring independent directors in 2006 and the number of these companies keeps increasing in next three years (cumulatively 45 in 2007, 66 in 2008, and 86 in 2009).\(^{381}\)

Finally, this Figure shows that independent directors, overall speaking, remain not so desirable for the majority of listed companies, even though it is highly recommended by TWSE as a good governance practice. Taking all factors into consideration, status quo probably would be a best strategy for most listed companies.

Figure 7: The Proportions of Companies with Independent Director(s) in Top Five Industries (2005-2010)

Source: Taiwan Stock Exchange

Figure 7 presents the proportions for listed companies with independent directors in five industries. As this Figure shows, more than 50% of electronics companies had independent directors during the period of 2005 to 2010, which is significantly higher than the average (approximately 30%) in the market. That may mean the institution of independent directors is more desirable in electronics industry than in others. Similarly, that may be partially explained by the fact that the majority of Newly-Listed Companies are in the electronics industry.

It is worth noting that in the textiles industry the percentages sharply decrease (from 17.02% in 2005 down to 2.17% in 2010). Such decrease may indicate that textiles companies think the independent directors not desirable as a corporate governance practice in their industry. Even facing the possible disadvantages changing the status quo (amending articles of incorporation), textiles companies prefer not having independent directors. On the contrary, financial companies (including banks, insurance companies, and securities dealers) hire more

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382 Figures for each year are computed by the data as of December of each year.
independent directors and all of them have independent directors. However, the reason for the sharp increase is based on the mandate of competent authority, but not on their own choices.

**Figure 8: Numbers of Listed Companies with Audit Committee (2007-2010)**

![Graph showing the number of listed companies with audit committees from 2007 to 2011.5]

Source: Taiwan Stock Exchange

Figure 8 contains the data only from 2007 when the concept of audit committee was officially adopted, under the meaning of the TSEA. It appears that there were only a few listed companies that established an audit committee. Under the TSEA, a company with audit committee cannot hire supervisors. Before the audit committee is introduced, it is no question that all Taiwan’s companies, for a very long time, get used to work with supervisors as the primary monitors. The establishment of an audit committee inevitably would have a great deal of impact on the way which internal governance system works within a company that always hires supervisors as monitoring device. Such shocking impact may be so unbearable as to dissuade most companies from setting up an audit committee replacing supervisors.
As seen in the Figure 9, most of listed companies that have an audit committee are in the electronics industry. It may be concluded that audit committees are more desirable to electronics industry than to other industries. However, due to a small number of the data, such statement may be much more speculative than conclusive.

Figure 10: Average Percentages of Ownership Held by Foreign Investors (Financial Institutions, Judicial Person, and Trust Fund) in All Listed Companies (2005-2010)

Generally, foreign investors care the governance issues more than local investors. As the appointment of independent directors is deemed as a good governance practice, it is possible that
investors would take it into consideration while deciding to invest any given company. Figure 10 reflects the preference that such kind of investors may have. As seen in the Figure, foreign investors, on average, hold more ownership in the companies with independent directors than in those with no independent directors. Although the differences seem small, some companies may like to induce more capital from the foreign investors who prefer the presence of independent directors, by appointing some independent directors. Overall, the capital market seems not to provide strong incentives for many companies to reinforce their internal governance systems associated with independent directors.

Figure 11: Average Percentages of Ownership Held by Foreign Investors (Financial Institutions, Judicial Person, and Trust Fund) in All Listed Electronics Companies (2005-2010)

![Average Percentages of Ownership Held by Foreign Investors](source: Taiwan Stock Exchange)

As above, electronics companies, for some reason, prefer the independent directors to those in other industries. In the electronics industry, the ownership differences (between companies with independent directors and companies without independent directors) held by foreign investors remain insignificant (see Figure 11 for details). Due to that fact, in addition to foreign investors’ preferences, there may be some reasons that electronics companies favor
independent directors since the market forces seems not vigorous enough to force companies to appoint more independent directors.

4.4.2 Who Are Independent Directors in Taiwan?

Table 11 presents the occupations of independent directors in Taiwanese listed companies; most of them are directors, professors, managers, and CEOs.

Table 11: Occupations of Independent Directors in Taiwanese Listed Companies

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Total number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Director</td>
<td>155</td>
<td>29.03</td>
</tr>
<tr>
<td>Professor</td>
<td>133</td>
<td>24.91</td>
</tr>
<tr>
<td>Manager</td>
<td>66</td>
<td>12.36</td>
</tr>
<tr>
<td>CEO</td>
<td>65</td>
<td>12.17</td>
</tr>
<tr>
<td>Accountant</td>
<td>39</td>
<td>7.30</td>
</tr>
<tr>
<td>Lawyer</td>
<td>24</td>
<td>4.49</td>
</tr>
<tr>
<td>Government Officer</td>
<td>10</td>
<td>1.87</td>
</tr>
<tr>
<td>Politician</td>
<td>10</td>
<td>1.87</td>
</tr>
<tr>
<td>Physician</td>
<td>2</td>
<td>0.37</td>
</tr>
<tr>
<td>Others</td>
<td>30</td>
<td>5.62</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>534</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Taiwan Stock Exchange (as of October, 2008)

Like independent directors in the U.S., lack of incentive will be another issue that could undermine the effectiveness of independent directors. There are no regulations regarding how independent directors are to be compensated, except that the compensation given to independent directors and supervisors can be separated from that of other directors. It might be true that the more legal responsibilities they carry, the more independent they would presumably be in

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conducting their jobs. However, the uncertain and heavy legal risk also lowers the willingness of desirable candidates to be independent directors.

Table 12 illustrates the average annual compensation that an independent director in Taiwanese listed companies has received. The compensation rate grows from 20,400 dollars in 2004 to 39,100 dollars in 2007, which may have provided independent directors with monetary incentives to offer robust monitoring. Also, this Table shows that independent directors in companies with an audit committee have been compensated more than those in companies without an audit committee. That may indicate that independent directors, also audit committee members, have to spend more time on monitoring which includes the tasks that conventional supervisors are supposed to carry out.

Table 12: Average Annual Compensation for Each Independent Director of Listed Companies

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average Annual Compensation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent Director</td>
<td>612,000</td>
<td>801,000</td>
<td>923,000</td>
<td>1,173,000</td>
</tr>
<tr>
<td>(20,400)</td>
<td>(26,700)</td>
<td>(30,766)</td>
<td>(39,100)</td>
<td></td>
</tr>
<tr>
<td>Growth Rate</td>
<td>n/a</td>
<td>30.88%</td>
<td>15.23%</td>
<td>27.09%</td>
</tr>
<tr>
<td>Non-Independent Director</td>
<td>n/a</td>
<td>1,828,000</td>
<td>1,941,000</td>
<td>2,146,000</td>
</tr>
<tr>
<td>(60,933)</td>
<td>(64,700)</td>
<td>(71,533)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth Rate</td>
<td>n/a</td>
<td></td>
<td>6.18%</td>
<td>10.56%</td>
</tr>
<tr>
<td>Independent Director in</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies with Audit</td>
<td>2,656,000</td>
<td>3,364,000</td>
<td>4,440,000</td>
<td>4,199,000</td>
</tr>
<tr>
<td>Committee (88,533)</td>
<td>(112,133)</td>
<td>(148,000)</td>
<td>(139,966)</td>
<td></td>
</tr>
<tr>
<td>Growth Rate</td>
<td>n/a</td>
<td>26.66%</td>
<td>31.99%</td>
<td>-5.43%</td>
</tr>
</tbody>
</table>

Unit: New Taiwan Dollar (NTD); 30 NTD= 1 USD (shown in parentheses)

Source: Taiwan Stock Exchange

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4.5 Policy Implications

4.5.1 Will Taiwan’s Reforms Continue to Go Forward?

It is no question that the institution of independent directors in Taiwan has many potential problems, so most commentators are not satisfied with current internal governance system and keep to advocate further reforms. However, it appears that most listed companies prefer traditional supervisor system than the U.S.-styled committee system. Also, even Taiwanese companies with independent directors tend to have few independent directors on their boards. Previous policymaking experience indicates any government’s reforms towards a mandatory policy are expected to encounter a huge pressure from the industry. Thus, for Taiwanese policymakers, there will not be enough political incentives for them to take an aggressive reform, unless another shocking scandal like Procomp or Reba strikes Taiwan so seriously that voters’ angry pushes overwhelming pressure on policymakers. Now, Taiwan is completely democratic and both major political parties have much potential in taking power by earning the support of majority voters. Therefore, once another serious shocking scandal breaks out again, the voices of voters can be a form that pushes the corporate governance reform forward. Currently, Taiwanese policymakers, however, may prefer keeping a conservative policy about independent directors in the near future.

4.5.2 Create Friendly Environment for Independent Directors

In the theoretical debates in the U.S. and Taiwan, there is no clear answer to the question regarding whether independent directors can be an effective governance mechanism that lowers the possibilities of corporate wrongdoing committed by management (controlled by controlling shareholders). Since the institution of independent directors has become a formal mechanism in
Taiwan that is believed to benefit companies in some aspects, how to make this mechanism work should draw our attention. This dissertation concludes that current institution of independent directors in theory is less likely to function in an anticipated manner, because current legal and business environment in Taiwan is unfriendly for such institution to work, as analyzed above. As a result, in order to facilitate independent directors to function as much as possible, Taiwanese policymakers must consider creating a friendly environment in which independent directors can comfortably carry out their jobs.

In order to mitigate the problems associated with controlling shareholders’ dominance in the boardroom, Taiwanese policymakers have proposed some amendments to some articles of the TCA. They include:

4.5.2.1. Mandatory Cumulative Voting in Directorial Elections

In Taiwan, where controlling shareholders may be ubiquitously present, the mandatory cumulative voting may be useful in some situations because it allows minority shareholders, who possibly have different interests from controlling shareholders’, to elect at least one (independent) director representing them, and accordingly that can strengthen a culture of director independence.386

According to the Article 198 of the TCA, the cumulative voting is a non-mandatory default rule for the directorial elections. Under cumulative voting, whereby shareholders support one candidate with all of their votes (i.e., the number of shares timing the number of board seats to be elected), minority shareholders can take advantage of securing a seat in the boardroom. However, companies can adopt other election methods that facilitate controlling shareholders to

386 Black, Preconditions for Strong Securities Markets, supra note 270, at 800.
secure more board seats than in the cumulative voting. To avoid this, a bill is proposed to make the cumulative voting mandatory to all companies. Taiwan’s Legislative Yuan passed the bill on Dec. 14, 2011.

A disadvantage of mandatory cumulative voting is potential disharmony in the boardroom if there are many sects among directors that have different kinds of interest. Such disharmony in boardroom sometimes could lead to an inefficient board whose members have a grudge against others. Independent directors who are truly independent can solve this problem because minority shareholders trust monitor provided by independent directors more than by controlling shareholders’ representatives. Therefore, if some candidates are truly independent from controlling shareholders, minority shareholders will be comfortable when supporting these candidates. Instead of sending their own candidates who may have a grudge against controlling shares into boardroom, supporting truly independent directors in the election seems to be better off for shareholders as a whole. However, minority shareholders may lack sufficient information to determine whether a particular independent director is truly independent from controlling shareholders. In this situation, minority shareholders may prefer supporting their own candidates to independent director candidates nominated by controlling shareholders.

Cumulative voting still has functions in the introduction of independent directors. When several groups of minority shareholders are unable to have their own candidates elected even under cumulative voting, they can instead propose a slate. If some of independent candidates are trustworthy to them, the slate can be a good coordinator guiding them to vote a preferred quality director, who can do the monitoring for them. In contrast, without cumulative voting, minority shareholders will not likely to get their favorite candidates elected in the director elections with straight voting.
4.5.2.2 Mandatory Disclosure in Making Self-Interested Decisions

A bill was proposed that an interested director should disclose his or her conflicts of interest in any board decision before such a board decision is to be made. In case the interested directors fail to make disclosure, the board decision associated with any conflicts of interest between the company and directors should be void. This can alleviate the problem that the controlling shareholders embezzle the corporate assets through related-party transactions approved by the board primarily consisted by their affiliates. For a public company that appoints independent directors pursuant to the TSEA, any related-party transactions should be approved by the board of directors. In the circumstances, independent directors are expected to review and verify that the proposed transactions will be made at arm’s length. However, no investigation power is vested with independent directors and a problem of informational asymmetry will be raised unless disclosure of material information is made by the interested director or persons involved. Thus, informational asymmetry will makes such review and verification by independent directors meaningless. The proposed provision will force the interested directors voluntarily disclose information to the board, which alleviate the informational asymmetry problem that independent directors will encounter in monitoring board’s behavior. Taiwan’s Legislative Yuan passed that bill on Dec. 14, 2011.

4.5.2.3 Imposition of Liability on Shadow Directors

Under Taiwanese laws, controlling shareholders do not owe any obligation to other shareholders. Even when they become directors, they owe the fiduciary duty only to the
company rather than shareholders.\textsuperscript{387} If they wish to escape possible liabilities as a director, they can appoint a “dummy director” who will act in accordance with her instructions. Such so-called “shadow director” do not have responsibility for the wrongdoing committed by her dummy director unless there is clear evidence proving her instructions cause wrongdoing.

To solve this problem, a new proposed provision of Article 8 of the TCA provides that a shadow director shall be liable for her wrongdoing. Under the new provision, a shadow director shall have fiduciary duty and take criminal responsibility as if she were an actual director. What is the scope of fiduciary duty for a shallow director is not clear since the provision is quite new. One thing is certain that imposition of criminal liability should be the most striking effect to shallow directors. Under the rules of criminal laws in Taiwan, people shall not be punished unless a statute clearly says so. Previously, without a provision with respect to shallow directors, they usually can escape criminal liability when they use dummies to commit wrongdoing for their benefits, unless there is persuasive evidence that could prove shallow directors’ behavior causes such wrongdoing.

Additionally, a proposed Article 23 of the TCA provides that the shareholder meeting can exert the right of disgorgement to force a fiduciary in violation of her duty to return the profits obtained by her illegal acts to the company. Taiwan’s Legislative Yuan passed these two provisions on Dec. 14, 2011.

\textsuperscript{387} Under Taiwanese laws, directors owe duty to the company in which they serve but they have no direct duty to company shareholders.
4.5.2.4 No Directors and Supervisors Appointed by Same Institutional Shareholder

The current Article 27 of the TCA provides that an institutional shareholder can appoint representatives that serve as both directors and supervisors. A controlling shareholder who makes some arrangements to secure dominance in the execution (board of directors) and monitoring (supervisors) within a company can manipulate this Article. Article 26-3 of the TSEA makes Article 27 of the TCA inapplicable only to public companies. Almost all Taiwanese scholars criticize the current Article 27. They believe that the Wang family, in the Reba scandal, manipulated this Article to secure the most board seats of all the affiliated companies. Before Reba, a bill that deleted this Article encountered a great deal of opposition from the industry, so it failed to get approval from legislation. Another reason that Taiwanese policymakers keep this controversial Article is the government’s intention to secure its dominance in some types of companies involved with businesses that offer public goods or services such as electricity, gasoline, water, and public transportation. If the government holds less than 50% of the shares of a company, then that company will not be deemed a state-run company so that the government’s representatives are not subject to the supervision of the Legislative Yuan. Thus, there are few incentives for the government to delete this Article.

A bill passed by the Legislative Yuan on Dec. 14, 2011 provides that an institutional shareholder cannot appoint several representatives concurrently elected by both directors and supervisors, and that can mitigate the dominance of controlling shareholders, in terms of internal governance system in Taiwan. Unfortunately, an institutional shareholder can still have several of its representatives elected as directors or supervisors, so a controlling shareholder can keep its dominance in the boardroom by well manipulating this Article.
4.5.2.5 Others

When independent directors are not truly independent in fact and tend to be influenced by a controlling shareholder, the approval by independent directors seems an insufficient safeguard against related-party transactions. Thus, scholars argue that it can be valuable to give approval power for larger transactions to non-interested shareholders. Some commentators suggest that independent directors and supervisors be elected by counting heads rather than by counting stock shares and votes, which is the only current method. If independent directors were to be elected by counting the numbers of shareholders, then controlling shareholders would have less control over election of independent directors. This method would empower small shareholders since one of the responsibilities of independent directors is to protect the interests of small shareholders.

4.5.3 Mandatory Independent Director Policy is Not Appropriate

This dissertation argues that mandatory appointment of independent directors is not appropriate for Taiwan, based on the following reasons:

The effectiveness of independent directors remains doubtful, at least from theoretical point of view. Especially in Taiwan, independent directors will face many kinds of difficulties as they carry out their anticipated tasks. Specifically, some factors (such as uncertain independence, information asymmetry, the presence of shareholders, the majority of insiders on boards, weak power vested with independent directors, and no functional committees) will be making independent directors ineffective.

388 Black, Preconditions for Strong Securities Markets, supra note 270, at 808.
389 Id.
390 Liu & Yang, supra note 3, at 837.
In a given company which hires no independent directors, minority shareholders can have their representatives elected as directors who can monitor board behavior for them. Due to the potential conflicts of interest between different groups of shareholders, they will monitor against each other, and thus an internal checks and balances system can be created. Independent directors may be unnecessary in this type of situations. Besides, non-independent directors supported by minority shareholders have more time and interest in monitoring than an independent director. Thus, in some companies, such non-independent directors may be more effective monitors than independent directors.

Currently, although scholars have stressed the importance of independent directors, they seem to be undesirable for most mid-size and family-founded (except for few interested in inducing foreign investments or oversees listing) Taiwanese companies. Even though companies are required to appoint independent directors, they are likely to look for the candidates who are unwilling to involve active monitoring against management. In short, if companies do not have enough incentive to hire independent directors, they may easily become “rubberstamps” working for management or controlling shareholders rather than all shareholders.

As mentioned, a mandatory policy would be inappropriate for Taiwan. The current settings for independent directors seem better than a mandatory policy. Now, only Newly-Listed, financial, and large-size companies shall appoint independent directors. Under the TWSE’s Listing Rules, Newly-Listed companies can opt not to hire independent directors after being listed. Imposing the mandatory appointment of independent directors on financial and large-sized companies will not cause much shock for them, because they normally have more abilities to bear the costs of hiring independent directors. However, this may not be the case for small-sized companies.
Currently, the majority of the existing body of corporate law literature tends to merit the functions of independent directors in the context of corporate governance. However, there have been many scholars insisting that independent directors are not the solution for every corporate governance problem.\(^{391}\) One size does not fit all. Every single company will have their unique needs and should have freedom, under the permitted governance structure by laws, to develop the desirable accountability mechanisms tailored for their special needs.\(^{392}\) After all, “what is a proper board for one company may not be good for another,” so each company should have freedom to decide what is best for its needs.\(^{393}\) In other words, there may be no single optimal corporate governance model that is applicable to all companies in all situations.\(^{394}\)

### 4.5.4 Supervisors and Independent Directors Should Not Coexist

Supervisors and independent directors should not coexist in one company due to their overlapping functions and a free-riding problem. Thus, a company with supervisors must not appoint independent directors. The board of directors is still a managing device and supervisors will be the monitoring device that oversees the managerial behavior. On the contrary, companies that appoint independent directors must not have supervisors. Whether to appoint either supervisors or directors should be optional for companies.

Some may argue that independent directors can cooperate with supervisors who lack managing information for a better monitoring. Ideally, this could happen. However, this

\(^{391}\) Davis, supra note 246, at 1306.

\(^{392}\) Bainbridge, NYSE’s Director Independence, supra note 110.

\(^{393}\) Pease, supra note 17, at 34. See also Chancellor Strine also states that “Delaware's approach recognizes that what works for one corporation might not be optimal for another.” Strine, Delaware Way, supra note 137, at 686; Veasey, Good Governance Practices, supra note 137, at 2184.

argument is premised on a good coordination between independent directors and supervisors. Without a well-established coordination, free-riding and repetitive monitoring will inevitably occur.

4.5.5 Conclusion

In the U.S., good corporate governance may be predictable from board independence, the existence and role of the audit committee, or efficient takeover market. For Taiwan, only emphasizing the importance of the board independence seems senseless unless some preconditions are met. As Professor Black stated, some developing countries “need honest judges and regulators, good disclosure rules, and the beginnings of a culture of honesty before it makes sense to worry whether public company boards have, say, a majority of independent directors.”395

The most difficult challenge for Taiwanese independent directors to overcome is the influence from controlling shareholders who can control majority of the board and supervisors as well. In fact, their actual independence (from the controlling shareholders) remains questionable.

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395 Black, Preconditions for Strong Securities Markets, supra note 270, at 848.
Chapter Five: An Empirical Analysis on the Effectiveness of Independent Directors in Taiwan—Do Independent Directors Matter on Firm Performance?  

The reasons why Taiwan has introduced an institution of independent directors have been explained in Chapter Four. As such institution is relatively unfamiliar to Taiwanese companies, how it has been functioning so far is arguably unclear. In this chapter, this dissertation will launch an empirical project examining the effectiveness of independent directors in Taiwan. Admittedly, there are many ways to examine the possible contributions of independent directors. Here, this dissertation focuses on the firm performance, which is straightforward and can be reflected in concrete figures. I hypothesize that the presence of independent directors makes Taiwanese listed companies perform better. The null hypothesis is that there is no association between the presence of independent directors and firm performance. As will be explained later, the sample consists of Taiwanese listed electronic companies that have appointed independent director(s) (Companies with independent directors) and those that have never hired any independent directors (Companies without independent directors) between 2005 and 2008. The total observations are 424 (106 per year) for Companies with independent directors and 352 (88 per year) for Companies without independent directors. This project will use Tobin’s q as a measure of firm performance, which is the dependent variable. Independent variables include board size, presence of independent directors (dummy), firm age, firm size, the number of blockholders (holding more than 5% of outstanding shares of the company), year (dummy), and an interaction between independent directors and block-holders. The regression results can reject null hypothesis, and suggest that there is significant correlation between the presence of independent directors and firm performance.

396 I complete this empirical project with assistance by a friend, who instructed me to operate regressions.
5.1 The Purpose of this Empirical Project

Since Taiwan’s introduction of independent directors, some commentators have believed that independent directors can, due to the qualifications of independence required by relevant regulations, avoid the undue influence and interference from the management (e.g., inside directors and officers), and more importantly, from the controlling shareholders, while making decisions in the boardrooms. If this theory is true, with the presence of independent directors on board, there will be an effective and robust mechanism of internal control so as to deter the management and controlling shareholders from committing wrongdoing, such as self-dealing transactions, which benefits the wrongdoers at the expense of minority shareholders. However, others contend that it is more appropriate for Taiwan to consider how to make supervisors function in an effective way, than to just borrow a new concept from the foreign jurisdiction (i.e., the U.S.), which may not fit into Taiwan’s legal and business environment.

As illustrated in previous chapters, TWSE’s Listing Rules require companies to appoint at least two independent directors while applying for listing. Such rules are mandatory to all Newly-Listed Companies. The Listing Rules, to some extent, appear to adopt the theory that suggests that independent directors are good for companies. Even so, scholars argue that it needs some supporting empirical evidence, when any major codification for corporate governance is made. The introduction of independent directors should be treated the same because of its tremendous impact on Taiwan’s corporate governance system. Stimulated by the Procomp scandal that is believed to be one of the most shocking cases in Taiwan’s history, Taiwan’s policymakers seem to go forward with codifying independent directors in the TSEA too fast without seriously taking empirical evidence into consideration. Since the theoretical debate is

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Clark, supra note 172, at 312.
likely inconclusive, at this point, empirical evidence may provide some implications for Taiwanese policymakers.

5.2 The Values of Independent Directors

In the U.S., the board of directors is vested with almost all powers concerning the operations of the company. In fact, managers are the persons who run the daily affairs for the company. Under the separation between ownership and control, management has the power to run the business, but it may not care too much about the firm performance, because those who make up management are not owners of the company, and the agency problem arises. The agency theorists argue that agents (i.e., management) will likely pursue their own interests at the expenses of owners, if they are not being effectively monitored. In the corporate governance context, recent literature supports that the board of directors can effectively monitor management on behalf of shareholders. However, for various reasons, management (such as CEOs) may control the board members, and it is unrealistic to expect the board, which consists of insiders, to effectively monitor management because of their allegiance to CEOs, the persons who nominate them. To deal with this problem, the conventional wisdom of U.S. corporate laws argues that the board should be independent from management so as to reduce agency costs, because it can more effectively monitor management than a non-independent board can.

Basically, there are two main functions of the board of directors are expected to have: one is the advisory function, and the other is the monitoring function. Regarding the advisory

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398 E.g., Fosberg, supra note 131; Hillman & Dalziel, supra note 264.
399 Many scholars agree the fact that most U.S. medium to large size companies are run by the management team that holds a small fraction of the company’s shares. Fosberg, supra note 131, at 24.
400 The self-monitoring incentives of inside directors are limited “since they benefit from some of activities which they were placed on the board to stop.” Due to the conflicts of interest, they are not expected to offer an effective monitoring on the management. Id. at 24.
401 Hillman & Dalziel, supra note 264, at 385.
function, independent directors are usually business veterans or experts in some professional areas that may serve the company’s need, so they may be able to help management form business strategies that improve the company’s competitive advantages. With respect to the monitoring function, an independent board may prevent self-dealings that would harm the interests of shareholders from happening by offering a robust review on suspicious transactions. Board monitoring also lessens the possibilities that management would shirk its responsibilities. Afraid of being dismissed, management has incentives to perform in a satisfactory manner. By actively replacing incompetent managers, the board of directors could recruit new managers for better performance. Overall, by effectively monitoring on management’s behavior, the board of directors will be able to align managers’ interests with shareholders’ interests.

It is a belief that the U.S. agency theory is also applicable to Taiwan’s companies. Therefore, with an attempt to build a better governance system, the Listing Rules provide that some types of professional expertise (such as legal, accounting, or financial) or experience that the company needs will be a prerequisite in order for someone to be an independent director in Taiwan, for they are expected to provide professional advice that will help the company run better. Admittedly, monitoring should be the most important function that Taiwan’s legislature expects the board of directors to have, because Taiwan’s introduction of independent directors is primarily motivated by some serious corporate scandals like the Procomp scandal. However, it may be difficult to measure how effectively a board might decrease the possibilities of management committing wrongdoing.\(^\text{402}\)

\(^{402}\) A research conducted by Lin by interviewing Taiwanese independent directors. Most of interviewees expressed their inabilities to dig out more information than which they were given from the insiders. Based on such findings and inherent limitations for independent directors in theory, Lin concluded that Taiwanese independent directors were not able to detect the irregularity in the related-party transactions, in which Taiwanese controlling shareholders and management used to embezzle the corporate assets. Yu-Hsin Lin, Independent Directors, supra note 67.
Instead, positive economic contributions by independent directors may be another perspective in determining the effectiveness of independent directors. In addition, it would be impossible to observe or know for certain whether a board of directors provides effective monitoring in reality, but a board’s structure may more or less suggest how effective its monitoring is. Specifically, if a board of directors is dominated by insiders (CEO and other senior officers) or by controlling shareholders, no effective monitoring can be anticipated. In contrast, a board primarily consisted of independent directors (who have no financial ties with managers and controlling shareholders) is presumptively able to objectively assess managerial performance and to avoid possible exploitations that harm the interests of shareholders (especially minority shareholders). Unlike a board that is heavily influenced by management or controlling shareholders, an independent board may be more likely to dismiss underperforming managers. Therefore, a board of directors with more independence from managers and controlling shareholders is believed to be good governance practice, which may have positive economic contributions to the company. As a result, an independent board can, in theory, reduce the agency costs and create values for shareholders, by effectively monitoring managerial activities, which may deviate from shareholders’ best interests in some conflicting situations arising from the scenario of separation between ownership and control.\cite{403}

Knowing the possible contributions that an independent board may have, this dissertation focuses on firm performance, because these types of contributions are most straightforward. As the TWSE introduced independent directors only a decade ago, the evidence with respect to firm

\cite{403} It should be noted that Taiwan’s supervisors are also responsible for overseeing the legality of management conduct and to maintain the integrity of financial reports, but they have no authority to review the legitimacy or appropriateness of managerial conduct. As agreed by most Taiwanese commentators, supervisors usually are “bubbleheads” for senior managers or controlling shareholders and rarely effectively function as a monitoring device. Thus, the quality of supervisors’ monitoring seems that it would impact how well a firm runs, but in reality their influences tend to be insignificant. Their presence may be too slight to be perceived.
performance is very critical. To Taiwanese policymakers, such evidence can be taken into consideration when they examine the current policy and think of any further reforms. Currently, the appointment of independent directors is optional for most public companies, but mandatory for Newly-Listed Companies under TWSE’s Listing Rules. A thorough examination for the economic effects on companies with independent directors is necessary for policymakers when assessing whether or not a current policy needs to be maintained or modified.

In short, this project will focus on the question of whether the companies with independent directors perform better than those without independent directors. This dissertation will focus on companies’ performances after having independent directors, and will examine whether the U.S. corporate law wisdom of independent directors could also be applied in Taiwan. This project hypothesizes that companies with independent boards perform better than those without independent boards. As will be explained later, this project will focus its research only on Taiwan’s listed companies in the electronics industry. The hypothesis and null hypothesis are as follows:

\[ H1: \text{The presence of independent directors makes Listed Companies perform better in Taiwanese electronics industry.} \]

\[ H0: \text{There is no association between the presence of independent directors and firm performance in Taiwanese electronics industry.} \]

5.3 Literature Review

There has been a great deal of literature that has explored the possible benefits that independent directors can bring to companies, from a variety of different perspectives. For
example, regarding the cost of debt, an empirical study found that board and audit committee independence were associated significantly with lower costs of debt because the credibility or integrity of the company’s financial reporting, which would be processed under the monitor of the board of directors and of the audit committee, was very important to creditors in evaluating the risks.\textsuperscript{404} Beasley’s research indicated that a larger proportion of outside directors on the board of directors significantly reduced the likelihood of financial statement fraud, but the presence of an audit committee did not have the same result.\textsuperscript{405}

Regarding the correlation between independent directors and firm performance, the evidence is usually mixed in the body of previous literature. Baysinger and Butler found that an increase on board independence tended to lead to better corporate financial performance.\textsuperscript{406} Millstein and MacAvoy found that firms with active and independent boards performed better than those with passive and non-independent boards.\textsuperscript{407} Rosenstein and Wyatt argued that the appointment of outside directors was positively associated with reactions on stock prices.\textsuperscript{408} Wagner, Stimpert, and Fubara’s study also suggested that the greater presence of outside directors was associated with higher performance, but they also found similar results regarding inside directors.\textsuperscript{409} In the context of a takeover, Byrd and Hickman’s findings suggested that

\textsuperscript{405} Mark S. Beasley, *An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443 (1996).
bidders whose majority of board of directors consisted of independent outside directors had
significantly higher abnormal returns on the date of bidding announcement than others.\textsuperscript{410}

However, Fosberg found no relationship between the proportion of outside directors on
the board and various variables, such as ROE (return on equity) and S/TA (sales to total assets
ratio), as measures of managerial performance.\textsuperscript{411} Hermalin and Weisbach found no evidence
supporting that a relationship between board composition and firm performance existed.\textsuperscript{412}
Klein’s research also found no association between firm performance and board composition.\textsuperscript{413}
In addition, Bhagat and Black suggested that firms with more independent directors were not
better than other firms with regard to performance.\textsuperscript{414} Hermalin and Weisbach even suggested
that board composition was endogenously chosen and that might explain why it had no
correlation with firm performance.\textsuperscript{415}

In Taiwan, the evidence is controversial too. Some research found that board
independence (or the appointment of independent directors) was correlated with firm
performance,\textsuperscript{416} but others did not found the same results.\textsuperscript{417} Generally, most previous empirical

\textsuperscript{410} John W. Byrd & Kent A. Hickman, \textit{Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids},
\textsuperscript{411} Fosberg, supra note 131.
\textsuperscript{412} Benjamin E. Hermalin & Michael S. Weisbach, \textit{The Effects of Board Composition and Direct Incentives on Firm
\textsuperscript{413} April Klein, \textit{Firm Performance and Board Committee Structure}, 41 J. L. & Econ. 275 (1998).
\textsuperscript{414} Sanjai Bhagat & Bernard Black, \textit{The Non-Correlation between Board Independence and Long-Term Firm
\textsuperscript{415} Benjamin E. Hermalin & Michael S. Weisbach, \textit{Boards of Directors as An Endogenously Determined
\textsuperscript{416} E.g., YU-HUI HSU, \textit{THE RELATIONSHIP BETWEEN INDEPENDENT DIRECTORS SYSTEM AND FIRM VALUE}, MASTER
THESIS, COLLEGE OF MANAGEMENT, NATIONAL CHIAO TUNG UNIVERSITY (2008); YU-HSUAN SUN, \textit{THE EFFECTS
OF RELATIONSHIP BETWEEN INDEPENDENT DIRECTOR SYSTEM AND STATE OWNED MINOR OWNERSHIP ON THE
CORPORATE PERFORMANCE IN TAIWAN}, MASTER THESIS, DEPARTMENT OF DEVELOPMENT OF NATIONAL TAIWAN
UNIVERSITY (2007).
\textsuperscript{417} E.g., SHIUE-HAN JUANG, \textit{THE IMPACT OF THE BOARD STRUCTURE AND THE MULTIPLE DIRECTORSHIPS OF
INDEPENDENT DIRECTORS ON FIRM PERFORMANCE—THE EMPIRICAL STUDY OF LISTED ELECTRONIC COMPANIES
IN TAIWAN}, MASTER THESIS, DEPARTMENT OF MANAGEMENT SCIENCE, NATIONAL CHIAO TUNG UNIVERSITY
(2007).
literature in Taiwan supports that there is a correlation between independent directors and firm performance, but the recent literature reports the negative findings.\textsuperscript{418}

5.4 Sample and Data Collection

The data used in this part will mainly be from an electronic database compiled by TWSE’s Market Observation Post System (MOPS), which provides the annual reports, ownership held by directors, numbers of independent directors, and financial figures of Taiwan’s listed companies.\textsuperscript{419} In this system, although the Listing Rules were promulgated in 2002, the numbers of independent directors are available only from January of 2005. Due to the limited available data and to create the sample, this project includes listed companies that have ever appointed independent director(s) as a major part of the sample (from January 2005 to December 2008). As to the definition of independent directors for this empirical project, an independent director is one who has (1) no financial or business ties with the company; (2) no marriage or immediate blood relationships with the company’s big individual shareholder (an individual holding more than 1% of outstanding shares) or top-ten shareholders; and (3) no employment relationship with the company’s big firm shareholders (a firm holding more than 5% of company’s outstanding shares) or top-five shareholders.\textsuperscript{420}

In order to control the differences among industries that could possibly affect firm performance, the dissertation only includes Taiwan’s electronic companies in sample companies.\textsuperscript{421} The reasons include: (1) the majority of listed companies with independent

\textsuperscript{418} Len-Yu Liu, \textit{supra} note 355, at 125.

\textsuperscript{419} The English version of MOPS is available at \url{http://emops.twse.com.tw/emops_all.htm} (last visited May 6, 2011).

\textsuperscript{420} Basically, the data are collected from the MOPS, so the definition of independent directors should be in line with the definition of TWSE’s Listing Rules.

\textsuperscript{421} The term “electronic companies” here means Taiwan’s listed companies engaging in manufacturing or distributing semiconductors, computers and peripheral equipment, optoelectronics, communications and Internet
directors consist of electronic companies (for instance, based on the data as of January, 2005, there were 224 companies that appointed independent directors, and 157 were electronic companies); (2) the second largest population of companies (37 companies in 2010) that had ever appointed independent directors is in the finance-related industry (e.g., insurance and banking). This type of industry is normally heavily regulated by laws, and their appointments of independent directors are normally mandatory, and therefore, this type of industry may not be appropriate for this research;\textsuperscript{422} (3) the corporate governance structures and firm performance normally vary from industry to industry, and even from company to company. Thus, focusing on one particular industry may help avoid too many noises for this project’s purpose. As explained above, the population of sample companies in this project will entirely consist of Taiwan’s listed electronic companies.

It should be noted that the appointments of independent directors do not necessarily begin from the very first date of the year (i.e., Jan. 1). In addition, in situations such as resignations, retirements, or deaths of independent directors, companies may, for a certain period of time, have no independent directors on boards. Furthermore, although the Newly-Listed Companies have obligations to have two independent directors while applying for listing, the Listing Rules do not apply when the company re-elects new directors for the next term, which means some of them may not continue to hire independent directors if they think it unsuitable or unnecessary. Thus, the position of independent directors is often vacant among Taiwan’s listed companies. To avoid a lot of elimination of samples because of such vacancies, this project equipment, and other electronic parts or components. As the diversity of businesses in which a company may engage, it may be not easy to categorize a company into a particular industry. Here, the electronic companies here will be those categorized by TWSE into the electronics-related industries.\textsuperscript{422} In some literature, to keep homogeneity of the sample, the financial companies, such as banks and insurance companies, will be excluded as they are normally subject to different and strict regulatory constraints than other companies. See Kam-Ming Wan, \textit{Independent Directors, Executive Pay, and Firm Performance}, available at SSRN: http://ssrn.com/abstract=392595.
computes the average numbers of independent directors on a monthly basis. For example, if one company has two independent directors for only six months during a whole year, that company will still be counted and the average number will be 1. However, in a case where the average is below 1.00, that means the company does not have an average of one independent director on board, and this project assumes that the presence of independent directors would be too slight to affect firm performance, so the company is eliminated from the sample. Based on this criterion, there are 106 Companies with independent directors to comprise sample, and 424 observations between 2005 and 2008.

For the comparison purpose, this project also randomly selects 88 Companies without independent directors (one-third of companies that never hire any independent director between 2005 and 2008), as the other main part of the sample (352 observations between 2005 and 2008). As a result, the total number of sample companies will be 194 (106 Companies with independent directors and 88 Companies without independent directors) and there are 776 observations in total.

5.5 Variables

5.5.1 Dependent Variable

Based on the aforementioned hypothesis, in order to investigate whether board independence has a significant association with firm performance, firm performance will be the dependent variable, but how to measure it will be an open question. There may be no single ideal way to measure firm performance, and a variety of accounting and financial measures have been utilized in previous empirical literature. This project will choose Tobin’s q as a measure of firm
performance. Tobin’s q is understood as the ratio of the firm's market value to the replacement cost of its assets, but how to compute q raises another question.

This project computes Tobin’s q as \( Q = \frac{\text{Market Value of Common Stocks} + \text{Book Value of Preferred Stock} + \text{Book Value of Long-Term Debt}}{\text{Book Value of Total Assets}} \). In the equation for Q, market value of the firm's common stocks equals the number of common shares outstanding times the company’s share price on the last trading day of each year (e.g., December 31). The preferred stock may not have a precise basis to measure the market value; this project instead uses the book value of preferred stock as market value in the equation.\(^{424}\)

### 5.5.2 Independent Variables

The independent variables in this project will include a number of factors that could affect firm performance. They include:

- *Presence of independent directors (dummy=1; otherwise=0);* 
- *Board size (number of all directors)*;\(^{425}\)
- *Firm age (years from establishment)*;
- *Firm size, proxied by log (revenues)*;

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\(^{424}\) *Id.* For this research’s purpose, this will only have a very slight impact on the computation of Tobin’s q, because there was only one company in the sample which issued preferred stock, and the ratio (preferred stock/overall outstanding stock) is relatively small.

\(^{425}\) The number of directors also changes during the year, due to directors’ resignations, retirements, and other similar reasons. The annual reports of sample companies reveals when such vacancies occur. The dissertation computes the number of directors at a cut-off date (i.e., June 30 of each year). For example, if one of four directors was dismissed before June 30, the number of directors would be calculated as three; otherwise, the dismissed director would be counted, and the number will be four.
- Number of block-holders who have more than 5% of all outstanding shares of the company;

- Year (dummy) (2005=0; 2006=1; 2007=2; 2008=3).

Additionally, this project also finds IND and BLOK have an interaction during the variable diagnoses, so another independent variable (“IXB”=IND multiplying BLOK) is to be created to examine the effect of such a coexistence on firm performance. See Table 13 for definitions for all variables used in the regression.

Table 13: Variables & Definitions

<table>
<thead>
<tr>
<th>Abbreviations of Variables</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q (firm performance)</td>
<td>(Market Value of Common Stocks + Book Value of preferred Stocks + Book Value of Long-Term Debt)/ Book Value of Total Assets</td>
</tr>
<tr>
<td>ID (presence of independent directors)</td>
<td>Presence of independent directors=1; otherwise= 0</td>
</tr>
<tr>
<td>BOD (board size)</td>
<td>Number of all directors</td>
</tr>
<tr>
<td>AGE (firm age)</td>
<td>Years from establishment</td>
</tr>
<tr>
<td>SIZE (firm size)</td>
<td>Firm’s annual revenues (log)</td>
</tr>
<tr>
<td>BLOK (number of block-holders)</td>
<td>Number of block-holders who have more than 5% of all outstanding shares of the company</td>
</tr>
<tr>
<td>YEAR (data year)</td>
<td>2005=0; 2006=1; 2007=2; 2008=3</td>
</tr>
<tr>
<td>IXB (interaction b/w IND and BLOK)</td>
<td>IND multiplying BLOK</td>
</tr>
</tbody>
</table>
5.6 Descriptive Statistics

As Table 14 shows, the mean for Q is 1.2431 and mean for BOD is 6.8041. It is also worth to note that the maximum number of block-holders in sample companies is 7, and the mean is 1.7796. This illustrates the fact that block-holders (or even controlling shareholders) are very common in Taiwanese listed companies, which is very different from what is usually seen in U.S. public companies.

Table 14: Descriptive Statistics

<table>
<thead>
<tr>
<th>Variables</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q</td>
<td>.0937</td>
<td>9.3800</td>
<td>1.2431</td>
<td>0.9310</td>
<td>1.0921</td>
</tr>
<tr>
<td>Q(log)</td>
<td>-2.3676</td>
<td>2.2386</td>
<td>-.0486</td>
<td>-.0714</td>
<td>.7086</td>
</tr>
<tr>
<td>IND</td>
<td>.0000</td>
<td>1.0000</td>
<td>.5463</td>
<td>1.0000</td>
<td>.4981</td>
</tr>
<tr>
<td>BOD</td>
<td>3.0000</td>
<td>23.0000</td>
<td>6.8041</td>
<td>7.0000</td>
<td>2.0103</td>
</tr>
<tr>
<td>AGE</td>
<td>2.0000</td>
<td>58.0000</td>
<td>17.0674</td>
<td>15.0000</td>
<td>9.4400</td>
</tr>
<tr>
<td>SIZE(log)</td>
<td>12.1104</td>
<td>27.1032</td>
<td>18.8058</td>
<td>18.0944</td>
<td>3.7077</td>
</tr>
<tr>
<td>BLOK</td>
<td>.0000</td>
<td>7.0000</td>
<td>1.7796</td>
<td>1.0000</td>
<td>1.3292</td>
</tr>
<tr>
<td>YEAR</td>
<td>.0000</td>
<td>3.0000</td>
<td>1.5000</td>
<td>1.5000</td>
<td>1.1187</td>
</tr>
<tr>
<td>IXB</td>
<td>.0000</td>
<td>6.0000</td>
<td>.9626</td>
<td>.0000</td>
<td>1.3000</td>
</tr>
</tbody>
</table>

Source: Taiwan Stock Exchange
N=776
Q= Tobin’s q
IND= the presence of independent directors (dummy=1; otherwise=0)
BOD= the number of all board members
NINS= shares held by all non-independent directors (%)
AGE= firm age
SIZE= firm size, proxied by annual revenue (log)
YEAR= dummy 2005=0; 2006=1; 2007=2; 2008=3
BLOK= the number of block-holders
IXB= IND timing BLOK
5.7 Regression Results and Implications

This project will fit the data using a regression model with ordinary least squares (OLS) estimation. Under the constant variance assumption, the OLS estimator is known to have the nice property of being unbiased with minimum variance. However, the result of the residual analysis suggests a mild violation to the assumption, i.e. there is heterogeneity in the variances. The consequence is that the inference for the coefficients may be misled. To fix the problem, for the estimation we consider using the weighted least squares (WLS) methods. The steps are as follows:

1. Variable selection and multi-collinearity test;
2. Run the OLS regression;
3. Run the WLS regression;
4. Run OLS and WLS regression using one-year lag data for Tobin’s q.

This project obtains the weights, \( w_i = 1/h_i \). The weights can be understood as the adjustment on the observations to correct their influence over the parameter estimates. Specifically, an observation with lower precision should not be treated as equally importantly as an observation that provides more precise information, otherwise the estimation would be ineffective. Therefore, in the estimation procedure we "reweight" the data using the weights in order to correct the "importance" of each observation.

First, this project runs the regression with all 7 independent variables (BOD, IND, AGE, SIZE, BLOK, YEAR, and IXB). After diagnoses for multi-collinearity issues and variable selections, SIZE and BOD are eliminated from the independent variables. This project proceeds
with another regression with five variables (AGE, IND, YEAR, BLOK, and IXB). Regression result is reported below.

**Table 15: OLS Estimates**

Q is the dependent variable as a measure of performance, proxied by log. t-statistics are in parentheses. p<.05 marked with * and P<.01 marked with ** P<.001 marked with *** (N=776)

<table>
<thead>
<tr>
<th>AGE</th>
<th>IND</th>
<th>BLOK</th>
<th>YEAR</th>
<th>IXB</th>
<th>Adj-R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>-.016</td>
<td>.269</td>
<td>.051</td>
<td>-.185</td>
<td>-.081</td>
<td>.157</td>
</tr>
<tr>
<td>(-5.752)***</td>
<td>(3.371)**</td>
<td>(1.990)*</td>
<td>(-8.751)***</td>
<td>(-2.312)*</td>
<td></td>
</tr>
</tbody>
</table>

Table 15 suggests that all five independent variables have significant correlations with firm performance. However, as the data are across four years from 2005 to 2008, there will be a heteroskedasticity issue for the penal data. To deal with that issue, this project continues to run a WLS regression. The WLS result is reported below.

**Table 16: WLS Estimates**

Q is the dependent variable as a measure of performance, proxied by log. t-statistics are in parentheses. p<.05 marked with * and P<.01 marked with ** P<.001 marked with *** (N=776)

<table>
<thead>
<tr>
<th>AGE</th>
<th>IND</th>
<th>BLOK</th>
<th>YEAR</th>
<th>IXB</th>
<th>Adj-R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>-.004</td>
<td>.413</td>
<td>.033</td>
<td>-.199</td>
<td>-.102</td>
<td>.160</td>
</tr>
<tr>
<td>(-2.438)*</td>
<td>(5.363)***</td>
<td>(1.217)</td>
<td>(-10.170)***</td>
<td>(-2.790)**</td>
<td></td>
</tr>
</tbody>
</table>

This project also notices that it may take time for independent directors to make contributions to the company. For this reason, I use one-year lag data for independent variables
in the equation to run the regressions. For example, 2006 Tobin’s q will be dependent variable and independent variables are 2005. The OLS and WLS are reported below.\footnote{This project loses one-year observations (194) because the data of 2009 for Tobin’s q are not available.}

### Table 17: OLS Estimates (one-year lag)

Q is the dependent variable as a measure of performance, proxied by log. t-statistics are in parentheses. \(p<.05\) marked with * and \(P<.01\) marked with ** \(P<.001\) marked with *** (N=582)

<table>
<thead>
<tr>
<th>AGE</th>
<th>IND</th>
<th>BLOK</th>
<th>YEAR</th>
<th>IXB</th>
<th>Adj-R(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.016</td>
<td>0.217</td>
<td>0.053</td>
<td>-0.173</td>
<td>-0.070</td>
<td>0.108</td>
</tr>
<tr>
<td>(-4.946)***</td>
<td>(2.235)*</td>
<td>(1.631)</td>
<td>(-5.705)***</td>
<td>(-1.591)</td>
<td></td>
</tr>
</tbody>
</table>

### Table 18: WLS Estimates (one-year lag)

Q is the dependent variable as a measure of performance, proxied by log. t-statistics are in parentheses. \(p<.05\) marked with * and \(P<.01\) marked with ** \(P<.001\) marked with *** (N=582)

<table>
<thead>
<tr>
<th>AGE</th>
<th>IND</th>
<th>BLOK</th>
<th>YEAR</th>
<th>IXB</th>
<th>Adj-R(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.009</td>
<td>0.251</td>
<td>0.057</td>
<td>-0.186</td>
<td>-0.081</td>
<td>0.107</td>
</tr>
<tr>
<td>(-3.934)***</td>
<td>(2.811)***</td>
<td>(1.749)</td>
<td>(-6.858)***</td>
<td>(-1.839)</td>
<td></td>
</tr>
</tbody>
</table>

As the WLS result in Table 16 (basically same result in Table 18) indicates, Age and Year are negatively and significantly correlated with firm performance, which indicates that older firms may have less competitive advantages than younger ones. This is probably because younger companies have utilized more of their resources on innovative research, which is very important in the electronics industry. In contrast, IND and BLOK are positively associated with firm performance (even though insignificant for BLOK). Both independent directors and blockholders benefit firm performance. Interestingly, the coexistence of independent directors and blockholders may have negative effect on firm performance, which may indicate there can be a confliction between them leading to inefficiency in terms of operation of business. Thus, the
above result rejects the null hypothesis, and concludes that independent directors may have made Taiwanese listed companies perform better in the electronics industry.

5.8 Conclusion

In conclusion, the regression results suggest that independent directors may positively contribute to firm performance. Based on this finding, Taiwanese policymakers have some empirical grounds to support a more aggressive independent director policy in the future. However, with the presence of block-holders or controlling shareholders, independent directors may not be able to function effectively in terms of firm performance. This implies that the future independent director policy of Taiwan should pay more attention on this issue. Finally, the result is consistent with the arguments previously presented in this dissertation that Taiwanese independent directors are unlikely getting rid of influence from big shareholders.
Chapter Six: Conclusion

After news of many corporate scandals broke out, Taiwanese policymakers realized that the internal governance system in the TCA was ill designed and they sought reforms to build a more effective governance system. As U.S. corporate laws are becoming more and more important to Taiwan, and the corporate governance issues have been emphasized in the competitive global capital market, in order to deal with its own governance problems, Taiwan introduced the institution of independent directors, which has long been advocated as a good corporate governance practice in the U.S.

The U.S. corporate conventional wisdom argues that independent directors will benefit companies in some aspects, but it is believed that they will face some inherent limitations while carrying out the monitoring tasks. The most serious issue is how to make sure an independent director has true independence from management. In addition to the limitations that U.S. independent directors normally face, Taiwanese independent directors also encounter other constraints arising from characteristics of Taiwan’s business environment. Under the Taiwan’s laws and regulations, I argue that independent directors have few chances to rid themselves of the controlling shareholders’ influence. Even in absence of shareholders who have dominance in the boardroom and supervisor system, independent directors will still encounter difficulties in carrying out the monitoring tasks while insiders are unwilling to disclose the material information before any board decision is to be made. In conflict-of-interest transactions (or, related-party transactions), which have frequently been utilized as a form of embezzlement, it is likely that independent directors are unable to detect wrongdoing or even illegality. As a result, this dissertation concludes that Taiwanese independent directors will function in a very limited way. The current set-up of independent directors is a mixed product under various types of
pressure from different interest groups (e.g., investors, voters and the industry). Even if Taiwan implements more aggressive reforms and adopts the mandatory independent director policy for all listed (or even public) companies, that may be useless because companies will likely use any methods to bypass the mandatory rules. Therefore, the current set-up may be a necessary compromise. After all, an optimal corporate governance system cannot be expected in a short time.

Even though there are some theoretical flaws in Taiwanese settings regarding independent directors, this dissertation finds that the presence of independent directors is significantly correlated with firm performance in the electronics companies, which means that independent directors as monitors may have made positive contributions to companies on whose boards they serve. However, combined with presence of block-holders, the presence of independent directors has negative association with firm performance. This result indicates that the coexistence of independent directors and block-holders may become a problem for companies in terms of operation of business. This empirical result is consistent with the argument that independent directors are not likely to be effective monitors at the presence of controlling shareholders or block-holders. Taiwanese policymakers should take this into consideration in making future policy of independent directors for Taiwan.

As a matter of fact, the institution of independent directors remains relatively unfamiliar and undesirable to most Taiwanese companies. Currently, Taiwan is in an experimental stage regarding this institution, and has been trying to create a friendly environment for independent directors. It is unclear whether this institution will function as an effective monitor in a satisfying manner in the near future. Since Reba, Taiwanese listed companies have not experienced additional serious scandals. Politically speaking, with a lack of momentum for more ambitious
policy with respect to corporate governance issues, it is very likely that current policy will be sustained for a while, unless another serious and harmful scandal strikes Taiwan again.
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