

WEAK INDEPENDENT DIRECTORS, STRONG CONTROLLING
SHAREHOLDERS: DO INDEPENDENT DIRECTORS CONSTRAIN TUNNELING
IN TAIWAN?

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Abstract

One of the most important challenges to modern corporate governance is to constrain controlling shareholder from tunneling corporate resources at a cost to non-controlling shareholders. RPTs have been proved by empirical studies as a major channel for tunneling. OECD has also stressed the challenge of abusive RPTs to Asian corporate governance. This Dissertation serves an initial attempt to empirically assess the extent to which independent directors in Taiwan constrain tunneling. Taiwan serves as an appropriate jurisdiction for research in that private benefits agency problem is prevalent among Taiwanese public companies and that independent directors were newly introduced to Taiwan's corporate boards, which traditionally follow dual-board system.

Nevertheless, the results are daunting. RPTs among Taiwanese public companies are common but rarely monitored by the board. Interview results further confirm this finding. Overall, independent directors' oversight on RPTs or tunneling is generally weak. In addition, most RPTs that are sent for board review are explicitly required by the law to do so. The law plays a decisive role in constraining RPTs. Self-regulation by firms of self-dealing transactions is rare. The value of independent directors in reconciling conflicts of interest matters has not been recognized by Taiwanese public companies. The existence of statutory supervisor, which is the traditional corporate monitors under dual-board system, further weakens the monitoring function of independent directors.

Furthermore, there exists tremendous information asymmetry between

independent directors and controlling shareholders, in particular, the shareholder managers. The information needed to uncover abusive RPTs is among the hardest to obtain. To overcome information asymmetry, independent directors in Taiwan generally choose to join a board with which they are familiar. The interview results reveal that independent directors generally maintain close social relationships with the controlling shareholders. Thus, there is concern that bias arising from the social ties could hinder the independence of directors.

Finally, this Dissertation evaluates the effectiveness of legal transplantation of independent directors from a single board system to a dual board system. Transplantation is a long process where new legal measures grind against pre-existing local conditions. Taiwan is still in a transition period where one-third of listed companies operate under a dual board system with independent directors on the board. Independent directors were put on an advising board for some monitoring tasks while there exists another institution, the statutory supervisor, still in charge of corporate oversight. In addition, without complementary judicial deference to the decisions of independent boards, the value of independent directors to the firm greatly diminished. All these existing local conditions present challenges to the new legal device and hinder the transplantation process.

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INTRODUCTION

“These people [independent directors], decent and intelligent though they were, simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation.”

Warren E. Buffett¹

Over the past decade, corporate finance scholarship has increasingly focused on the private benefits agency problem, also termed tunneling, self-dealing, or private benefits of control. Coined by Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000), “tunneling” refers to the extraction of private benefits by controlling shareholders at the expense of non-controlling shareholders.² It is evident that public companies outside the United States and the United Kingdom typically have a controlling shareholder who controls the firm often without proportionate shareholdings.³ The divergence between control rights and cash-flow rights makes the firm more prone to tunneling by controlling shareholders thus hampering investors’

¹ WARREN E. BUFFETT, SHAREHOLDER LETTERS, BERKSHIRE HATHAWAY INC., Feb. 21, 2003 at 17, *available at* <http://www.berkshirehathaway.com/letters/letters.html>.

² Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000). [hereinafter Johnson et al., *Tunneling*]

³ Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 511 (1999). [hereinafter La Porta et al., *Corporate Ownership*]

confidence over market integrity and hindering national capital market development.

Therefore, one of the most important challenges in modern corporate governance is to constrain extraction of private benefits by controlling shareholders. Both theoretical and empirical studies have been devoted to understand tunneling and the ways through which controlling shareholders extract private benefits at a cost to investors. Related party transactions (RPTs) have been evident as one of the major ways through which controlling shareholders divert corporate resources to themselves. The prevalence of abusive RPTs could hamper market integrity and lead to a national discount on the capital market.⁴ In consideration of the significant impact of abusive RPTs on corporate governance, the OECD 2008 Asian Roundtable listed abusive RPTs as a major challenge in Asian corporate governance and initiated a task force to develop a practical guide to monitoring abusive RPTs.⁵

The “law and finance” literature has demonstrated that law, in particular legal protection of investors against tunneling or self-dealing of controlling shareholders, plays an important role in the development of financial markets.⁶ It is possible that

⁴ OECD, CORPORATE GOVERNANCE SERIES: GUIDE ON FIGHTING ABUSIVE RELATED PARTY TRANSACTIONS IN ASIA 11-12, September 2009, at <http://www.oecd.org/daf/corporate/principles>. [hereinafter OECD RPT GUIDE]

⁵ OECD, CONCLUSIONS AND KEY FINDINGS NOTE, 2008 Asian Roundtable on Corporate Governance, May 13-14, 2008, Hong Kong, at http://www.oecd.org/document/39/0,3343,en_2649_34813_40144295_1_1_1_37439,00.html.

⁶ Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *The Law and*

laws affect the development of financial markets through constraint over tunneling.⁷ Accounting treatment and disclosure requirement of self-dealing transactions are certainly the foundation of effective legal control over tunneling.⁸ In addition to fair accounting treatment and disclosure, corporate boards should be the major institution in monitoring RPTs. Therefore, the independent director, being presumably independent from controlling shareholders, is an appropriate institution in policing RPTs on behalf of non-controlling shareholders.⁹

This Dissertation intends to explore the extent to which independent directors constrain tunneling by controlling shareholders in Taiwan. Taiwan serves as an appropriate jurisdiction for research in that private benefits agency problem is prevalent among Taiwanese public companies. A further twist in Taiwan's case is that independent directors were newly introduced to Taiwan's corporate boards, which follow dual-board system where the traditional monitoring function is served by statutory supervisors, instead of board committees. That adds to the complexity in

Economics of Self-Dealing, 588 J. FIN. ECON. 430 (2008); Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

⁷ Vladimir Atanasov, Bernard Black, & Conrad S. Ciccotello, *Unbundling and Measuring Tunneling* 30-31 (Univ. of Texas Sch. of Law Law & Econ. Working Paper No. 117), available at <http://ssrn.com/abstract=1030529>. [hereinafter Atanasov et al., *Unbundling Tunneling*]

⁸ *Id.*, at 31-34.

⁹ OECD RPT GUIDE, *supra* note 4, at 8.

analyzing the effectiveness of independent directors in constraining tunneling activities.

Chapter 1 reviews relevant literature and lays the foundation for this Dissertation. Chapter 2 details the methodology of this research study, mainly in-depth interviews, and presents basic information about the samples. Chapter 3 reviews the current state of corporate governance in Taiwan. Chapter 4 reports empirically the function of independent directors and their oversight of RPTs among sample Taiwanese public companies. Chapter 5 analyzes the institutional constraints of independent directors in overseeing controlling shareholders, reviews the effect of legal transplantation, and provides a brief suggestion to the future roadmap. Finally, this Dissertation concludes with a summary of the findings.

CHAPTER 1. INDEPENDENT DIRECTORS AS CORPORATE MONITORS

I. Background

Economists see boards of directors as one of the decision-control measures that reduce agency costs arising from the separation of ownership and control in corporations.¹⁰ In the United States where corporate ownerships are mostly widely held, the principal agency cost problem is managerial indiscretion arising from the conflicts of interests between managers and shareholders. The legal system has relied on outside independent directors to monitor managerial abuses on behalf of dispersed owners and to render impartial judgments in situations involving conflicts of interests.¹¹ Following the Enron and Worldcom debacles, the law relied on independent directors even more in monitoring managerial irregularities.

However, most public companies outside the United States and United Kingdom are not widely held but are controlled by families or the state.¹² While the presence of a controlling shareholder reduces managerial agency problem, it suffers from private

¹⁰ They describe boards of directors as “the common apex of the decision control systems of organizations, large and small, in which decision agents do not bear a major share of the wealth effects of their decisions.” Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 311 (1983).

¹¹ Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 904-912 (1996).

¹² La Porta et al., *Corporate Ownership*, *supra* note 3, at 511.

benefits agency problems where controlling shareholders extract private benefits at a cost to minority shareholders.¹³ Insofar as the costs of private benefits agency problem are greater than the benefits of reduction in managerial agency problem, the challenges of corporate governance in a controlling shareholder system would be to minimize the extraction of private benefits by controlling shareholders while preserving managerial discretions for making business decisions.¹⁴

Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) use the term “tunneling” to refer to the extraction of private benefits by controlling shareholders.¹⁵ One way to constrain tunneling (or self-dealing) is to improve the legal system, whether by setting stricter substantive standards of review, requiring more disclosures or enhancing enforcement mechanisms.¹⁶ Mirroring the role of independent directors in widely held shareholder systems, this dissertation explores the extent to which independent directors, as a legal institution, reduce the private benefits agency costs in controlling

¹³ Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785-786 (2003).

¹⁴ This is the trade-off between discretion and accountability in corporate governance. Alessio M. Paces, *Controlling the Corporate Controller's Misbehaviour* 8-11 (Rotterdam Institute of Law and Economics Working Paper Series No. 2009/01, Dec. 2008), available at <http://ssrn.com/abstract=1327800>.

¹⁵ Johnson et al., *Tunneling*, *supra* note 2, at 22.

¹⁶ Gilson proposes three ways to eliminate inefficient controlling shareholder systems: improving the legal system, increasing exposure of control to the market, and increasing access to global capital markets. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1653 & 1973-78 (2006). [hereinafter Gilson, *Complicating the Controlling Shareholder Taxonomy*]

shareholder systems.

II. Independent Directors and Managerial Agency Problem

A large body of empirical literature examines the extent to which independent directors reduce managerial agency costs by evaluating the effect of board independence on firm performance. However, many of them fail to establish positive correlation between the two.¹⁷ Commentators suspect that the uncertain statistical results may due to the fact that firm performance is generally correlated with too many factors that the study might not capture; besides, board composition is usually endogenously determined. Another line of studies directly investigates the effect of board independence on specific board actions.¹⁸ Such studies suffer less from the endogeneity of board composition and thus are more powerful in explaining the effect of board independence. In general, studies on specific board actions report significant results. Board independence appears to improve the quality of board decisions on CEO replacement, responses to hostile takeover, adoption of poison pills, and the design of

¹⁷ For a literature review, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 950 (1999); Benjamin E. Hermalin & Michael S. Weisbach, *Board of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL'Y REV. 7 (2003); Bernard Black, Hasung Jang & Woonchan Kim, *Does Corporate Governance Predict Firms' Market Values? Evidence From Korea*, 22 J. L. ECON. & ORG. 366, 369-71 (2006).

¹⁸ These board actions include CEO dismissal, executive compensation, corporate acquisition, adoption of anti-takeover measures. For a literature review, see Hermalin & Weisbach, *supra* note 17, at 14-17; Lin, *supra* note 11, at 926-39.

executive compensation.

Finally, other studies evaluate the oversight function of independent directors by studying whether the presence of independent directors reduces the probability of financial-statement misconducts. (Appendix A) These studies use many different measures to proxy financial-statement misconduct, including abnormal accruals, financial-statement restatements, enforcement actions by securities authorities, cost of debt, and accounting conservatism. Five out of twelve studies used enforcement actions by securities authorities, fraud that had been reported in the Wall Street Journal Index, and/or securities fraud litigation as proxies for the presence of financial-statement fraud. Interestingly, all five studies found a negative correlation between the percentage of a firm's outside directors and the firm's propensity to commit fraud, suggesting that outside directors are effective corporate monitors.¹⁹

Four out of twelve studies used the presence of abnormal accruals as a proxy for fraud. Among them, Klein (2002) and Peasnell, Pope and Young (2005) found that

¹⁹ Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443 (1996); Patricia M. Dechow, Richard G. Sloan, & Amy P. Sweeney, *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1 (1996); Hatice Uzun, Samuel H. Szewczyk, & Raj Varma, *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33 (2004); Eric Helland & Michael Sykuta, *Who's Monitoring the Monitor? Do Outside Directors Protect Shareholders' Interests?*, 40 FIN. REV. 155 (2005); Gongmeng Chen, Michael Firth, Daniel N. Gao, & Oliver M. Rui, *Ownership Structure, Corporate Governance, and Fraud: Evidence from China*, 12 J. CORP. FIN. 424 (2006).

higher levels of outside directors correlate with lower levels of abnormal accruals²⁰ and Carcello, Hollingsworth, Klein and Neal (2006) found that the presence of audit committees' financial expertise correlates with reductions in abnormal accruals.²¹ However, no such correlation surfaced in Park and Shin (2004), whose sample consisted of firms from Canada, a jurisdiction where ownership is concentrated and where the labor market for outside directors is not well developed.²²

The remaining three studies used measures that focus on one of the three following issues: earnings restatements, the cost of debt, and conservative accounting policy. The results are mixed. Anderson, Mansi and Reeb (2004) found that board independence was associated with lower cost of debt, suggesting that, in general, board independence enhances the reliability of financial reports.²³ Ahmed and Duellman (2007) used three different measures to determine whether or not a firm had adopted a conservative accounting policy: according to the findings, the percentage of

²⁰ April Klein, *Audit Committee, Board of Director Characteristics, and Earnings Management*, 33 J. ACCT. & ECON. 375 (2002); K.V. Peasnell, P.F. Pope & S. Young, *Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?*, 32 J. BUS. FIN. & ACCT. 131 (2005).

²¹ Joseph V. Carcello, Carl W. Hollingsworth, April Klein & Terry L. Neal, *Audit Committee Financial Expertise, Competing Corporate Governance Mechanisms, and Earnings Management* (working paper, Feb 2006), available at <http://ssrn.com/abstract=887512>.

²² Yun W. Park & Hyun-Han Shin, *Board Composition and Earnings Management in Canada*, 10 J. CORP. FIN. 431 (2004);

²³ Ronald C. Anderson, Sattar A. Mansi & David M. Reeb, *Board Characteristics, Accounting Report Integrity, and the Cost of Debt*, 37 J. ACCT. ECON. 315 (2004).

inside directors was negatively related to accounting conservatism.²⁴ In contrast to other studies, Agrawal and Chadha (2005) used earnings restatements to measure fraud and found no relation between the probability of earnings restatements and board independence.²⁵

In summary, ten out of twelve studies found positive relations between board independence and financial-statement misconduct, suggesting that outside directors do reduce managerial agency costs. Still, two studies found no such correlation. Hence, the findings are somewhat mixed. Interestingly, although most of the studies confirm that board independence helps prevent fraud, most studies did not find that complete independence of audit committees would reduce the probability of financial-statement fraud.²⁶ The result negates the new requirement of Sarbanes-Oxley Act where full independence of audit committee members is required.²⁷ Nonetheless, some studies found that the presence of outside “financial expertise”-possessing directors help reduce the probability of earnings management, which is highly correlated with

²⁴ Anwer S. Ahmed & Scott Duellman, Accounting Conservatism and Board of Director Characteristics: An Empirical Analysis, 43 J. ACCT. ECON. 411 (2007).

²⁵ Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. L. & ECON. 371 (2005).

²⁶ E.g. *Id.*; Klein, *supra* note 20; Peasnell et al., *supra* note 20. For a literature review, see Roberta Romano, *The Sarbanes-Oxley Act And The Making Of Quack Corporate Governance*, 114 YALE L.J. 1521, 1532-33 (2005).

²⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

fraud.²⁸

Even though most of the empirical studies found correlations between outside directors and fraud prevention, we should be cautious in reading into these results. Similar to the problems faced by other studies on the impact of board structure on firm value, studies on the impact of outside directors on fraud prevention suffer from potential endogeneity problems because board structures are usually voluntarily chosen and are endogenous to other firm characteristics.²⁹ It may be that “good” firms, meaning those without fraud, choose to have more outside directors on the board; the results may just be a reflection of self-selection.³⁰ In other words, it may not be a causal relationship but simply an association. Even though most empirical studies of corporate governance have tried to address potential endogeneity problems, commentators argue that such efforts have been inadequate because these studies fail to build theoretical models that clarify the sources and effects of endogeneity problems and thus overlook the possibility of disparate treatment effects across firms.³¹ Before researchers develop better identification strategies to address this problem, analytical

²⁸ E.g. Agrawal & Chadha, *supra* note 25; Carcello et al., *supra* note 21.

²⁹ Hermalin and Weisbach, *supra* note 18. Renee Adams, Benjamin E. Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey* 1-2 (Fisher College of Business Working Paper Series), available at www.ssrn.com/abstract=1299212.

³⁰ Romano, *supra* note 26, at 1532.

³¹ Yair Listokin, *Interpreting Empirical Estimates of the Effect of Corporate Governance*, 10(1) AM. L. ECON. REV. 90, 91-92 (2008).

statisticians would find it difficult to establish a causal relationship between board independence and fraud prevention.

III. Independent Directors and Private Benefits Agency Problem

A. Controlling-Minority Structure (CMS)

For the past decade, important empirical works have demonstrated that the ownership structure of non-U.S. public firms is actually quite different from that of their U.S. counterparts. Rafael La Porta, Lopez-de-Silanes and Shleifer (1999) found that, except in economies with very good shareholder protection, most corporations around the world are controlled by families or the state.³² In addition, the controlling shareholders typically have power over a given firm in excess of their cash-flow rights, primarily through the use of dual class shares, pyramids, cross-shareholding and participation in management.³³ Studies on regions in East Asia and Western Europe present similar results.³⁴

In East Asia, concentration of ownership in public companies is especially

³² La Porta et al., *Corporate Ownership*, *supra* note 3, at 511.

³³ *Id.*

³⁴ The study shows that almost 37% of Western European firms are widely held and 44% of the firms are family controlled. Widely held firms are especially important in U.K. and Ireland, while family control is more important in continental Europe. Mara Faccio and Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 366 (2002).

salient—more than two-thirds of firms are controlled by a single shareholder, and significant corporate wealth in East Asia is concentrated among a few families.³⁵

Corporate control in East Asian countries is typically enhanced by pyramid structures and cross-holding among firms.³⁶ Bebchuk, Kraakman and Triantis (2000) apply the term *controlling-minority structure* (CMS) to the pattern of ownership that, through structural devices, separates controllers' *ownership* rights (cash-flow rights) from controllers' *control* rights (voting rights).³⁷ Family control and CMS characterize Taiwan's public firms. Yeh and Woitdke (2005) found that 72% of Taiwanese public firms had a controlling shareholder and that, among them, 83% were controlled by a family.³⁸ In addition, there was considerable divergence between cash-flow rights and control rights in over 75% of the firms that have controlling shareholders, meaning

³⁵ Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 110 (2000).

³⁶ Pyramid structures are defined as owning a majority of the stock of one corporation which in turn holds a majority of the stock of another, a process that can be repeated a number of times. Through pyramid structure, controlling shareholders can control firms through a chain of companies, which can be viewed as another form of separation of ownership and control. For cross-holding, that means a company further down the chain of control has some shares in another company in the same business group. See La Porta et al., *Corporate Ownership*, *supra* note 3, at 473, and *id.* at 93.

³⁷ Lucian Aye Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 295 (Randall K. Morck, ed., 2000).

³⁸ Yin-Hua Yeh & Tracie Woitdke, *Commitment or Entrenchment? Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1874 (2005). *C.f.* Using the same 20% cut-off point, Yeh, Lee & Woitdke (2001) report that 51.4% while Claessens et al. (2000) report 48.2% of Taiwan's public companies are family-controlled. Yin-Hua Yeh, Tsun-Siou Lee & Tracie Woitdke, *Family Control and Corporate Governance: Evidence From Taiwan*, 2 INT'L REV. FIN. 21, 31 (2001); Claessens et al., *supra* note 35.

approximately 54% of Taiwanese public companies are CMS firms.³⁹

B. Private Benefits Agency Problem (Tunneling)

Both dispersed-ownership structures and controlled-ownership structures suffer from less serious agency problems than does CMS because CMS lacks the major mechanisms that limit agency costs in other ownership structures.⁴⁰ In contrast to the dispersed-ownership structure, the controlling party in a CMS faces no threats from corporate-control contests because the control-enhancing structural devices per se are highly effective anti-takeover measures.⁴¹ Moreover, in contrast to the controlled-ownership structure, the controllers in a CMS are entrenched but do not internalize most of the value effects of their decisions because the controllers' cash-flow rights are relatively low.⁴²

Two major agency problems afflict CMS: (1) divergence-of-interests agency problems, and (2) entrenchment agency problems.⁴³ The first type of agency problem

³⁹ Yeh & Woidtke, *supra* note 38, at 1872.

⁴⁰ The agency problem associated with dispersed ownership structure is the famous principal-agency problem that arises from the separation of ownership and control as identified by Jensen & Meckling (1976). In addition to the managerial agency problem, firms with controlling structure also suffer from private benefits agency problem where controlling shareholders extract private benefits that are not provided to non-controlling shareholders. Gilson & Gordon, *supra* note 13, at 785-786.

⁴¹ Bebchuk et al., *supra* note 37, at 301; Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 677 (2005).

⁴² Bebchuk et al., *supra* note 37, at 301.

⁴³ Morck et al., *supra* note 41, at 676-79.

arises from a divergence between a controller's cash-flow rights and voting rights. This agency problem is similar to the agency problem between managers and shareholders in firms with dispersed-ownership structures, as identified by Jensen and Meckling (1976). The controller in a CMS firm is freer to extract private benefits of control than are the managers in firms with dispersed-ownership structures because the controller controls the firm. This phenomenon is called the entrenchment agency problem. Whereas firms with dispersed-ownership structures are vulnerable chiefly to divergence-of-interest agency problems and whereas firms with controlled-ownership structures are vulnerable chiefly to entrenchment agency problems, CMS firms are vulnerable to the two types of agency problems simultaneously. The combination of the two agency problems provides controllers of CMS firms not only the incentives but also the power to extract private benefits at the cost of minority shareholders. Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) use the term 'tunneling' to refer to "the transfer of resources out of a company to its controlling shareholder."⁴⁴ Tunneling is a common type of corporate fraud in CMS-dominated economies. Taiwan apparently has this kind of economy.

Bebchuk, Kraakman and Triantis (2000) further show that, in CMS contexts, the

⁴⁴ Johnson et al., *Tunneling*, *supra* note 2.

agency costs that arise can be much greater than those in the contexts of either dispersed-ownership structures or controlled-ownership structures because the size of agency costs increases, not linearly, but at a sharply increasing rate as the size of “cash-flow rights” holdings decreases.⁴⁵ An empirical study by Claessens, Djankov, Fan and Lang (2002) and one by Lins (2003) suggest, from their findings, that firm value declines as the gap between the largest shareholder’s or management group’s control rights and cash-flow rights grows, a suggestion that is consistent with tunneling.⁴⁶ Lemmon and Lins (2003) and Bozec and Laurin (2007) further support this suggestion by noting that, according to their respective findings, a CMS firm’s firm value exhibits relatively steep declines when the firm experiences either a decline in investment opportunities or a relatively high free cash flow, either of which provides incentives for firm insiders to expropriate minority shareholders.⁴⁷

Alternative corporate governance measures may help to mitigate the agency costs imbedded in CMS.⁴⁸ However, alternative corporate-governance measures, such as a

⁴⁵ Bebchuk et al., *supra* note 37, at 301-05.

⁴⁶ Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159, 170-72 (2003).

⁴⁷ Michael L. Lemmon & Karl V. Lins, *Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis*, 58 J. FIN. 1445 (2003); Yves Bozec & Claude Laurin, *Large Shareholder Entrenchment and Performance: Empirical Evidence from Canada*, 35 J. BUS. FIN. & ACCT. 25 (2007).

⁴⁸ Bebchuk et al., *supra* note 37, at 306.

market for corporate control and the presence of outside blockholders, are generally weak and cannot be implemented in Taiwan as long as one shareholder/family continues to control public firms. Hence, the Taiwanese government has sought to strengthen the monitoring function of corporate boards by introducing independent directors into the boardroom.

C. Related Party Transaction as a Proxy for Tunneling

To see whether board independence helps tackle tunneling, we need to first find out the ways through which tunneling happens. Recent empirical research studies have identified related party transactions as a major channel for tunneling. Cheung et al. (2009) examines asset transfer transactions between related parties in Hong Kong and finds that the prices of RPTs are unfavorable compared to those of similar arm's length deals. That is, firms pay higher prices when acquiring assets from related parties and receive lower prices when selling assets to related parties.⁴⁹

The minority shareholders of listed firms in China also suffer from tunneling through loans to the controlling shareholders and their affiliates. Jiang et al. (2008) examines the financial data of 1,377 public companies in China from 1996 to 2004

⁴⁹ Yan-Leung Cheung et al., *Buy High, Sell Low: How Listed Firms Price Asset Transfers in Related Party Transactions*, 33 J. BANKING & FIN. 914 (2009). [hereinafter Cheung et al., *Asset Transfer*].

and discovers that “tens of billions of RMB were siphoned from hundreds of Chinese publicly listed companies” through inter-corporate loans.⁵⁰ In addition to asset transfers and inter-corporate loans, loan guarantees to controlling shareholders and their affiliates also proved to be one of the major ways expropriation happens among listed firms in China.⁵¹

Beyond academia, policy makers and practitioners from around the world also recognize RPTs as a major channel for misappropriation of non-controlling shareholders. The OECD Asian Roundtable on Corporate Governance has since 2007 spent several sessions to discuss the appropriate regulatory policy towards RPTs⁵² and formed a special task force in 2008 to develop a practical guide to monitoring abusive RPTs.⁵³ The guide, published in September 2009, identifies abusive RPTs as “one of the biggest corporate governance challenges facing the Asian business landscape.”⁵⁴

D. Empirical Evidence

⁵⁰ Such inter-corporate loans are typically reported as “Other Receivables” in the financial statements. To get a sense of the severity of this problem, Jiang et al. reports that on average, “Other Receivables” accounts for 8.1% of the total assets. And around 30% to 40% of “Other Receivables” of the top 30% firms that have the most “Other Receivables” can be traced back to major shareholders or their affiliates. See Guohua Jiang et al., *Tunneling in China: The Remarkable Case of Inter-Corporate Loans* (working paper, May 2008), available at <http://ssrn.com/paper=1154314>.

⁵¹ Henk Berkman, Rebel A. Cole & Lawrence J. Fu, *Expropriation Through Loan Guarantees to Related Parties: Evidence From China*, 33 J. BANK. FIN. 141 (2009).

⁵² OECD 2007 Asian Roundtable on Corporate Governance, June 27-28, 2007, Singapore, at http://www.oecd.org/document/48/0,3343,en_2649_34813_39336752_1_1_1_1,00.html.

⁵³ OECD 2008 Asian Roundtable on Corporate Governance, May 13-14, 2008, Hong Kong, at http://www.oecd.org/document/39/0,3343,en_2649_34813_40144295_1_1_1_1_37439,00.html.

⁵⁴ OECD RPT GUIDE, *supra* note 4, at 9.

Drawing on prior research that finds related party transaction a major channel through which controlling shareholders extract private benefits of control, recent empirical studies examine the extent to which board independence constrains tunneling by looking into the effect of board independence on related party transactions.

In a 22-country study, Dahya, Dimitrov, and McConnell (2008)⁵⁵ find that a higher proportion of independent directors is associated with a lower likelihood of related party transactions. Such correlation implies that independent directors constrain resource diversion by dominant shareholders. Recent South Korean studies further provide evidence on the possibility of independent directors to control self-dealing by insiders. Black, Jang and Kim (2006) reports that better-governed firms enjoy higher market value. However, when trying to sort out possible sources for such correlation, they find that better-governed firms are not more profitable. Rather, they find stronger evidence that investors value the same earnings more highly for better-governed firms. This could reflect that investors believe that better-governed firms will be more profitable in the future, that better-governed firms will suffer less

⁵⁵ Their major finding is that in firms with dominant shareholders, corporate value is positively correlated with board independence, especially in countries with weak legal protection for minority shareholders. Jay Dahya, Orlin Dimitrov & John J. McConnell, *Dominant Shareholders, Corporate Boards and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON. 73 (2008).

tunneling, or both.

Furthermore, they return to the overall governance index and try to find the predictive power of each subindex. They found strong evidence that greater board independence predicts higher share prices in South Korea and the result is likely to be causal. The authors suspect that such result could be because outside directors may help to control self-dealing by insiders, which historically has been a serious problem in South Korea. Black and Kim (2008) continue with the Black, Jang, and Kim (2006) study and use multiple identification strategies to further address the endogeneity problem faced by the prior study. Black and Kim (2008) found evidence that share-price increases are associated with boards in which 50% or more of the directors are outside directors.⁵⁶ In addition, several years after the reforms, large firms' profitability rose and the firms' asset sales to related parties declined. However, they do not find evidence on other types of related party transactions.

Cheung et al. (2009) directly examine the effect of board independence and the presence of audit committee on the transfer price of related-party asset transfer transactions. They find that the presence of an audit committee is the only corporate

⁵⁶ Bernard Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data* (Working Paper March 2008), available at <http://ssrn.com/abstract=968287>.

governance characteristic that affects pricing on both asset acquisition and sale. Firms with an audit committee pay lower prices to related parties for asset acquisition and receive higher prices from related parties from asset disposal.⁵⁷ From these two studies, we might conclude that a majority independent board or an audit committee could constrain tunneling through asset transfer between related parties.

Additional evidence from China supports the notion that more outsiders on the board help prevent tunneling through operational activities. Gao and Kling (2008) examine the effect of corporate governance mechanisms on operational tunneling based on data of listed firms in China from 1998 to 2002. They determine the extent of tunneling by the difference between accounts receivables and payables that are based on RPTs. They find that outsiders in the boardroom prevent operational tunneling.⁵⁸

III. Incentives for Independent Directors

To examine the effectiveness of independent directors in preventing corporate fraud, we need to identify and to understand the incentives available to independent directors. The incentives have always been the most difficult task in the institutional

⁵⁷ However, the percentage of independent non-executive directors on the board has no impact on the prices paid or received in asset transfer transactions either with related parties or arm's length third parties. Cheung et al., *Asset Transfer*, *supra* note 49, at 921-22.

⁵⁸ Lei Gao & Gerhard Kling, *Corporate Governance and Tunneling: Empirical Evidence From China*, 16(5) PAC.-BASIN FIN. J. 591, 600-601 (2008).

design of outside/independent directors.⁵⁹ Gilson and Kraakman (1991) acknowledge the lack of incentives available to U.S. outside/independent directors and propose a new institution of “professional directors” that monitor firms on behalf of institutional investors in the United States.⁶⁰ They argue that even if outside directors possess good character and are financially independent from the management, they still depend on management for their tenure as directors. In addition, most of them, especially for those who serve as executives of other public companies, share the same ideological disposition on the extent to which outside directors should monitor management. Furthermore, outside directors are not socially independent from the management and they do not have affirmative incentives to monitor effectively.

Monks and Minow (2003) also doubted that outside/independent directors have enough incentive to aggressively oversee management, after evaluating the time and the money that U.S. outside directors spent in their own firms.⁶¹ In addition, the researchers point out that the collegial culture of a board may also undermine outside directors’ willingness and ability to speak out for outside shareholders.⁶²

⁵⁹ Laura Lin provides a comprehensive review on the constraints and incentives of outside directors. Lin, *supra* note 18, at 912-21.

⁶⁰ Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 872-76 (1991).

⁶¹ ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 224-25 (3rd ed. 2003).

⁶² *Id.* at 225-26.

In theory, to incentivize outside/independent directors, we should either penalize them for doing a poor job or reward them for doing a good job.⁶³ Empirical evidence shows that the courts seldom hold outside directors liable for negligence in oversight and that, even if liability is present, it rarely takes the form of out-of-pocket liability.⁶⁴ The reasons for this phenomenon are straightforward: we do not want outside directors to be overly risk averse in making corporate decisions or to feel that serving in the position is too costly.⁶⁵ If we neither can create nor want this liability, an important question then arises: how can we incentivize outside directors to do a better job? One way is to grant them shares that would align the directors' interests with shareholders' interests. Beasley (1996) and Ahmed and Duellman (2007) respectively found that higher outside-director shareholding is associated with a lower incidence of financial-statement fraud and with a higher incidence of conservative accounting practices, which reduce agency cost.⁶⁶ However, too much shareholding would erode the independence of directors. Hamdai and Kraakman (2007) recently proposed another

⁶³ *c.f.* Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus To Join Your Board)*, 28 DEL. J. COP. L. 1 (2003) (arguing that external rewards or punishment may not and in fact do not work on outside directors and suggesting that altruism is a better lens to screen outside director behavior).

⁶⁴ Bernard Black et al., *Liability Risk for Outside Directors: a Cross-Border Analysis*, 11 EUR. FIN. MGMT. 153 (2005); Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

⁶⁵ Assaf Hamdai & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1679 (2007).

⁶⁶ Beasley, *supra* note 19; Ahmed & Duellman, *supra* note 24.

way to incentivize outside directors: reward outside directors when they do a good job.⁶⁷ However, the practicability of this approach is still debatable.

Despite the efforts among legal scholars to identify proper legal interventions, economists think that market forces would force outside directors to perform their duties. Fama and Jensen (1983) hypothesize that outside directors compete in the outside directors' labor market and "have incentives to develop reputations as experts in decision control" because "the value of their human capital depends on their performance as internal decision managers in other organizations."⁶⁸ Srinivasan (2005) supports that argument by presenting evidence showing that outside directors experience labor-market penalties after the firms that the directors serve announce accounting restatements. Such findings suggest that a market for outside directors exists in the United States and that outside directors, especially audit-committee members, bear reputational costs for financial-reporting failures.⁶⁹ In a 22-country study, Dahya, Dimitrov and McConnell (2008) also report evidence of a robust market for independent directors in that 71% of the independent directors in their sample

⁶⁷ Hamdai & Kraakman, *supra* note 65.

⁶⁸ Fama & Jensen, *supra* note 10, at 315.

⁶⁹ Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members*, 43 J. ACCT. RES. 291 (2005).

serve on multiple boards.⁷⁰ However, even if such market exists, how to properly measure the reputational penalty and whether or not such markets operate effectively so as to generate the right incentives for the outside directors remains an open question.⁷¹

In sum, it is still debatable whether or not outside/independent directors have proper incentives to effectively oversee management. To be sure, countries around the world are undertaking corporate-board reforms and are hoping that outside/independent directors can properly monitor either the management or the controlling shareholders on behalf of public shareholders.

⁷⁰ Dahya, Dimitrov & McConnell, *supra* note 55.

⁷¹ Gilson and Kraakman argue that the theory proposed by Fama and Jensen suffers from “perfect market” fallacy. Such theory assumes that the market for directors operates effectively. However, there is no evidence showing that such an effective market for outside directors exists. Gilson and Kraakman, *supra* note 60, at 875-76.

CHAPTER 2. METHODOLOGY

I. Hypothesis and Research Questions

A. Hypothesis

Independent directors are viewed as an important internal governance institution in reducing agency costs and monitoring corporate activities. In Taiwan's context, the most important agency costs faced by non-controlling shareholders of public companies come from the possibility of siphoning out corporate assets by controlling shareholders, so-called "tunneling." Tunneling is also the most serious and commonly seen corporate fraud in Taiwan. Hence, it is worthwhile to test the following hypothesis in Taiwan's context:

Independent directors are able to constrain tunneling by controlling shareholders.

B. Research Questions

The purpose of this dissertation is to find out whether the institution of independent director prevents controlling shareholders from siphoning out corporate

assets in Taiwan. Thus, the main research question is,

Do independent directors in Taiwan prevent tunneling?

In order to answer this question, I use related party transaction (RPT) as a proxy for tunneling and empirically inquire into the extent to which independent directors monitor RPTs. To that end, I specifically address the following subsidiary questions:

Do firms in Taiwan engage in RPTs that can potentially serve as channels through which tunneling occurs?

To what extent do independent directors monitor RPTs?

What are the constraints of independent directors in Taiwan in serving as corporate monitors?

II. Methodology

A. Interviews

1. Sampling Method

The main concern with sampling is whether the samples fairly represent the population so that the researchers can draw inferences about the population from the

samples.⁷² Quantitative research studies usually require probability sampling where each unit in the population must have “an equal and independent chance of inclusion” in the sample and the parameters required for creating such samples are quite restrictive.⁷³ However, social science research studies often examine situations where probability samples are not feasible; hence, researchers tend to rely instead on nonprobability sampling strategies.⁷⁴

Some of the commonly used nonprobability samples are convenience samples, purposive samples, snowball samples, and quota samples. This research study mainly concerns the experience of independent directors in reviewing related party transactions and intends to interview independent directors of Taiwanese public companies. The names of independent directors are available through the Market Observation Post System maintained by the Taiwan Stock Exchange. However, corporate directors in general are difficult to reach. In addition, the topic of related party transactions is business sensitive. Therefore, the most practical sampling strategy for this research study is convenience sampling and snowball sampling.⁷⁵

Convenience samples choose samples that are close at hand or easily accessible.

⁷² DAVID R. ANDERSON, *STATISTICS FOR BUSINESS AND ECONOMICS* 223-224 (9th ed. 2007).

⁷³ BRUCE L. BERG, *QUALITATIVE RESEARCH METHODS FOR THE SOCIAL SCIENCES* 48-49 (7th ed. 2009).

⁷⁴ Nonprobability sampling tends to be the norm in social science qualitative research. *Id.* at 49-52.

⁷⁵ Snowball sampling is similar to convenience sampling and is most popular among studies concerning various classes of deviance, sensitive topics, or difficult-to-reach populations. *Id.* at 50-51.

I started interviewing respondents whom my friends or I personally know. In addition, I distributed questionnaires in two institutions where mandatory courses are offered to corporate directors. The questionnaires stated the purpose of the research and leave the respondents with the option to provide their contact information for in-depth interviews. 4 interviews were obtained through distribution of questionnaires. The last sampling strategy used by this research is snowball sampling, where samples are referred by current respondents.⁷⁶ Over 75% of the interviews are obtained through snowballing.

2. Types of Interviews

In terms of the structure of the interviews, qualitative interviews can be categorized as structured (or standardized), semi-structured, and unstructured interviews. Structured interviews are formally structured and the wording, sequence, and language of the questions cannot be adjusted during the interview. A structured interview operates more like a pencil-and-paper survey.⁷⁷ An unstructured interview is completely unstructured and there is no set order or wording of the questions. The

⁷⁶ Snowball sampling is also called chain referral sampling or respondent-driven sampling. The researcher usually first identify several people with required characteristics, interview these people, and then ask them to refer other possible respondents. This is the most practical way to access an otherwise difficult-to-reach population. *Id.* at 51.

⁷⁷ *Id.* at 104-106.

interviewers may add or omit questions among interviews.⁷⁸

This research study adopts semi-structured and in-depth interviews, where the interviewer generally followed a set of predetermined questions but was allowed to make adjustments depending on the situation.⁷⁹ The benefit of conducting semi-structured, instead of structured, interviews is that semi-structured interviews allow more latitude and freedom for respondents to talk about what is of interest or importance to them.⁸⁰ Such leeway allows further exploration of soft information such as the personal relationship between interviewees and the controlling shareholder or management team as well as their personal incentives in joining the board.

Both telephone interviews and face-to-face interviews are included in this research study. 62% of the interviews in this research are conducted through telephone. Traditionally, telephone interviews are seen as appropriate only for short and structured interviews. However, by comparing the interview transcripts, a recent empirical study of interview modes found that there is no significant difference between telephone interviews and face-to-face interviews. The study suggests that

⁷⁸ *Id.* at 106-107.

⁷⁹ *Id.* at 107-109.

⁸⁰ Semi-structured interviews are appropriate when respondents have information or knowledge that may not have been thought of in advance by the researcher. SHARLENE NAGY HESSE-BIBER AND PATRICIA LEAVY, *THE PRACTICE OF QUALITATIVE RESEARCH* 125-26 (2006).

telephone interviews can also be used successfully in qualitative research.⁸¹

Telephone interviews are also suitable for sensitive topics and hard-to-reach groups. Interviewees generally feel protected and have a higher perception of anonymity when talking about sensitive topics, such as RPTs and personal relations, over the phone than in person.⁸² Directors are considered hard-to-reach groups because they generally are of high social status and busy. Sometimes it is much easier to obtain telephone interviews than in-person interviews. Furthermore, telephone interviewing is a much more cost-effective method for researchers who do not have abundant resources.

3. Conceptual Framework of the Interview Protocol

The interview protocol aims to assess three issues: (1) the monitoring of RPTs in practice, (2) the incentives of independent directors, and (3) the general monitoring function of independent directors. (Appendix B)⁸³ To understand the extent to which independent directors in Taiwan monitor RPTs, we need to understand whether they

⁸¹ Judith E. Sturges & Kathleen J. Hanrahan, *Comparing Telephone and Face-to-face Qualitative Interviewing: A Research Note*, in QUALITATIVE RESEARCH 2 VOLUME 1 COLLECTING DATA FOR QUALITATIVE RESEARCH 31 (Alan Bryman Ed. 2007).

⁸² *Id.*, at 32-33.

⁸³ To prepare interviews, Weiss suggests the researchers to start from a “substantive frame” and use that to create a guide. ROBERT S. WEISS, LEARNING FROM STRANGERS: THE ART AND METHOD OF QUALITATIVE INTERVIEW STUDIES 45-51 (1994).

have the experience of reviewing RPTs? Are they provided with abundant information to review RPTs? Do they have sufficient knowledge about the laws and regulations? And, in general, what is their interaction with the internal control department, which presumably is an important source of information about RPTs?

Furthermore, we need to understand whether independent directors have enough incentives to act as corporate monitors. Incentives include pecuniary rewards and non-pecuniary benefits. For pecuniary rewards, we investigate both equity and non-equity compensation. For non-pecuniary benefits, we explore the motivation of independent directors to serve the position. This study also tries to evaluate the general monitoring role of independent directors by examining their personal relations with controlling shareholders and executives, time expended, the culture of the board, and their self-perception of their responsibility.

Table 1 Conceptual Framework of Interview Protocol

Issues	Conceptual Framework
Monitoring of RPTs	<ul style="list-style-type: none">• Interaction with Internal Control Department• Knowledge of RPTs Regulation• Experience in Reviewing RPTs• Access to Information
Incentives	<ul style="list-style-type: none">• Motivation• Shareholding• Compensation
General Monitoring Function	<ul style="list-style-type: none">• Personal Relationship With Controlling Shareholder or Management Team• Time Spent on Corporate Matters• Board Culture• Self-perceived Responsibility

4. Limitations

Interviewing methods are subject to certain limitations. First, the respondents may not report the whole truth. Weiss (1994) acknowledged that respondents may not report something either because their memory faded or because they want to present a positive picture of themselves. Often, what is reported may be spotty, but little will be invented.⁸⁴ That is, if you are asking about what really happened in the past, the respondents may omit certain facts but few of them will invent something that never occurred. Thus, one way to avoid lying is to ask detailed or fact-specific questions.

⁸⁴ *Id.*, at 148.

Second, shading responses are especially likely when respondents are asked about opinions, attitudes, appraisals, evaluations, values or beliefs.⁸⁵ Although some of the questions in the protocol ask about respondents' attitudes or opinions, respondents are also asked to provide a concrete example to avoid unclear answers. Due to the limitations which inhere in this method of data gathering, this study attempts to minimize the use of subjective questions wherever possible.

B. Review Corporate Documents

Relevant corporate information about sample firms was obtained from the Market Observation Post System ("MOPS") maintained by Taiwan Stock Exchange⁸⁶. MOPS is a platform for public companies to post relevant corporate information required by the law. Information about corporate ownership, subsidiaries, affiliated companies, decisions of board meetings, corporate governance characteristics, and related party transactions was obtained from 2007 annual reports, which are available on MOPS.

⁸⁵ *Id.*, at 149.

⁸⁶ Market Observation Post System, <http://newmops.tse.com.tw/>.

III. Sample

A. Interviews

From September 2008 to December 2009, I interviewed 40 independent directors of Taiwanese public companies. Table 2 lists relevant information about the interviewees. Since the interviews are in connection with the relationship between interviewees and controlling shareholders as well as RPTs in specific companies which are confidential, all interviewees are kept anonymous and represented by numbers according to the sequence of interviews. The date of the interview and the industries of the companies they served are also provided.

The average length of interviews is sixty-six minutes. The interviewees on average have 4.2 years of experience in serving as independent directors. Only eleven of them also serve on audit committees. The small number of interviewees serving on audit committees is due to the fact that only three percent of the public companies in Taiwan have chosen the board committee system and established audit committees.⁸⁷

⁸⁷ As of March 2009, 53 out of 1776 public companies establish audit committees. *See* Taiwan Stock Exchange, Summary Data of Stock Market, available at <http://www.twse.com.tw/ch/statistics/statistics.php?tm=07>; Highlights of Equity Issuance by Public Companies, available at <http://www.otc.org.tw/ch/bulletin/statistics/statistics.php> (last visited Feb. 24, 2010); Market Observation Post System, List of Companies Established Functional Board Committees, available at <http://newmops.tse.com.tw/> (last visited May 1, 2009).

After deducting repetitive firms, a total of fifty-seven (57) firms are represented by the interviewees. 57.5 percent of the interviewees serve on a single board while 42.5 percent serve on multiple boards. Among those who serve on multiple boards, 82 percent serve on two boards. Only few interviewees serve on more than three boards.

(Table 2 and 3)

Table 2 List of Interviews.

No.	Date	Industry	Experience (Yrs)	On Multiple Boards	Total No. of Firms	On Audit Committee	Length of Interviews (min)
1	Sept. 28, 2008	Electronics (Computer, Electric Optical)	5	1	2		66
2	Sept. 29, 2008	Others	5		1		46
3	Sept. 30, 2008	Oil, Gas & Electricity	1		1		88
4	Oct. 7, 2008	Electronics (Semiconductor); Finance	5	1	2	1	60
5	Oct. 9, 2008	Chemical, Biotech & Medical Care; Electronics (Electric Optical, Telecom and Internet, Computer, Others)	7	1	5		40
6	Oct. 10, 2008	Electronics (Semiconductor)	2		1		50
7	Oct. 12, 2008	Electronics (Computer)	2		1		78
8	Oct. 13, 2008	Electronics (Semiconductor)	2		1		17
9	Oct. 15, 2008	Electronics (Computer)	3	1	2		86
10	Oct. 22, 2008	Electronics (Semiconductor, Electric optical)	10	1	2	1	65
11	Oct. 25, 3008	Electronics (Information Services); Transportation	2	1	2		61
12	Oct. 26, 2008	Electronics (Semiconductor); Electronics (Others)	7	1	2		30
13	Oct. 30, 2008	Electronics (Semiconductor, Computer)	5	1	4	1	70
14	Nov. 11, 2008	Electronics (Electric Optical, Information Services)	8	1	2	1	57
15	Jan. 14, 2009	Chemical, Biotech & Medical Care	6	1	2		53
16	Feb. 12, 2009	Electronics (Information Services)	5		1		25
17	Feb. 17, 2009	Transportation	1		1		28
18	Feb. 18, 2009	Electronics (Semiconductor, Telecom and Internet)	4	1	2		50
19	Feb. 19, 2009	Electronics (Others)	1		1		82
20	Feb. 19, 2009	Finance; Electrical Mechanics	6	1	2	1	56
21	Feb. 25, 2009	Electronics (Telecom and Internet, Component)	7	1	2	1	41
22	Feb. 25, 2009	Electronics (Others)	1		1		50
23	Feb. 26, 2009	Electronics (Computer)	6		1		15
24	Feb. 24, 2009	Finance	3		1	1	45

25	Mar. 1, 2009	Finance	1		1		68
26	Oct. 12, 2009	Electronics (Electric Optical), Finance	4	1	2		65
27	Oct. 16, 2009	Electronics (Semiconductor)	8		1		21
28	Oct. 16, 2009	Finance	2		1		120
29	Oct. 21, 2009	Finance	2		1		50
30	Oct. 22, 2009	Electronics (Computer, Others), Finance	4	1	3		98
31	Nov. 5, 2009	Finance	2		1		100
32	Nov. 13, 2009	Electronics (Semiconductor, Electric optical)	5	1	2	1	63
33	Nov. 26, 2009	Finance	1		1		90
34	Nov. 27, 2009	Finance	6		1	1	131
35	Dec. 1, 2009	Finance; Electronics (Electric Optical)	9	1	2	1	60
36	Dec. 2, 2009	Finance	6		1		50
37	Dec. 3, 2009	Finance	5		1		118
38	Dec. 3, 2009	Tourism	6		1		100
39	Dec. 14, 2009	Oil, Gas & Electricity	2		1		143
40	Dec. 15, 2009	Others	2		1	1	120
Average (Total)			4.2	(18)	(63)	(11)	66

Table 3 Number of Interviewees on Multiple Boards.

No. of Boards	1	2	3	4	5
No. of Interviewees	23	14	1	1	1
Percentage	57.5%	35.0%	2.5%	2.5%	2.5%

Among the 40 interviews, 25 are phone interviews and 15 are in-person interviews. The occupations of the interviewees are quite diverse, including accountants, CEOs, law firm partners, university professors, venture capitalists, and government officials (include former SEC chairman and director general of banking bureau in Financial Supervisory Commission). Some of the interviewees are opinion leaders in Taiwan's corporate governance reform who not only are familiar with corporate governance but also involve deeply in the reform. For example, three of the interviewees are either founders or heads of the Taiwan Corporate Governance Association, a major nonprofit that promotes Taiwan's corporate governance. Thus, the insights of these people are not limited to their experience with specific companies but also expand to their observation of overall corporate governance in Taiwan.

B. Sample Firms

Among the 57 sample firms, 32 are TSE-listed companies, 15 are OTC-traded companies, and 10 are public companies. The sample firms represent 11.1% of TSE-listed firms and 4.2% of OTC-traded firms that have at least one independent director on the board (Table 4).

Table 4 Numbers of Firms That Have Independent Directors

	TSE- Listed	OTC- Traded	Total
No. of Firms that have at least one independent director ⁸⁸	289	362	651
No. of Sample Firms	32	15	47
Percentage	11.1%	4.2%	7.2%

Source: Market Observation Post System (<http://newmops.twse.com.tw/>), Taiwan Stock Exchange.

Table 5 and Figure 1 and 2 provide the industry distribution of TSE-listed firms and sample firms. 61.4% of the sample firms are in the electronics industry; however, this skew simply results from the industry distribution of population firms. Firms in the electronics industry constitute 46% of TSE-listed firms and 70% of TSE-listed firms that have independent directors. Although sample firms do not cover each industry, they cover firms from the top five industries, namely electronics, finance,

⁸⁸ As of December 2009, there are 289 TSE-listed and 362 OTC-traded companies that have at least one independent director on the board. See List of Firms That Have Elected Independent Directors and Statutory Auditors, Market Observation Post System (<http://newmops.twse.com.tw/>), December 2009, Taiwan Stock Exchange.

chemical, biotech and medical care, electrical mechanics and others. Hence, even though the sample firms are not randomly selected, the industry distribution fairly represents the underlying population.

Table 6 provides descriptive statistics of sample firms. The sample covers a wide variety of public firms. The average paid-up capital of sample listed firms is 16,761.96 million New Taiwan Dollar (NTD) (523.81 million USD), which is much larger than the average capital of listed companies, 4,577.02 million NTD (143.03 million USD)⁸⁹. The largest sample listed firm has a paid-up capital of 135,434 million NTD, while the smallest has a capital of 237 million NTD.

The average market capitalization of sample listed firms is 37,120.85 million New Taiwan Dollar (NTD) (1,160.03 million USD), which is larger than the average market value of listed companies, 8,868.43 million NTD (277.14 million USD).⁹⁰

Since the Taiwan Stock Exchange (TSE) is the major trading exchange of Taiwanese firms, I also compare the size of TSE-listed sample firms with TSE-listed firms. The

⁸⁹ In 2008, the average paid-up capital (par value) of TSE-listed firms is 7,925.34 million NTD (247.66 million USD) and that of OTC-traded firms is 1,228.70 million NTD (38.40 million USD). Therefore, the average paid-up capital of TSE-listed and OTC-traded firms is 4,577.02 million NTD (143.03 million USD). See Summary Data of Stock Market and Highlights of Equity Issuance by Public Companies, *supra* note 87.

⁹⁰ In 2008, the average market capitalization of TSE-listed firms is 16,304.36 million NTD (509.51 million USD) and that of OTC-traded firms is 1,432.49 million NTD (44.77 million USD). Therefore, the average market capitalization of TSE-listed and OTC-traded firms is 8,868.43 million NTD (277.14 million USD). See Summary Data of Stock Market and Highlights of Equity Issuance by Public Companies, *supra* note 87.

average market capitalization of TSE-listed sample firms triples the market capitalization of total TSE-listed firms. Therefore, the sample firms are, on average, much larger than average Taiwanese listed firms. (Table 6 Panel A)

The corporate ownership of Taiwanese public companies is characterized by concentrated, family-owned, and divergent in control rights and cash-flow rights.⁹¹ However, to ascertain the ownership of sample firms is no easy task. It is hard to trace the ultimate owners and their exact shareholdings. First of all, controlling shareholders will purchase shares not only through their family members but also through nominal investment entities.⁹² These entities are mostly private or overseas entities whose ownership information is not publicly available. Secondly, the disclosure requirements in Taiwan are not sufficient for investors to identify the ultimate owners and their respective shares. Taiwanese public companies are required to disclose in the annual report (1) top ten shareholders or shareholders whose shares exceed 5% of outstanding shares, (2) the relationship among top ten shareholders, (3) the shares held by spouse or children under the age of 20 of top ten shareholders, (4) top ten shareholders of an

⁹¹ Yeh, Lee & Woitke, *supra* note 38, at 30-31; YIN-HUA YEH AND 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], FINANCIAL SUPERVISORY COMMISSION OF TAIWAN 294-95 (January 2006), *available at* http://www.fsc.gov.tw/news_detail2.aspx?icuitem=3365703.

⁹² Yeh & Woitke, *supra* note 38, at 1863-66.

institutional director or statutory auditor, and, (5) if that top ten shareholder is also an institution, the top ten shareholders of that institutional shareholder.⁹³

Current disclosure scheme is fragmented and formal. If a controlling shareholder purchases shares through more than three layers of investment entities, through complex cross-shareholding, or through individuals or entities that are not among the top ten shareholders, investors are not able to identify the ultimate owner or its shareholding. From the information available in the annual report, I calculated the shares controlled by the largest shareholder by adding up the shares held by the largest shareholder, any relatives that belong to the same family, and the companies or investment entities that are controlled by the largest shareholder. I assume that these relatives, companies, or investment entities are fully controlled by the largest shareholder. I did not calculate the cash-flow rights of the largest shareholder because there is not enough information in the annual report.

Figure 3 is the scatter chart of market capitalization and ownership of sample TSE-listed and OTC-traded firms. Around half of the sample firms have a market capitalization between 100 million US dollar and 1 billion US dollar and ownership concentration between 10% and 30%. Excluding financial firms and firms controlled

⁹³ See Regulations Governing Information to be Published in Annual Reports of Public Companies, art. 10 and 11 (Dec. 25, 2008), available at <http://eng.selaw.com.tw/FLAWDAT0201.asp>.

by the government, the average voting rights by largest shareholders is 27.06% and the median is 25.56% (Table 6 Panel B). The average voting rights of sample firms is a little lower than that found in Yeh and Ko (2006), where the average voting rights of largest shareholders of Taiwan's non-financial listed companies is 29.8% and the average cash-flow right is 22.13%.⁹⁴

95% of sample firms have a largest shareholder who, directly or indirectly, owns more than 5% of the shares (Table 6 Panel C). Around 65% (37 out of 57) of the sample firms have a largest shareholder who controls over 20% of the shares. When the control level is set at 20%, 30% (17 out of 57) of the sample firms are family-controlled. The percentage of family-controlled sample firms is smaller than the population. Yeh, Lee, and Woidtke (2001) and Claessens et al. (2000) report respectively that 51.4% and 48.2% of their sample firms are family-controlled when cutting at 20%.⁹⁵

A further classification of largest shareholders is presented in Panel D. The largest shareholders of almost half of the sample firms are individuals; 42% are families; and 40% are other public companies. Only six sample firms are controlled by the government. Since the shareholding information of family members of the

⁹⁴ YEH & KO, *supra* note 91, at 294-95.

⁹⁵ Yeh, Lee & Woidtke, *supra* note 38, at 31.

individuals who are the largest shareholders is not available, I was not able to identify some individuals as families. However, it is reasonable to believe that more individuals would be classified as families in my sample should more information becomes available. Using a special formula to determine the critical control level for each firm, Yeh, Lee and Woidtke (2001) reported that 75.96% of publicly traded companies in Taiwan are controlled by families.⁹⁶

39% (22 out of 57) of sample firms belong to business groups, an organizational form where concern over expropriation of minority shareholders arises most frequently⁹⁷. 20% (11 out of 57) of the firms have their CEOs serve as chairpersons, raising concerns for potential conflicts.⁹⁸

⁹⁶ Yeh, Lee & Woidtke, *supra* note 38, at 31.

⁹⁷ Johnson et al., *Tunneling*, *supra* note 2. Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferretting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121, 121-22 (2002).

⁹⁸ U.S. corporate governance activists call for splitting the roles of CEO and board chairperson. See ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 242-44 (4th ed. 2008).

Table 5 Industry Distribution of Sample Firms.

Industry	TSE-listed Firms	TSE-listed Firms that have Independent Directors	TSE-Listed Sample Firms	All Sample Firms
Cement	7	0	0	0
Food	20	0	0	0
Plastics	21	3	0	0
Textiles	46	4	0	0
Electrical Mechanics	36	11	1	1
Electrical Appliance & Cable	12	1	0	0
Chemical, Biotech & Medical Care	35	12	2	4
Glass	5	0	0	0
Pulp & Paper	7	0	0	0
Steel & Iron	27	4	0	0
Rubber	9	2	0	0
Automobile	5	1	0	0
Electronics	336	192	19	35
Construction	37	7	0	0
Transportation	18	2	2	2
Tourism	6	0	0	1
Whole Sale & Retail	10	0	0	0
Oil, Gas & Electricity	8	2	1	1
Finance	37	26	7	11
Others	36	8	1	2
Total	718	275	33	57

Figure 1 Industry Distribution of Sample Firms.

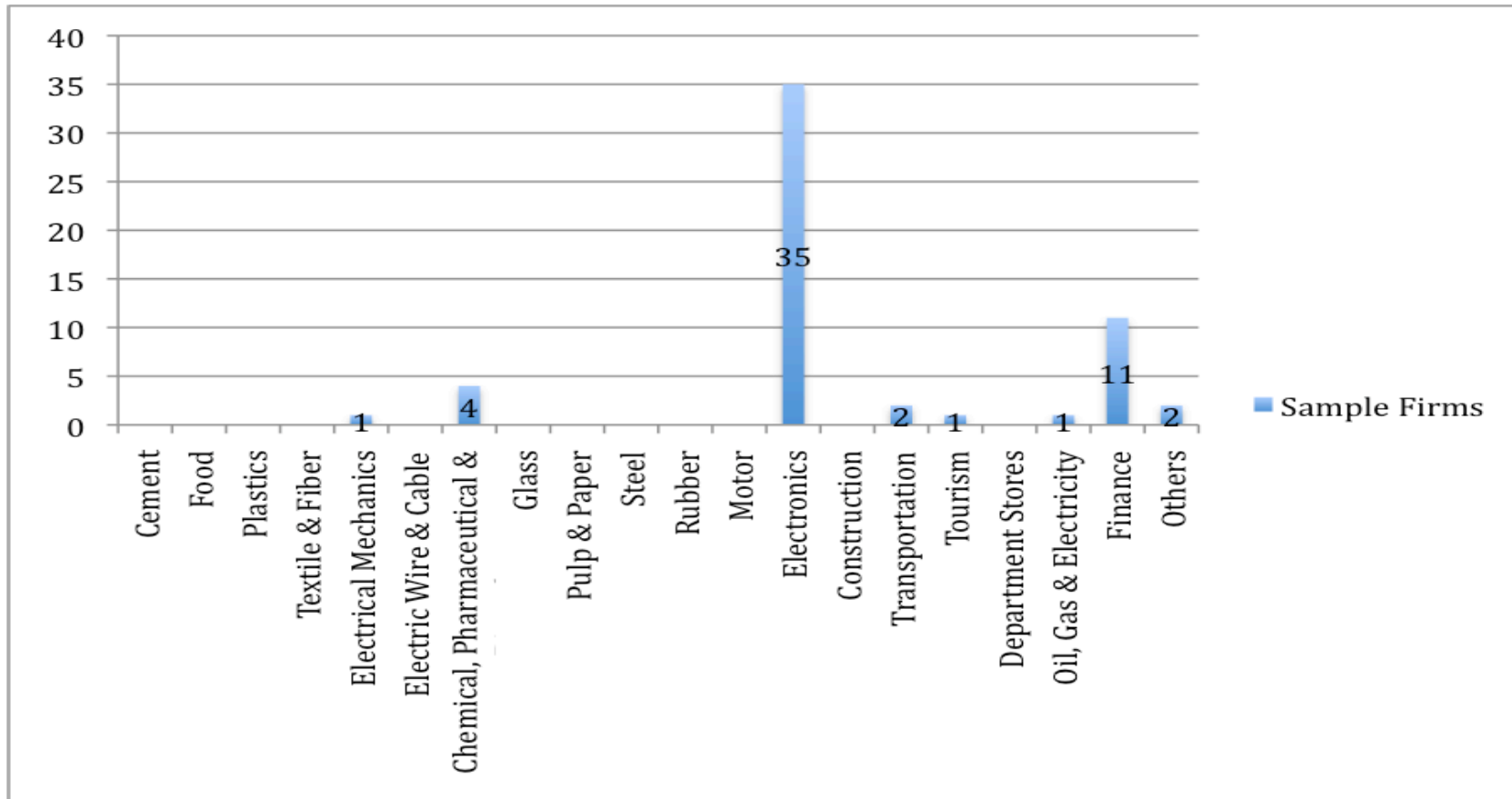


Figure 2 Industry Distribution of TSE-Listed Sample Firms

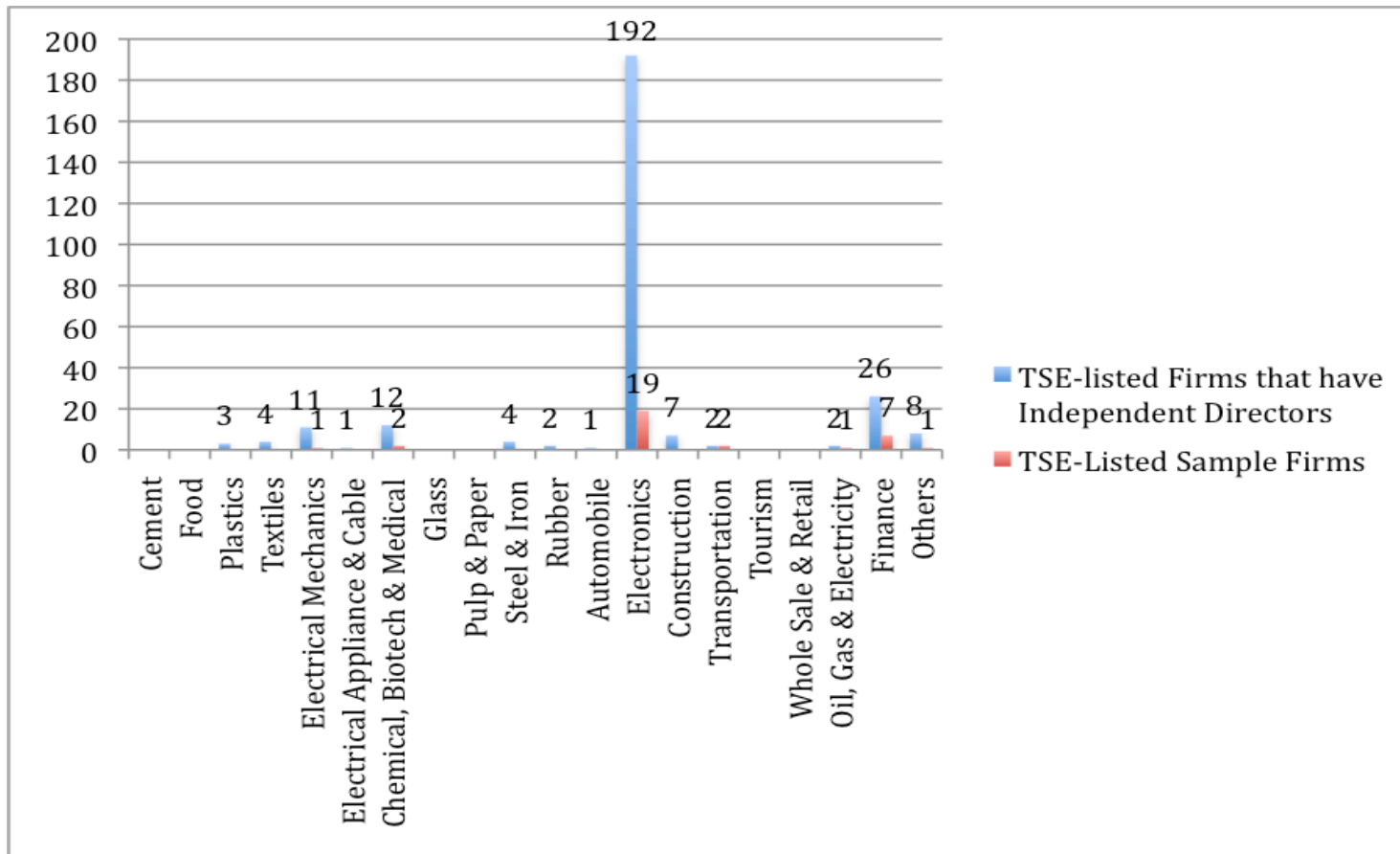


Table 6 Descriptive Statistics of Sample Firms.

Panel A: Paid-up Capital and Market Capitalization

	Average	Median	Minimum	Maximum
<i>TSE-Listed Firms</i>				
Paid-up Capital	7,925.34* (247.66)**			
Market Capitalization	16,304.36 (509.51)			
<i>OTC-Traded Firms</i>				
Paid-up Capital	1,288.70 (38.40)			
Market Capitalization	1,432.49 (44.77)			
<i>All TSE-Listed and OTC Firms</i>				
Paid-up Capital	4,577.02 (143.03)			
Market Capitalization	8,868.43 (277.14)			
<i>Sample TSE-Listed and OTC Firms</i>				
Paid-up Capital	16,761.96 (523.81)	1,735.00 (54.22)	237.00 (7.41)	135,434.00 (4,232.31)
Market Capitalization	37,120.85 (1,160.03)	10,362.27 (323.82)	175.38 (5.48)	282,385.45 (8,824.55)

* NTD million

** USD million

Panel B: Percentage Ownership by Largest Shareholder (%)

	All Sample Firms	Sample Firms Excluding Financial and Government-controlled Firms	Family and Individual-Controlled Sample Firms
Mean	31.64	27.06	25.81
Median	26.81	25.56	20.41
Minimum	4.37	4.37	4.66
Maximum	99.71	82.35	82.35
Number of Firms	57	40	25

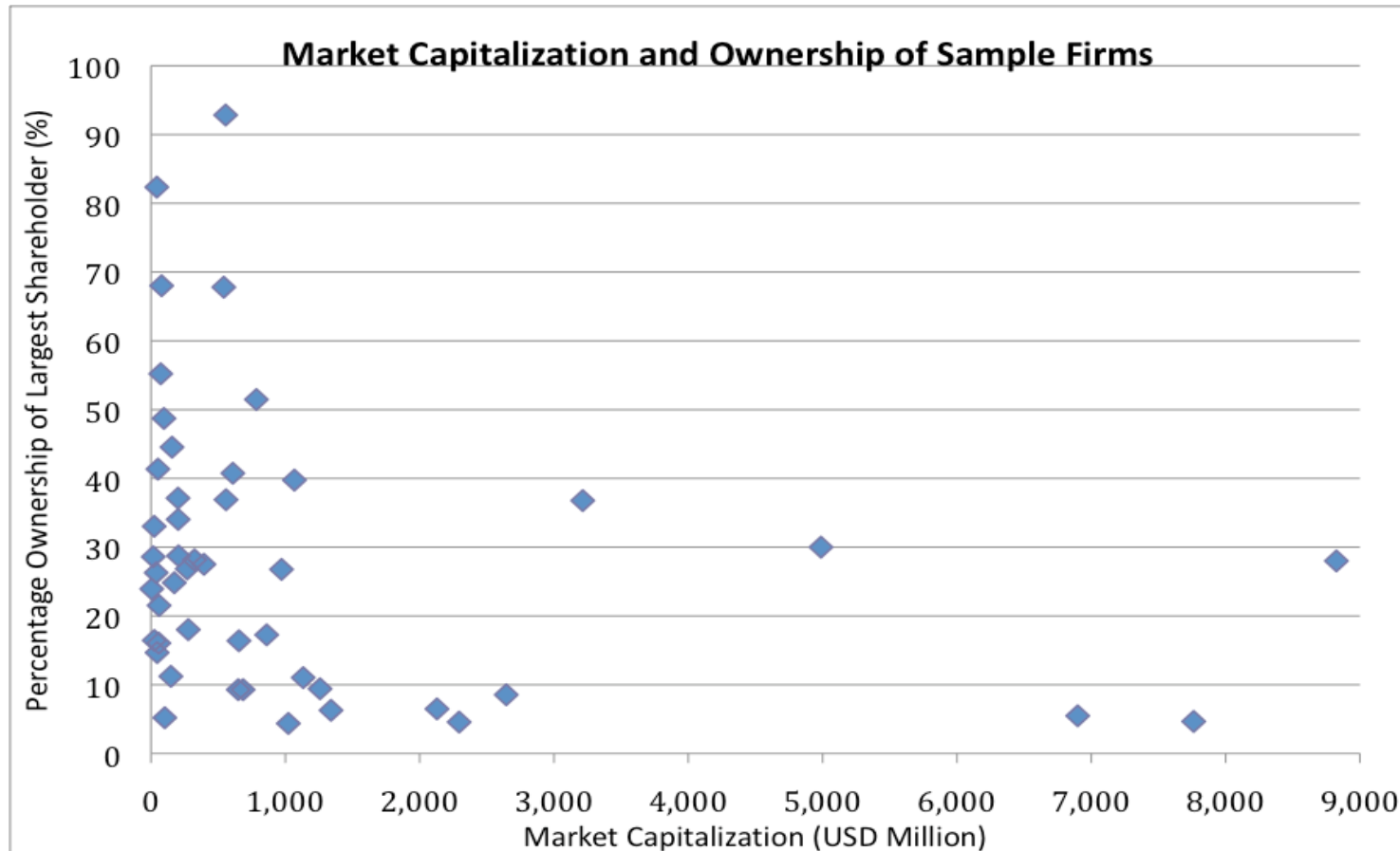
Panel C: Cutoff in Percentage Ownership by Largest Shareholder

	5%	10%	20%	30%	40%
No. of Sample Firms	54	46	37	23	14

Panel D: Classification of Largest Shareholder

	Individual	Investment Company	Public Company	Family	Government
No. of Sample Firms	26	7	23	24	6

Figure 3 Market Capitalization and Ownership of Sample TSE-Listed and OTC- Traded Firms.



CHAPTER 3. CORPORATE GOVERNANCE IN TAIWAN

I. An Overview

The corporate environment in Taiwan is very different from that in the U.S. In short, corporate ownership is concentrated and family-dominated.⁹⁹ The largest shareholders of the non-financial firms in Taiwan control 62.69% of the board seats and 49.55% of the statutory auditors. Hence, large shareholders in Taiwan not only own public firms, they also manage and control public firms. The average control rights of the largest shareholders in non-financial firms is 29.81%, however, the average cash-flow rights are only 22.13% (Table 7).¹⁰⁰ This discrepancy provides an incentive and opportunity for controlling shareholders to tunnel corporate assets at the expense of minority shareholders.¹⁰¹

Before the introduction of independent directors in 2002, many of the corporate boards in Taiwan functioned like paper meetings. The board members are either founding family members or top executives. Typically, family members are involved deeply in the management of the company. For example, Procomp Informatics Ltd.,

⁹⁹ Yeh, Lee & Woidtke, *supra* note 38, at 30-31.

¹⁰⁰ Cross-shareholding and pyramidal structure are the most common structural devices used to create deviations. YEH & KO, *supra* note 91, at 294.

¹⁰¹ See text accompanying note 40-48.

**Table 7: Comparison of Board Composition and Ownership Structure Between
Financial Firms and Non-Financial Firms in Taiwan**

	Financial Firms	Non-Financial Firms
Panel A: Board Composition		
Percentage of Largest Shareholder as Directors	59.18	62.69
Percentage of Largest Shareholder as Statutory Supervisors	57.48	49.55
Number of Board Members	11.80	7.13
Number of Statutory Supervisors	3.29	2.57
Panel B: Ownership Structure		
Control (Voting) Rights of Largest Shareholders	24.95	29.81
Cash-Flow Rights of Largest Shareholders	17.17	22.13
Excess Control (Control Rights – Cash-Flow Rights)	7.78	7.68
Pyramidal Structure	0.46	0.18
Cross-Shareholding	0.34	0.33

Source: YIN-HUA YEH AND 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], FINANCIAL SUPERVISORY COMMISSION OF TAIWAN Table 10-2 at 294-95 (January 2006).

the subject of Taiwan's largest corporate fraud case in 2004, is controlled by Su-Fei Yeh and her brother. Ms. Su-Fei Yeh is the chairperson and CEO of Procomp and her brother, Meng-ping Yeh is the vice chairperson. Among the five board members, the Yeh family holds two seats and the remaining three seats are all held by top executives of Procomp.¹⁰² In practice, the Yeh family controls the board and, in turn, the firm.¹⁰³

¹⁰² PROCOMP INFORMATICS CO., LTD., ANNUAL REPORT 7 (2003), available at <http://newmops.tse.com.tw/>.

¹⁰³ The general vote of the board only needs majority of the directors attending, and majority vote of the attended directors. That means Procomp's board decisions could be made by Ms. Su-Fei Yeh and her brother as long as one other director attending the board meeting. GONG SI FA [Corporation Law] art.

Similarly, Xue-Ren Lu and his wife hold two seats of the five board seats of Infodisc Technology Corp., the subject of the second-largest corporate fraud case in 2004.¹⁰⁴

In theory, controlling shareholders, with major shareholdings, monitor the management more effectively and reduce agency costs greatly as long as their interests are in line with outside investors. Under this scenario, the interests of minority shareholders would not be sacrificed when the controlling shareholders dominate the board. However, if the control rights of the controlling shareholders exceed their cash-flow rights, as in the case of Taiwan and most other countries, the interests of controlling shareholders deviate from those of minority shareholders, creating a danger that minority shareholders could be expropriated.

This is exactly the danger in Taiwan's corporate governance.¹⁰⁵ For example, in 2004, Ms. Su-Fei Yeh of Procomp and her brother controlled all five board seats while only held 7.83% of Procomp's shares.¹⁰⁶ Similarly, Mr. Lu of Infodisc controlled 80% of the board seats in 2004 while owning only 6.9% of the shares.¹⁰⁷ In both companies,

206, § 1 (2009) (Taiwan). "Unless otherwise provided for in this Act, resolutions of the Board of Directors shall be adopted by a majority of the directors at a meeting attended by a majority of the directors."

¹⁰⁴ INFODISC TECHNOLOGY CO., LTD., ANNUAL REPORT 8 (2003), *available at* <http://newmops.tse.com.tw/>.

¹⁰⁵ YEH & KO, *supra* note 91, at 294-95.

¹⁰⁶ YING-HUA YEH, ZHENGFA DE GUWANG [THE DISAPPEARING KING OF STOCK MARKET] 92 (2005). [hereinafter YEH, THE DISAPPEARING KING]

¹⁰⁷ *Id.*, at 144.

the control rights of the largest shareholders far exceed their cash-flow rights, and such deviation reaches its peak before the corporate debacles. Table 8 shows the increasing pattern of such deviation over the years for Procomp and Infodisc.

Table 8 Excess Control of Procomp and Infodisc

	1999	2001	2003	2004
<i>PROCOMP</i>				
Percentage of Board Seats Controlled by Largest Shareholders (A) ^a	55.5%	55.5%	100%	100%
Percentage of Shareholding by Largest Shareholders (B)	15.48%	13.23%	10.32%	7.83%
Excess Control (A/B)	3.6	4.2	9.7	12.8
<i>INFODISC</i>				
Percentage of Board Seats Controlled by Largest Shareholders (A)	100%	100%	80%	80%
Percentage of Shareholding by Largest Shareholders (B)	34%	19.5%	9.9%	6.9%
Excess Control (A/B)	2.9	5.13	8.1	11.6

Source: YEH, *THE DISAPPEARING KING*, at 92, 144.

^a. Percentage of board seats controlled by largest shareholders refers to the percentage of directors that are largest shareholders, family members of the largest shareholders, or company employees.

Business Groups

Another characteristic of Taiwan's corporate ownership structure — business group — further provides channels for expropriation.¹⁰⁸ Business groups control and

¹⁰⁸ TAIWAN SECURITIES & FUTURES INSTITUTE, CORPORATE GOVERNANCE IN TAIWAN

contribute most to the economy of Taiwan. The top 100 business groups in Taiwan own more than 6,300 affiliated firms and hire more than 3 million employees in 2007. The total revenue of the top 100 business groups is 7.8 times that of Taiwan's government in 2007.¹⁰⁹ Their revenue growth in 2007, 16.01%, also far exceeds that of the GNP of Taiwan.¹¹⁰ Among the top 10 business groups, 9 are in the financial industry. Family business continues to dominate Taiwan's economy. In terms of total asset value, family business groups account for 73.56% of the top 100 business groups. Seven major families in Taiwan control almost 40% of the total assets of the top 100 groups.¹¹¹

Given the importance of business groups to Taiwan's economy, the corporate governance of business groups becomes vital. One of the key issues therein is the fairness of the transactions among group firms. While sometimes these transactions facilitate the growth of business groups, they also provide channels for controlling

5-6 (October 2009).

¹⁰⁹ Chailease Finance Co., Ltd., News Center, *Taiwan Dichu Dashing Chituan Chiye Yanjiu* [Research on Large Business Groups in Taiwan], Oct. 16, 2008, available at http://www.chailease.com.tw/ugC_NewsCenter_Detail1.asp?hidID=65&hidPage1=1&hidShowType=his.

¹¹⁰ Zhao Fen Kao, *Diaocha: Guonei Baida Chiye 2007 Nian Yingshou Chengzhang 16.01%* [Survey: The Top 100 Business Groups Feature Revenue Growth of 16.01% in 2007], CENTRAL NEWS AGENCY, Oct. 16, 2008, available at <http://www.cna.com.tw/SearchNews/doDetail.aspx?id=200810160059>.

¹¹¹ The major families include the Tsai family of Cathay and Fubon Groups, the Wu family of Shin Kong and Tai Shin Groups, the Wang family of Formosa Plastics Group, the Gu family of China Trust, Chailease, and Taiwan Cement Group, the Kuo family of Foxconn Group, the Hsu family of Far Eastern Group, and the Hsu family of Chi Mei Group. *Id.*

shareholders to tunnel out corporate assets. Several business practices in Taiwan further provide controlling shareholders easy access to corporate assets without much oversight in place. For example, cross-shareholding between public parent companies and subsidiaries keeps public companies in stable management.¹¹² Controlling shareholders can further control the board by electing subsidiaries as institutional directors or statutory supervisors, providing that the subsidiary assigns an individual representative to perform its duty. Individual representatives of such subsidiaries can also be elected as directors or statutory supervisors. Furthermore, more than one such individual representative can be elected as directors or statutory supervisors.¹¹³ Hence, through cross-shareholding, controlling shareholders can literally appoint anyone he/she wants to serve as directors and statutory supervisors and embezzle corporate resources without any internal oversight.

Many financial shenanigans in the late 1990s related to the abusive practice of cross-shareholding and institutional directors. Controlling shareholders of public companies use subsidiaries or other affiliated firms to buy shares of public companies

¹¹² Cross shareholding may help corporation to (1) maintain stable control of management, (2) facilitate human capital investment, (3) enhance the operational efficiency of strategic alliance with other firms (4) diversify risks, and (5) facilitate financial arrangements among group firms. Ming-Jye Huang, *Jiao Cha Chi Gu v.s. Gong Si Jian Kong [Cross Shareholding v.s. Corporate Governance]*, in GONG KAI FA SHIN GONG SH FA ZHI YU GONG SI JIAN KONG [PUBLIC COMPANY REGULATION AND CORPORATE GOVERNANCE] 185, 194-203 (2001).

¹¹³ GONG SI FA [Corporation Law] art. 27, § 1 & 2 (2009) (Taiwan).

in order to manipulate stock prices and sell their shares at a manipulated price. In many cases, controlling shareholders borrowed money from the bank by pledging their shares and set up investment companies or directly bought shares of public companies to maintain stock price. Among the companies that suffered from financial distress in the late 1990s, the pledging rate of directors, statutory supervisors and major shareholders reached 100% in Hong Fu Construction Co., 97% in Fun An Metal Co., 92% in Huang Pu Construction Co., 70% in firms belonging to the Hsin Ju Qun Group.¹¹⁴ The average pledging rate of financial distress companies is 37.32% compared to 15.15% for regular companies.¹¹⁵

Such practice would bring huge monetary rewards for a controlling shareholder in the bull market. However, when the market goes down, controlling shareholders need more money to maintain the stock price of their companies in order to avoid paying back their loans because of the decreasing value of the pledged shares. Such pressure causes controlling shareholders to embezzle corporate funds and eventually results in financial distress. Han Yang Group and Dong Long Metal Co. are typical cases.¹¹⁶

¹¹⁴ TAIWAN CORPORATE GOVERNANCE ASSOCIATION, RESEARCH REPORT ON CORPORATE GOVERNANCE, MODULE 1: BUILDING A SOUND CORPORATE GOVERNANCE ENVIRONMENT IN TAIWAN 27-28 (2003).

¹¹⁵ *Id.* at 26.

¹¹⁶ Xiu-Fang Hong and Gui-Rui Chen, *The Impact of Cross Shareholding on Corporate Governance*, 19

In 2001, the Corporation Law of Taiwan was finally amended to prohibit cross-shareholding between parent and subsidiaries.¹¹⁷ In 2004, the Corporation Law was further amended to abandon the voting rights of shares owned by subsidiary firms.¹¹⁸ To strengthen the independence of directors and statutory supervisors, the Securities Exchange Law of Taiwan was amended in 2006 to prohibit different individual representatives of the same institutional shareholder or government shareholder of public companies from concurrently being elected as directors and statutory supervisors.¹¹⁹ However, the impact of the amendments was limited. First, the prohibition on cross-shareholding does not apply retrospectively. Existing cross-shareholdings at the time of the amendments are still legal and valid. Second, both cross-shareholding prohibition and voting right abandonment apply only between parent firms and subsidiaries in which the parent firm holds a majority of shares. The inflexibility of the legal threshold of 50% shareholding makes the prohibition easy to circumvent.¹²⁰ Hence, despite the legal reform, cross-shareholding is still popular among Taiwanese public firms.

TUNGHAI L. REV. 211, 230 (2003).

¹¹⁷ GONG SI FA [Corporation Law] art. 167, § 3 & 4 (2001) (Taiwan).

¹¹⁸ GONG SI FA [Corporation Law] art. 179 (2004) (Taiwan).

¹¹⁹ ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 26-3 (2006) (Taiwan).

¹²⁰ Wen-Yeu Wang, *Cong Gu Quan Jie Gou Lun Gong Si Zhi Li Fa Zhi* [An Essay on Corporate Governance From the Perspective of Ownership Structure], 10 CROSS-STRAIT L. REV. 5, 21 (2005).

II. Corporate Scandals

A. Milestone Cases

1. The Rebar Group and the Wang Family (2006)

On December 29, 2006, two Rebar group firms, China Rebar Co. and Chia Hsin Food and Synthetic Fiber Co. (Chia Hsin), filed for insolvency protection. The next day, founder and chairman, You-Tseng Wang fled secretly to Shanghai, China (later to the United States). On January 5, 2007, depositors of the Chinese Bank, an affiliate bank of the Rebar group, staged a run on the bank, withdrawing around US\$500 million in cash on a single day. The Taiwanese government soon took over the Chinese Bank. Under mounting pressure related to their lax supervision of the Rebar Group, the Chairperson of the Financial Supervisory Commission (FSC) and the Director General of the Banking Bureau resigned on January 15, 2007.¹²¹ Two months later, on March 8, 2007, You-Tseng Wang, his wife and 105 others, including one brother and six sons of You-Tseng Wang who acted as executives in the group's subsidiaries, were accused of illegally amassing over US\$2.2 billion between 1998 and 2006 through made-up or unfair related-party transactions with dummy corporations and affiliated

¹²¹ Kevin Chen, *FSC Denies Insider Leak Helped Rebar Chairman Escape*, *TAIPEI TIMES*, Jan. 15, 2007 (Taiwan), at <http://www.taipetimes.com/News/biz/archives/2007/01/15/2003344936>.

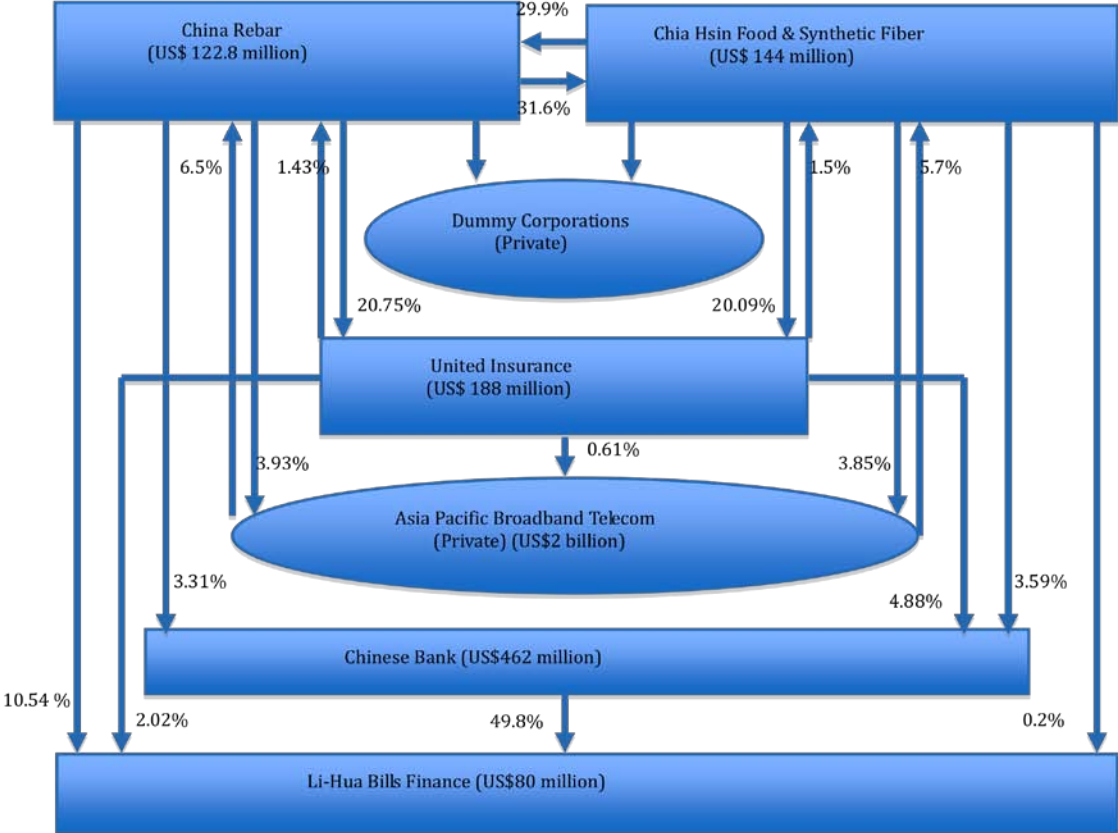
firms.¹²²

The business of the Rebar conglomerate encompassed financial, manufacturing, service, real estate, telecom, cable TV and Internet industries. The Rebar Group is consisted of five public companies (China Rebar, Chia Hsin, United Insurance, Chinese Bank and Li-Hua Bills Finance Co.), one large private company (Asia Pacific Broadband Telecom), and 68 paper companies.¹²³ The Wang family controls these many companies through cross-shareholding. First, the family set up many private investment companies and invested in public group firms through these investment companies. The family then controlled the board and the management of the public group firms and instructed private investment companies and public group firms to invest in Asia Pacific Broadband Telecom and dummy corporations. Lastly, Asia Pacific Broadband Telecom and other subsidiaries in turn invested in public parent companies (China Rebar and Chia Hsin). Figure 4 illustrate cross-shareholding of the Rebar Group.

¹²² Annie Huang, *Rebar Scandal Sets Record Fines, Prison Terms For Embezzlement*, TAIWAN TODAY, Mar. 16, 2007 (Taiwan), at <http://www.taiwantoday.tw/ct.asp?xItem=23976&CtNode=429>.

¹²³ *Id.*

Figure 4 Cross-Shareholding of the Rebar Group



Channels of embezzlement are usually a mix of fraudulent operational, investment and financing activities.¹²⁴ Table 9 summarizes the channels of tunneling in Rebar Group case.

Table 9 Channels of Tunneling in Rebar Group Case¹²⁵

Entities	Transactions
Group Firms — Paper Companies	<ol style="list-style-type: none"> 1. Fraudulent Operational Transactions 2. Advance payment for fraudulent real estate transactions 3. Inter-corporate Loan 4. Purchase corporate bond issued by paper companies through private placement 5. Purchase real estate with unfair appraisal report
Paper Companies — Outside Financial Institutions	Obtain loans from outside financial institutions by providing fraudulent transaction certificates
Group Financial Institutions — Outside Corporations	Force outside corporations to purchase corporate bond issued by group firms by requiring such purchase as a condition for loans
Controlling Shareholders — Group Firms or Paper Companies	Directly embezzle corporate cash

Cooperation from outside accountants is essential to the “success” of such large-

¹²⁴ Hsio-Ru Ma and Yi-Ting Ho, *Shou Cha Zhe Wu Bi yu Shen Ji Shi Bai — Li Ba An Zhi Xing Si (Insider Fraud and Audit Failure — Rethinking the Case of Rebar Group)*, 261 ACCOUNTING RESEARCH MONTHLY 28, 36 (2007). [hereinafter Ma, *Rebar Audit Failure*]

¹²⁵ Mei-Que Lee, *Ji Zeng Cai Kuai Ren Yuan Mian Ling Bu Shi Cai Bau zhi Chu Jing yu Dui Ce — Li Ba An de Yan Shen (Strategies of Accounting Personnel in Facing Financial Misstatement — An Extension of the Rebar Case)* 259 ACCOUNTING RESEARCH MONTHLY 46, 47 (2007).

scale financial shenanigans. Before 2002, the accounting firm of China Rebar and Chia Hsin was Deloitte and Touche. However, from the third quarter of 2002, the accounting firm of these two group firms was changed to non-big four accounting firms. Whether the corporation is audited by one of the big four accounting firms is an important proxy for the quality of corporate auditing. Shifting away from big four accounting firms can be considered as a signal of fraud. Moreover, the accountant, Si-Da Shen, who took over the auditing task was later proved to be non-independent and unethical. For example, he deleted, at the direction of the Wang family, transactions between group firms and one of the dummy corporations, Ho Hsin Co., from the related-party transactions footnote section of the financial statement working papers.¹²⁶ He also audited 34 paper companies which evidenced the fact that he knew that these corporations did not have real business.¹²⁷ After the explosion of Rebar debacle, he even asked staff members to trash working papers that had become “problematic.”¹²⁸

2. Procomp Informatics Co., Ltd. (2004)

¹²⁶ Ma, *Rebar Audit Failure*, *supra* note 124, at 40-41.

¹²⁷ These dummy corporations were all registered at the same building of China Rebar or the building next to China Rebar. In addition, these corporations do not have their own business, marketing or procurement personnel. They even shared accounting and finance personnel with China Rebar and Chia Hsin. Ma, *Rebar Audit Failure*, *supra* note 124, at 39.

¹²⁸ Ma, *Rebar Audit Failure*, *supra* note 124, at 45.

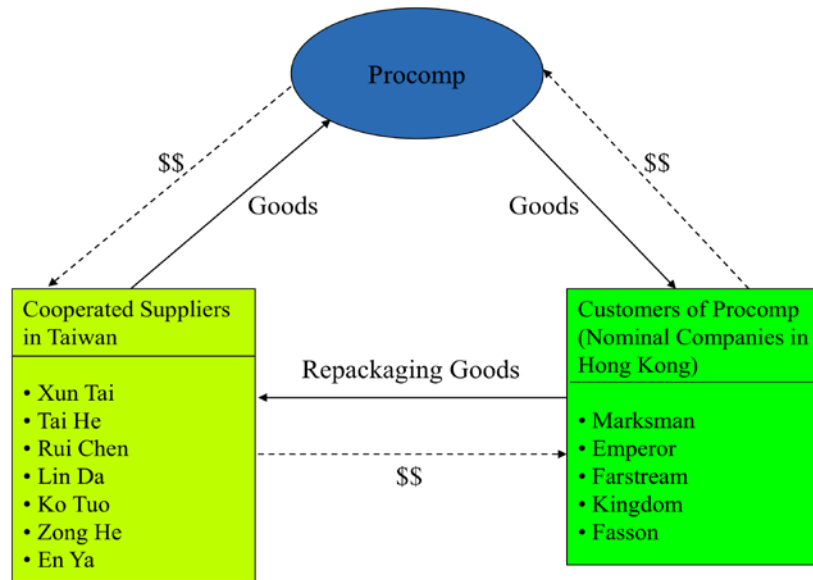
Procomp was a new high-tech company established in 1991 by Su-Fei Yeh. The company's major business was manufacturing gallium arsenide (GaAs), an important material for semiconductor. Procomp became a TSE-listed company in 1999, the year Procomp began to mass-produce GaAs. However, the net profit of Procomp began to decline in 1998. In the following five years, Procomp initiated at least five public offerings, including two equity offerings, two convertible bond offerings and one global depositary receipt offering (which was suspended in the end), raising more than NTD 11 billion (about US\$342 million). On June 15, 2004, Procomp filed for business reorganization because it couldn't repay the corporate bonds which would be due on June 17, 2004.

Later, an investigation revealed the fraudulent activities and complex financial arrangements that lead to the debacle. As one would imagine, with fund raising needs, a company that does not have outstanding business performance would try to increase its sales revenue. The fastest way to improve business performance in a deceptive way was to arrange fraudulent sales transactions. First, Su-Fei Yeh, the chairman of Procomp, set up five nominal companies in the British Virgin Islands under the name of company employees. From 1999, Procomp started to sell products to these five sales agents and the percentage of sales increased throughout the years, from 66.5% in

2001 to 75.3% in 2003.¹²⁹ To make most use of these products, Procomp further cooperated with seven other Taiwanese companies and asked them to purchase products from these five overseas agents and then sell products back to Procomp.

Figure 5 illustrates the sale and payment cycle of the deceptive sales transactions.

Figure 5 Deceptive Sales of Procomp



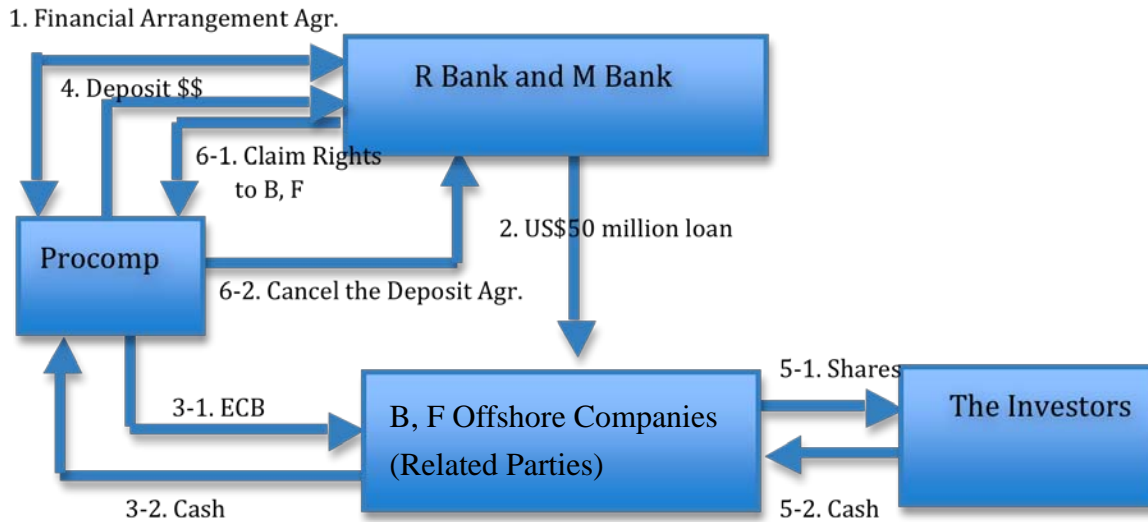
Source: Yeh, *Disappearing King*, at 64.

In addition to deceptive sales transactions, Procomp also “created” over 180 million US dollars of “cash” in various overseas banks through complex financial

¹²⁹ YEH, *THE DISAPPEARING KING*, *supra* note 106, at 62-64.

arrangements. All the cash “disappeared” right after the debacle went public. For example, Procomp issued 50 million US dollars of unsecured European Convertible Bonds (ECB) in 2003. The ECBs were actually purchased by two offshore companies (related parties) set up by Su-Fei Yeh under the names of Procomp’s employees. First, these two offshore companies borrowed 50 million US dollars from two overseas banks under the condition that Procomp would deposit the same amount in that bank as a security. However, Procomp not only concealed its relationship with those two companies, but also that it provides guarantee for those two companies as well as the fact that those “cash” accounts were restricted. Later on, those two offshore companies converted the bonds into shares and sold the shares in the market. To help those two companies get a better sale price, Procomp not only bought back its own shares but also delayed the announcement of an unfavorable financial forecast. Finally, when Procomp filed for insolvency in 2004, those banks immediately collected the money from Procomp’s account according to the agreement and the “cash” suddenly disappeared from the balance sheet. Figure 6 details the financial arrangements with regard to Procomp’s 2003 ECB offering.

Figure 6 Procomp's Fraudulent ECB Offering



3. Pacific Electric Wire & Cable Co., Ltd. (2004)

Established in 1957, Pacific Electric Wire & Cable Co., Ltd. (PEWC) was founded by Fa-Min Sun, the well-respected “Father of Wire and Cable in China” together with several other major families in Taiwan. Forty-seven years later, in 2004, his son Jack Tao-Tsun Sun (Jack Sun, Chairman of PEWC), Hong-Jiu Hu (CFO of PEWC), and several other leaders of the second generation of the major founding families were accused of tunneling over NTD 20 billion (USD 625 million) corporate assets and were formally charged with fraud. The case was widely billed as the

“corporate scandal of the century” in Taiwan and more than 300,000 shareholders of PEWC suffered financial losses from the transactions at issue in the lawsuit.¹³⁰ As of December 2009, the case was still pending at Taipei District Court.

In the early years, PEWC was co-managed by several founding families. Beginning in 1986, the second generation gradually took over. Later, it becomes clear that the incompetent second generation successors together with greedy managers led to the PEWC debacle. Jack Sun, the eldest son of founder Fa-Min Sun, and Hong-Jiu Hu, the long-term financial manager, are the key culprits in the scam.¹³¹ Jack Sun served as CEO of PEWC starting in 1986 and later was named chairman in 2000.¹³² After 18 months investigation, the prosecutor found that from 1993 to 1999, Jack Sun together with CFO, Hong-Jiu Hu, siphoned out at least NT \$ 17.1 billion (USD 534 million) in corporate funds from PEWC through 146 offshore paper companies. The major channels of tunneling were those 146 offshore companies, located mostly in

¹³⁰ *Ex-PEWC Executive Hu Faces 20 Years Plus NT\$1 Bil. Fine*, The China Post (Dec. 17, 2004), at <http://www.chinapost.com.tw/taiwan/2004/12/17/55694/Ex-PEWC-executive.htm>.

¹³¹ The latest court hearing revealed that Jack Tao-Tsun Sun was the key player of the PEWC fraud. Jyh-Yuan Liu, *Tai Dian An Sun Tao-Tsun Bei Ren Zhu Mou Chiang Chong Pan [Jack Sun Is Deemed to Be The Key Player in The PEWC Case — Face Harsh Sentence]*, Zi You Shi Bao (September 22, 2009), available at <http://n.yam.com/tlt/fn/200909/20090922744113.html>.

¹³² Ying-Li Lu, *Sun Tao-Tsun Ru He Wan Wan Tai Dian San Jin Qian Yi Chi Jin Reng Shi Mi [Jack Sun Play Out PEWC — Where Does Tens of Billions Go?]*, FEI FAN SHIN WEN ZHOU KAN [UNIQUE WEEKLY] (Oct. 11, 2009), available at <http://news.pchome.com.tw/magazine/report/po/ubnweekly/1422/125519040020345005001.htm>.

Hong Kong and the British Virgin Islands.¹³³

Sun and Hu secretly transferred funds into their own pockets through several different means. First, they directed PEWC to invest in several BVI companies, which were never disclosed in the financial statements. Then they used these BVI companies to apply for bank loans and asked PEWC to guarantee the loans. In addition, they also found various reasons to direct PEWC to advance payments to those BVI companies. After those BVI companies received the funds, Sun and Hu would then transfer the funds to many other paper companies for the purpose of money laundering and eventually for their personal use. Since those offshore companies would not repay loans to the bank, PEWC would have to pay back loans and consequently lose tens of millions of US dollars. To cover the shortage of cash due to the pre-payment to BVI companies, Hu then set up paper banks in Vanuata and issued fraudulent certificates of deposit to balance out the records.

Hu even invested in some of Taiwan's listed companies with those illegal funds and was elected chairman of Mosel Vitelic Inc., a listed chip-making company in Taiwan. After Hu retired from PEWC in 1999, chairman Ching-Yun Tung took over the financial department and found the fraud. However, Tung didn't expose the fraud

¹³³ The China Post, *supra* note 130.

but employed the same tricks to siphon NT \$760 million (US \$ 24 million) from PEWC.¹³⁴

Discrepancies between control rights and cash flow rights provide incentives for these families to tunnel corporate assets. The major controlling families are the Sun, Tong and Lee families, where the family members held 56.5% of the board seats and 71.4% of the board seats of executive directors. However, the total shareholding of these three families only added up to 6.3%.¹³⁵ In addition, more than half of the shares owned by directors, supervisors and managers are pledged.¹³⁶ That means these three controlling families enjoy dominant control over PEWC with very limited corresponding cash flow rights.

¹³⁴ The China Post, *supra* note 130.

¹³⁵ Ying-Hua Yeh, *Cong Gong Si Ji Li Mien Po Shi Tai Deng Tsai Wu Kun Jing Shi Mo [Analyzing the PEWC Shenanigan From the Perspective of Corporate Governance]*, 218 ACCOUNTING RESEARCH MONTHLY 99, 99-100 (2004). [hereinafter Yeh, *PEWC*]

¹³⁶ In 2002, 54.9% of the shares owned by directors, statutory supervisors and managers are pledged. *Id.*, at 101.

B. Analysis

Rebar, Procomp and PEWC are milestone tunneling cases in recent years. From the above discussion, it is clear that in all three cases the controlling shareholders had dominant control over the corporate board. It is also true in almost all other tunneling cases.¹³⁷ However, control over the board seats is usually not achieved through increased shareholding, but rather through cross-shareholding or proxy. Most of the time, controlling shareholders would even pledge their shares, which makes their financial bond with the firm even more tenuous.¹³⁸ In this case, the agency cost of controlling shareholders to other shareholders becomes higher than expected. Unfortunately, in all three cases, there is no independent director on the board to oversee the company on behalf of minority shareholders. Without such checks and balances, controlling shareholders did whatever they could to maximize their own wealth at the expense of other stakeholders.

To see whether independent directors could act as a check and balance to tunneling, we first need to understand the channels of tunneling. Channels of tunneling

¹³⁷ YEH, DISAPPEARING KING, *supra* note 106, at 178-182.

¹³⁸ *Id.*, at 189-191.

are usually a mix of operational, investment and financing activities.¹³⁹ The entities used in Taiwan are usually offshore subsidiaries and paper companies that are by definition the “related parties” of the company. Even though it is required that transactions with related parties be disclosed in the footnote of the financial statement and certain such transactions be approved by the board, the controlling shareholders tend to conceal such entities and transactions in order to cover up the fraud. Therefore, even if there are independent directors on the board, they will not be able to oversee such related party transaction simply because they usually don’t even know of their existence.

Nevertheless, we would expect a responsible independent director to sense that something is amiss. In situation of both Rebar and PEWC, the firms had a huge amount of non-core business investments — most of them are continuously losing money. The firms also provide loan guarantees for or advance payments to those investment businesses (related parties), which in the end caused the firms to lose a huge amount of money. A responsible independent director should be able to sense that something must be wrong when acknowledging that the firm has huge and complex offshore investments that are losing money for years yet the management still

¹³⁹ Ma, *Rebar Audit Failure*, *supra* note 124, at 36.

wants to keep them.¹⁴⁰ For example, in 2001, the long-term investment of PEWC reaches NT \$ 42.24 billion (USD 1.32 billion), which accounted for 59% of total assets and far exceeded owner's equity of NT \$ 39.4 billion (USD 1.23 billion).¹⁴¹

In the case of Rebar, Procomp and many other companies that tried to boost their revenue by fabricating sales transactions, the sales are increasingly concentrated on certain sales agents (usually related parties), the amount of account receivables are usually high, yet the turnover rates are usually low. Therefore, unusual increase of sales revenue coupled with increasing account receivables yet decreasing cash flow should provide a sign to independent directors about the justification of increasing sales revenue.¹⁴² However, whether the independent director in fact senses the red flag and if so, whether he/she has the courage and ability to investigate further is a question that this Dissertation intends to answer.

¹⁴⁰ YEH, DISAPPEARING KING, *supra* note 106, at 186-89.

¹⁴¹ Yeh, PEWC, *supra* note 135, at 101-102.

¹⁴² YEH, DISAPPEARING KING, *supra* note 106, at 192-94.

C. RPTs in Taiwanese Firms

1. A Survey of Literature

Prior literature and analysis of corporate scandals in Taiwan indicate that tunneling is a significant threat to corporate governance in Taiwan and the major channel of tunneling is through RPTs. However, the overall efficiency of RPTs is unclear.¹⁴³ The RPTs could be seen as a result of vertical integration and thus have positive effect on the growth of business group. On the other hand, the terms of RPTs could be manipulated by the controlling shareholders in order to serve their self interests in benefiting the parties in which controlling shareholders own higher equity stakes. In this case, RPTs reduce efficiency, and the firm could be better off by transacting with unrelated parties under fair terms.

Tunneling is by nature not easily observable by mere public information.¹⁴⁴ It usually takes years and countless public resources to investigate and uncover the tip of the iceberg. Thus, systematic measuring of the extent of tunneling activities is a hard subject for researchers. Most empirical studies use indirect measures, such as the level

¹⁴³ Bernard S. Black et al., *How Corporate Governance Affects Firm Value: Evidence on Channels from Korea* 17-18 (Working Paper August 2008), available at <http://ssrn.com/abstract=844744>.

¹⁴⁴ Atanasov et al., *Unbundling Tunneling*, *supra* note 7, at 1-2.

of investor protection in the legal system and the wedge between cash-flow rights and control rights of the controlling shareholders, as a proxy for tunneling and examine the relation between such proxies and firm value.¹⁴⁵

Some provide more direct evidence on tunneling, but all are based on data from emerging markets. Bertrand, Mehta and Mullainathan (2002) report evidence on tunneling in an Indian business group which is characterized with pyramidal ownership structures by measuring the responsiveness of firm profitability to shocks in industry profitability. In theory, a low-cash-flow-right firm will be less responsive to industry shocks than a high-cash-flow-right firm assuming that controlling shareholders tunnel resources from a low-cash-flow-right firm to a high-cash-flow-right firm. Bae et al. (2002) examine the stock market responses to merger announcements in Korea chaebols and find that the stock prices of chaebol-affiliated firms on average fall when announcing acquisition of group firms, suggesting that controlling shareholders expropriate wealth from minority shareholders through intra-group acquisitions.¹⁴⁶ Cheung et al. (2006) examines the stock market responses for the announcement of RPTs using data from Hong Kong and find that, on average,

¹⁴⁵ Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002); Claessens et al., *supra* note 46; Lins, *supra* note 46.

¹⁴⁶ Kee-Hong Bae et al., *Tunneling or Value Added? Evidence From Merger by Korean Business Groups*, 57 J. FIN. 2695 (2002).

firms announcing RPTs with major shareholders or directors experience excess negative returns than those announcing similar arm's length transactions.¹⁴⁷ Berkman et al. (2009) provide further evidence on tunneling through loan guarantees to the controlling blockholders in Chinese firms by testing whether the issuance is negatively related to firm value and firm performance.

While these studies manifest specific channels of tunneling, they do not provide evidence on exactly how controlling shareholders extract private benefits through these transactions. La Porta et al. (2003), using data set from Mexico where banks can be controlled by nonfinancial firms, examine the terms of bank loans with related parties and find that related lending accounts for 20 percent of commercial loans and enjoys lower interests rates than arm's-length loans. Related loans are 33 percent more likely to default and have a much lower recovery rate.¹⁴⁸ Cheung et al. (2009) further provide evidence on how controlling shareholders tunnel through asset transfer transactions. Using data containing specific asset transfer transactions disclosed by Hong Kong companies, they find that firms acquiring assets from related parties pay a higher price compared to similar arms' length transactions and firms selling assets to

¹⁴⁷ Yan-Leung Cheung et al., *Tunneling, Propping, and Expropriation: Evidence From Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343 (2006). [hereinafter Cheung et al., *Hong Kong*].

¹⁴⁸ Rafael La Porta, Florencio López-De-Silanes, Guillermo Zamarripa, *Related Lending*, 118(1) Q. J. ECON. 231 (2003).

related parties receive a lower price compared to similar arms' length transactions.¹⁴⁹

The result confirms the hypothesis that controlling shareholders in Hong Kong tunnel through related party asset transfer transactions.

Atanasov, Black and Ceccotello (2008) continue the effort in unbundling tunneling by dissecting tunneling into three types: cash flow, asset and equity. They develop economic models that explore how different types of tunneling affect share prices and financial results.¹⁵⁰ The study suggests that the law might affect finance through regulating tunneling activities. In addition, the study proposes that uniformity in accounting treatment of transactions and in disclosure is necessary for investors to understand and measure tunneling. Emerging markets need a strong securities regulator to support uniform accounting rules and disclosures.¹⁵¹

Although the efficiency and wealth transfer effect of RPTs cannot be determined unless the actual terms of specific transactions are available, a growing literature shows that transactions among related parties are generally detrimental to the value of minority shareholders. The empirical research result warrants more serious policy discussions on the disclosure and approval policy of RPTs. However, the law in

¹⁴⁹ Cheung et al., *Asset Transfer*, *supra* note 49.

¹⁵⁰ Atanasov et al., *Unbundling Tunneling*, *supra* note 7, at 11-21.

¹⁵¹ *Id.*, at 30-34.

Taiwan does not require public companies to disclose the transaction value of each RPT, rather it only require firms to disclose counterparty, the types of transactions, and the cumulative amount during the accounting year.¹⁵² Hence, insufficient information exists to test whether these RPTs are tunneling or propping. To date, there is a lack of systematic studies on the effect of RPTs by Taiwanese public companies. While assessing the effect of RPTs on shareholder value is beyond the scope of this research, a preliminary effort in presenting the current state of RPTs engaged by Taiwanese public companies and the state of board oversight over RPTs would shed light on the issue discussed in this Dissertation.

2. RPTs in Sample Firms

There are a total of 41 sample listed firms excluding financial firms. Among 41 sample firms, 39 have disclosed RPTs in their 2007 financial statements. I exclude transactions with wholly-owned subsidiaries since those transactions do not bear tunneling concerns. I categorize these transactions by counterparty and transaction type.

i. Counterparty

¹⁵² See Appendix C Statement of Financial Accounting Standards No. 6: Disclosure of Related Party Transactions, Section 4.

Counterparties can be categorized into four major types: controlling firms, chairmen, directors¹⁵³, and affiliated firms; and eleven sub-categories: controlling firms, firms affiliated with controlling firms, chairman, firms controlled by the chairman, relatives of the chairman, firms controlled by the relatives of the chairman, individual directors, firms affiliated with individual directors, company directors, firms affiliated with company directors, and finally, affiliated firms of the subject firm. A firm can only be counted once in each category as long as the firm enters into transaction with the subject type of party no matter how many transactions it conducts. On the other hand, a firm can be counted once in each and every category as long as it enters into transactions with each type of party. Table 10 shows the result.

Around half of the firms transact with the firms in which they invested — the affiliated firms. This reflects the popularity of vertical integration and business grouping in Taiwan's economy. The effect of this category of transactions could be twofold. First, the sample firm might benefit from such transactions if the sample firm has considerable influence over the affiliated firm and thus receives beneficial terms over the transaction.¹⁵⁴ Second, the minority shareholders of the sample firm might as

¹⁵³ Taiwan's Company Law allows a legal entity or government to be elected as a director, the so-called "company director". If a legal entity or government is elected as a director, it is free to assign an individual representative to perform its duty. See Company Law of Taiwan art. 27 I (2009).

¹⁵⁴ Cheung et al. (2006) and (2009) categorizes transactions between listed firms and its non-listed

well be expropriated from such transaction if the controlling shareholder also holds, either directly or indirectly, personal shares in the affiliated firms, and could personally benefit from the transaction by forcing the sample firm to enter into inferior terms with the affiliated firm. This situation is most likely to happen if the controlling shareholder's equity stake is higher in the affiliated firms.

Other transactions are with controlling firms, chairmen, directors, and their affiliated firms. Controlling firms, chairmen and directors are typically influential on board decisions and deserve great scrutiny when they transact with the firm. In addition, RPTs with these three constituencies involve conflicts of interest and could potentially serve as a vehicle for tunneling. In theory, this is when independent directors step in and ensure the fairness of the transactions on behalf of minority shareholders.

ii. Transaction Type

The types of transactions into which the firms enter might also provide clues about tunneling. Commentators have regarded some transactions *a priori* likely to result in expropriation of minority shareholders — asset acquisitions, asset sales,

subsidiaries as potentially propping transactions. Cheung et al., *Hong Kong*, *supra* note 147, at 356; Yan-Leung Cheung et al., *Tunneling and propping up: An analysis of related party transactions by Chinese listed companies*, 17(3) PAC.-BASIN FIN. J. 372, 381 (2009). [Hereinafter Cheung et al., *China*]

equity sales, trading relationship (purchases or sales of goods and services), and cash payments with a connected person or a private company majority-controlled by this person.¹⁵⁵ Recent empirical studies have also looked into specific types of RPTs and found that controlling shareholders in Hong Kong and China have embezzled corporate assets through asset acquisitions, asset sales, inter-corporate loans, and loan guarantees.¹⁵⁶ However, not every aforementioned type of RPTs results in tunneling.

¹⁵⁵ Under Hong Kong law, a connected person includes the listed firm's (or the subsidiary's) substantial shareholders, the chief executive, the directors, and their associates, including any company in which the above hold a substantial shareholding. Cheung et al., *Hong Kong*, *supra* note 147, at 349, 355-356.

¹⁵⁶ Berkman et al., *supra* note 51; Cheung et al., *Asset Transfer*, *supra* note 49; Jiang, *supra* note 50.

Table 10 Related Party Transactions - By Counterparty

	Controlling Firms		Chairmen				Directors				Affiliated Firms*
	Controlling Firms	Firms affiliated with the Controlling Firm	Chairman	Firms Controlled by the Chairman	Relatives of the Chairman	Firms Controlled by the Relatives of the Chairman	Individual Directors	Firms affiliated with Individual Directors	Company Directors	Firms affiliated with Company Directors	Affiliated Firms of the Subject Firm
No. of Firms	13	13	6	11	2	2	4	1	6	5	22

*Affiliated Firms refer to those firms in which the subject firm invested but excludes wholly-owned subsidiaries.

Table 11 Related Party Transactions – By Transaction Type

No. of Firms	Asset acquisitions	Asset sales	Equity acquisitions	Equity sales	Sale of goods and services	Purchase of goods and services	Loans and guarantees	Rent Expenses	Cash receipts	Others
	5	5	2	3	29	24	8	11	7	14

Friedman et al. (2003) acknowledge that while it is widely recognized that controlling shareholders tunnel assets out of the firms, sometimes they also prop up the firms using their private funds.¹⁵⁷ However, due to the clandestine nature of RPTs and the difficulty in discerning the market value of the subject assets, empirical research studies usually cannot explicitly distinguish propping activities from tunneling.¹⁵⁸

Using multiple classification methods, Cheung et al. (2006) pioneered efforts to categorize RPTs as tunneling or propping by examining the market-adjusted cumulative average abnormal returns (CARs) around the announcement day.¹⁵⁹ In general, the valuation effects are consistent with their classification using *a priori* knowledge, where asset transfers (including asset acquisitions, asset sales and asset swaps), trading relationships and cash payments with connected persons which are categorized as tunneling are value-destroying; cash receipts and subsidiary relationship as propping are value-enhancing. However, only the value changes in

¹⁵⁷ Friedman et al. (2003) develop a theoretical model to rationalize such propping behavior and conclude that controlling shareholders are likely to prop up the firms when firms experience moderate negative shock (hoping to tunnel more in the future if the firms can stay in business) and usually propped up firms are more highly leveraged. Eric Friedman, Simon Johnson & Todd Mitton, *Propping and tunneling*, 31 J. COMP. ECON. 732 (2003).

¹⁵⁸ Both Berkman et al. (2009) and Jiang et al. (2008) use the existence of related-party loan guarantees and inter-corporate loans as proxies for tunneling. Cheung et al., *Asset Transfer* try to directly assess the value of the assets by simulating the “fair value” of the traded assets. Berkman et al., *supra* note 51, at 141-42; Cheung et al., *Asset Transfer*, *supra* note 49, at 916-17; Jiang et al., *supra* note 50, at 13-15.

¹⁵⁹ Cheung et al., *Hong Kong*, *supra* note 147.

asset acquisitions, asset swaps, trading relationships, cash payments and cash receipts are statistically significant. The valuation effects of asset sales and subsidiary relationships are uncertain.¹⁶⁰ Using the same technique, Cheung et al. (2009) examine the valuation effect of 290 sample RPTs of Chinese listed companies during 2001 and 2002. Similar to the results of Cheung et al. (2006), the Chinese study finds that asset acquisitions, asset swaps, trading relationships, and cash payments are value-destroying and cash receipts are value-enhancing.¹⁶¹

The use of CARs as a measurement, which only reflects new information to the market, did not take into account the situation in which the investors could have anticipated the expropriation and acquired their shares at a discounted price.¹⁶² However, Cheung et al. (2006) find limited evidence that supports the anticipation argument, suggesting that investors cannot anticipate expropriation prior to the announcement of RPTs and the value change is likely due to the announcement of RPTs.¹⁶³

Table 11 provides a classification of the RPTs of the sample firms by transaction types. 29 firms (70 percent) engage in sales of goods and services transactions with

¹⁶⁰ *Id.*, at 366-371.

¹⁶¹ Cheung et al., *China*, *supra* note 154, at 385-387.

¹⁶² RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 216-217 (2d ed. 1995).

¹⁶³ Cheung et al., *Hong Kong*, *supra* note 147, at 375-379.

related parties; 24 (59 percent) engage in purchases transactions; 11 (27 percent) firms rent offices or warehouses from related parties; 8 (20 percent) provide loans and guarantees (similar to cash payments in Cheung et al. (2006)); 5 (12 percent) engage in asset transfer transactions; 22 (54 percent) engage in transactions with subsidiaries.

To assess whether the sample RPTs involve conflicts of interest, we also need to know the party of the transaction. I further classify sample RPTs by both counterparty and transaction type in Table 12 and 13. The most common RPTs with controlling firms are trading relationships, rent and asset acquisitions. 23 firms (56 percent) sell goods to and 13 firms (32 percent) purchase goods from controlling firms; 9 firms (22 percent) rent offices or warehouses from controlling firms; and 7 firms (17 percent) acquire assets from controlling firms. Since controlling firms have control power over sample firms, it is likely that the above transactions involve tunneling. Cheung et al. (2006) and Cheung et al. (2009) also presented confirming evidence.

Trading and renting relationships are also common among the RPTs with chairpersons. However, there are loans and guarantees as well as cash-receipt relationships with chairpersons. This suggests that a chairperson and his/her controlled firms not only benefits from financing by the sample firms, he or she also helps finance the sample firms by providing loans or guarantees if needed. The financing

chairperson and the firms that chairperson controls occur in two sample firms that are relatively small in size and controlled by individuals. In one of these firms, the chairperson also provides personal loans to the company with no interests. Hence, there are also propping transactions among sample firms.

The chairmen of 4 samples firms serve as guarantors for bank loans of the sample firms. Interestingly, 3 of these firms belong to the same business group controlled by a well-know family in Taiwan. Therefore, such practice could be seen as a group specific practice. One group sample firm borrows money from a bank which is controlled by the family of the spouse of the chairman. Overall, financing relationships between chairman and listed firms are not common and seems to be firm or business group specific.

Again, trading relationships are also common among the RPTs with company directors. This also reflects investments among firms that have business relationships. RPTs with subsidiaries or affiliates are mostly trading relationships. While 7 firms provide loans and guarantees to their affiliates, no sample firms receive cash or guarantees from affiliates. 6 firms sell assets or equity to their subsidiaries or affiliated firms, which mirrors the results in asset acquisitions where 7 firms purchase assets from controlling firms. Hence, in related-party asset transfer transactions, there is a

tendency that firms lower in the ownership chain tend to purchase assets from firms that are upstream. It is likely that the upstream firm (sometimes the controlling shareholder) will exert its influence over the terms and force the downstream firm (the subsidiaries or affiliates) to pay higher prices for the assets. Hence, from the evidence presented to us, we can reasonably infer that the asset or equity sales transactions with affiliated firms are most likely propping transactions for sample firms.¹⁶⁴

Overall, there are considerable asset acquisitions, trading transactions, as well as cash payment transactions between sample firms and their controlling shareholders, chairmen, and directors. Cheung et al. (2006) and Cheung et al. (2009) report that those transactions result in significant negative abnormal returns for listed firms in Hong Kong and China, suggesting that controlling shareholders might tunnel through those transactions. Although there is not a systematic study of RPTs in Taiwan testing the valuation effects of each type of transactions, we can still reasonably infer from logical reasoning and limited evidence from Hong Kong and China that sample Taiwanese firms may engage in tunneling activities through RPTs with controlling firms, chairmen and directors. Even if those transactions do not in fact involve tunneling, the conflicts of interest between related parties and sample listed firms also

¹⁶⁴ Cheung et al., *Asset Transfer*, *supra* note 49.

warrant the participation of independent directors in the decision-making process.

Table 12 Related Party Transactions – Cross Table 1

The number in the column represents the number of sample firms that has disclosed the type of RPTs with correspondent counterparty in 2007. If a sample firm engages in asset acquisition and sale of goods with controlling shareholder, this will count as one in (Asset Acquisition, Controlling Firm) column and one in (Sales of Goods and Services, Controlling Firm) column.

	Controlling Firm	Chairman	Directors	Affiliated Firms (not wholly-owned subsidiary) of Subject Firm	Total
Asset Acquisitions	7	1		2	10
Asset Sales	1	3		4	8
Equity Acquisitions			3		3
Equity Sales		1		2	3
Sale of Goods and Services	23	10	8	12	53
Purchase of Goods and Services	13	9	7	9	38
Loans and Guarantees	1	3	-	7	11
Rent Expenses	9	5	1		15
Cash Receipts	2	6	2		13
Other	10	5	2	6	23
Total	67	43	23	42	

Table 13 Related Party Transactions – Cross Table 2 (Detailed Breakdown)

	Controlling Firms		Chairman		Individual Directors		Company Directors		Affiliated Firms (not wholly-owned subsidiary) of Subject Firm	Total		
	Controlling Firm	Firms affiliated with Controlling Firm	Chairman	Firms Controlled by the Chairman	Relatives of the Chairman	Firms Controlled by the Relatives of the Chairman	Individual Directors	Firms affiliated with Individual Directors			Company Directors	Firms affiliated with Company Directors
Asset acquisitions	4	3		1						2	10	
Asset sales		1		3						4	8	
Equity acquisitions							3				3	
Equity sales				1						2	3	
Sale of goods and services	11	12		8		2		1	4	3	12	53
Purchase of goods and services	4	9		7		2		1	1	5	9	38
Loans and guarantees		1	1	2							7	11
Rent Expenses	8	1	1	2	2		1					15
Cash Receipts	2	1	5			1	1		1			13
Other	6	4	1	3		1			2		6	23
Total	35	32	8	27	2	6	5	2	8	8	42	

III. Corporate Board Reform

A. Traditional Two-tier Board Structure

The corporate-board structure around the world has two major styles: the Anglo-American style and the German style, also known as the “one-tier system” and “two-tier system,” respectively. In general, the “Anglo-American style” board structure, notably that of the United States and the United Kingdom, relies on the board of directors and several sub-committees to monitor the management; the German structure relies on a supervisory board to monitor management board while management board focuses on managing the company. The structure of a given board is clearly path dependent in relation to the given country’s political and economic conditions. Many Asian countries follow the German-style governance structure because they first transplanted their corporate law from European legal systems.

The corporate-board structure of Taiwan generally follows the Japanese-style governance structure, which is a modified version of the German governance structure. The governance structure in Taiwan and in Japan differs from the typical German governance structure in that the statutory-supervisor position in Japan and Taiwan is weaker than its German counterpart, the supervisory board. In Germany, the

supervisory board has the right to appoint or remove directors; however, in Japan and Taiwan, supervisors are nominated by the board and elected by the shareholders.¹⁶⁵ In addition, the statutory supervisors in Taiwan do not act collectively as a board as does their German or Japanese counterpart; rather, they act individually.¹⁶⁶ According to the Corporation Law of Taiwan, a supervisor is an independent supervisory institution responsible for auditing the business conditions of companies and for evaluating the performance of companies' boards of directors and managers.¹⁶⁷ However, in Taiwan, a supervisor has the right only to attend board meetings, not the right to vote. In addition, the pre-reform law set no qualification for supervisors. In practice, many supervisors are relatives or friends of the founding family, the controlling shareholder, directors, or top managers. Therefore, most statutory supervisors of Taiwanese public companies are just "rubber stamps."

¹⁶⁵ Ronald J. Gilson and Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 348 (2005).

¹⁶⁶ Japan reformed its statutory auditor system in 1993 to introduce a board of statutory auditors and require at least one member of the auditor board to be an outside auditor. Before that, statutory auditors in Japan act individually. *Id.* at 347-48.

¹⁶⁷ GONG SI FA [Corporation Law] art. 218, § I (2009) (Taiwan).

B. The 2002 Reform

In the aftermath of Enron and other high-profile corporate-fraud cases, the U.S. Congress, in enacting the Sarbanes-Oxley Act of 2002 (SOX), placed great reliance on outside/independent directors and audit committees as a means of monitoring both firms' internal control system and the integrity of firms' financial-reporting systems. Following the passage of SOX, many Asian countries, such as China, Japan, South Korea, and Taiwan, initiated corporate-board reforms to be in alignment with the U.S.-style governance structure. In response to local corporate-fraud scandals, Taiwan's financial authority has considered introducing the institution of independent directors to enhance corporate-monitoring functions. In 2002, the Taiwan Stock Exchange (TSE) began taking a leading role in requiring all newly listed companies to have at least two independent directors and one independent statutory supervisor. However, the TSE is still hesitant to apply such requirements to all listed companies owing to fierce opposition from industry. Instead, the TSE adopted the "comply or disclose" approach to require all listed companies to disclose the TSE-defined "independence" of their directors and supervisors. Since then, more and more public companies have voluntarily retained independent directors and independent supervisors.

C. The 2006 Reform

The Taiwan government's proposal for corporate-board reform has triggered much debate among scholars in Taiwan. The most prominent issue is whether or not Taiwan should introduce independent director and abandon the institution of statutory supervisor.¹⁶⁸ Finally, the Congress settled the dispute by revising the Securities and Exchange Act in 2006 to give public companies the option to choose whether or not they have independent directors.¹⁶⁹ In addition, public companies also have the option to choose whether or not they establish audit committees. And if they do, the law requires that the companies abandon the institution of statutory supervisor.¹⁷⁰ The amendment basically resembles the 2002 Japanese board reform, which also grants

¹⁶⁸ Taiwan's corporate scholars have different views on this issue. Some advocate the introduction of independent directors. See Syue-Ming Yu, *Taiwan Shin Gong Si Fa yu Du Li Dong Shi (Shang)* [New Taiwan Corporation Law and Independent Directors (I)], 123 FT L. REV. 63 (2002) (supporting transplantation of independent director because it is a global trend). Others propose an enabling approach to grant companies the option, but oppose having both independent directors and statutory supervisors in one company. See Wen-Yeu Wang, *She Li Du Li Dong Jian Dui Gong Si Zhi Li de Ying Xiang* [The Impact on Corporate Governance of Introducing Independent Directors and Statutory Supervisors], 56 THE L. MONTHLY 45 (2005) (supporting an enabling approach and suggesting that once the company chooses to introduce independent directors, it has to switch to a single board system and abandon the institution of statutory supervisors); Wang-Ruu Tseng, *Wo Guo You Guan Gong Si Zhi Li Ji Xing Si* [Some Thoughts on Corporate Governance in Taiwan], 103 THE TAIWAN L. REV. 61 (2003). Still others oppose the introduction of independent directors and propose to strengthen the institution of statutory supervisors. See Ming-Jye Huang, *Gong Si Jan Kong yu Jan Cha Ren Jye Du Gai Ge Ren* [Innovation of Taiwan's Corporate Auditor System - A Corporate Governance Perspective], 29 NATIONAL TAIWAN UNIV. L. J. 159 (2000) (Opposing the introduction of independent directors and purporting to strengthen the independence and monitoring function of statutory supervisors); Len-Yu Liu, *Jian Quan Du Li Dong Jian Shi yu Gong Si Ji Li zhi Fa Ji Yang Jiu* [Research on Building a Sound Legal System on Corporate Governance and Independent Directors and Statutory Supervisor], 94 THE TAIWAN L. REV. 131 (2003); Kuo-Chuan Lin, *Jian Cha Ren Xiu Zheng Fang Xiang zhi Jiang Tao* [Review of the Reform of Statutory Supervisors], 73 THE TAIWAN L. REV. 48 (2001).

¹⁶⁹ ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-2 (2006) (Taiwan).

¹⁷⁰ ZHENG QUAN JIAO YI FA art. 14-4.

corporations the option to choose between a U.S.-style board structure and traditional board structure.¹⁷¹

What distinguishes Taiwan's reform from Japan's reform is that the financial authority of Taiwan may deprive the choice of Taiwan's public corporation whereas that of Japan may not. Specifically, Taiwan's law grants the Financial Supervisory Commission (FSC) the right to mandate that any public corporation (1) have independent directors on the corporate board or (2) replace statutory supervisors with audit committees, which is made up of at least three independent directors with at least one possess financial expertise.¹⁷² Hence, the ultimate policy goal in Taiwan is to align all public firms' board structure with unitary board structure and to strengthen the monitoring function of corporate boards. In March 2006, the FSC has mandated that all public financial firms and those non-financial listed firms with equity value over NT\$50 billion (US\$1.6 billion) should have at least two independent directors on their board and that the total number of independent directors should be no less than one-fifth the number of board members.¹⁷³ As of October 2009, there are a total of 279 TSE-listed companies whose boards have a combined total of 632 independent

¹⁷¹ Gilson & Milhaupt, *supra* note 165, at 352-54.

¹⁷² ZHENG QUAN JIAO YI FA art. 14-2 & 14-4; Regulations Governing the Exercise of Powers by Audit Committees of Public Companies art. 4 (2006).

¹⁷³ Financial Supervisory Commission, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006.

directors.¹⁷⁴ That is, 38.2% of the TSE-listed companies have at least one independent director on their board.¹⁷⁵ In other words, there are still 61.8% of TSE-listed firms do not have any independent directors. Table 14 shows the breakdown:

Table 14 Breakdown of TSE-listed Firms that Have Independent Directors

Number of Independent Directors in Each Firm	Number of TSE-listed Firms	Percentage (%) of Total TSE-listed Firms
1	17	2.3
2	183	25.0
3	68	9.3
4	10	1.4
5	1	0.1
Total	279	38.2

Source: Taiwan Stock Exchange and Market Observation Post System, October 2009.

Under current regulation, there are three types of board structure in Taiwanese public companies: (1) with independent directors and an audit committee (no statutory supervisor), (2) with independent directors and statutory supervisors (no audit committee), (3) with only statutory supervisors. In general, large companies (with equity value over NT\$50 billion (US\$1.6 billion)) and newly listed companies, which are generally much smaller in size, should have at least two independent directors on the board. Other companies have the option to choose among the three types.

¹⁷⁴ Taiwan Stock Exchange, Market Observation Post System, <http://newmops.tse.com.tw/>.

¹⁷⁵ There are 731 TSE-listed companies as of October 2009. Taiwan Stock Exchange, Statistics: Status of Securities Listed on Taiwan Stock Exchange, <http://www.twse.com.tw/en/statistics/statistics.php?tm=07> (last visited Nov. 25, 2009).

D. The Experience of Japan and China

1. Japan

Japan undertook its corporate-board reform in 2002 by adopting an enabling approach, which allows companies to choose between the U.S. board-governance system and the Japanese board-governance system.¹⁷⁶ In analyzing some characteristics attributable to Japanese firms that, as of March 2004, adopted the U.S. governance structure, Gilson and Milhaupt (2005) initially tested the effectiveness of the enabling approach and the attractiveness of U.S.-style corporate-governance structure abroad. They found that factors that might affect the adoption of unitary board structure include the signaling effect, a firm's production technology, a firm's product-market competition, and group affiliation. In addition to finding no clear strategy of adoption, the researchers found no significant market reaction to the choice of adopting the unitary board structure. The finding may reflect the lack of reform-related consensus, which itself reflects some of the impetus behind the enabling approach. Gilson and Milhaupt's initial examination of the Japanese board reform

¹⁷⁶ It should be noted that, under Japanese corporate law, an "outside director" can be affiliated with a controlling shareholder or parent company as long as he/she is or was not the management, employee or director of the firm or its subsidiaries. That means an outside director in Japan can be affiliated and not independent. Gilson & Milhaupt, *supra* note 165, at 358.

suggests that formal convergence may trigger an initial reduction in overall system productivity because the new form was perhaps not complementary with other existing institutions.¹⁷⁷ This study reminds us of the importance of local forces in the success of corporate-governance reform.¹⁷⁸

2. China

In 2001, the China Securities Regulatory Commission issued its “Guidance Opinion on the Establishment of an Independent Director System in Listed Companies” requiring that all listed companies have at least two independent directors and that such directors constitute at least one third of the board. Clarke (2006) is generally pessimistic about the effectiveness of independent directors’ ability to police Chinese public companies.¹⁷⁹ First, the empirical research in China has found no strong link between independent directors and corporate performance. Second, Clarke (2006) examines the compatibility of the institution of independent directors with the existing legal infrastructure and with existing political and economic institutions. He

¹⁷⁷ Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 339 (2001).

¹⁷⁸ An insightful remark by the authors is “The transmission of ideas from one system to another is highly complex, and thus despite outward appearances of convergence of purpose in corporate governance reform around the world, the trajectory and end point of reform in any given system will be shaped by intensely local forces.” Gilson & Milhaupt, *supra* note 165, at 372.

¹⁷⁹ Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125 (2006).

further considers the availability of substitute institutions and the motivations underlying China's transplanting of independent-director institution. Finally, he argues that proponents of the independent-director position misconceive the nature of the corporate-governance problem in China as well as the function of independent directors in the United States, and have not taken into account specific features of the Chinese institutional environment. Therefore, he urges, China should develop a system of corporate governance that possesses Chinese characteristics.

The experiences of Japan and China remind us of the importance of local institutions' path dependence. In this regard, Gilson wisely observed that "the path dependent characteristics of a given national governance system confront the disciplining effects of the operative selection mechanisms. In the end, institutions are shaped by a form of corporate governance plate tectonics, in which the demands of current circumstances grind against the influence of initial conditions."¹⁸⁰

IV. Empirical Studies on Board Independence in Taiwan

Empirical corporate governance studies in Taiwan generally find positive correlation between board independence and firm value, suggesting that independent

¹⁸⁰ Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 332 (1996).

directors could increase firm value. In addition, the extent to which directors affiliate with controlling shareholders is correlated with the wedge between cash-flow rights and control rights of the controlling shareholders. This section summarizes studies related to board independence in Taiwan.

A. Board Independence and Firm Performance

Using data from Taiwan, Luan and Tang (2007) recently found a positive correlation between the appointment of independent directors and firm performance.¹⁸¹ They argue that the inconclusiveness of past empirical studies may be due to the lack of independence of most outside directors. Luan and Tang use a unique dataset from Taiwan, where the government imposed a stringent definition of directors' "independence". The two researchers' study presents a comparison between the firm performance of firms that voluntarily appointed independent directors and that of firms that did not do so.

However, Luan and Tang's study is subject to several limitations. First, the sample firms are limited to those in the electronics industry. Although electronics industry accounts for majority of the public firms in Taiwan, it is still unclear whether

¹⁸¹ Chin-Jung Luan & Ming-Je Tang, *Where is Independent Director Efficacy?*, 15 CORP. GOVERNANCE: AN INT'L REV. 636 (2007).

or not findings from electronics industry can be generalized. Second, because the sample firms voluntarily chose to retain independent directors, there may be a self-selection effect. Third, the board structure is also likely to be endogenous to other firm characteristics.

Rather than use “independence” as a benchmark, Yeh and Woidtke (2005) categorize the directors according to their affiliation with controlling shareholders.¹⁸² They find board affiliation with a controlling family negatively associated with firm performance measured by Tobin’s Q and ROA. The result is only significant in family-controlled firms, not in non-family-controlled firms.¹⁸³ As with most corporate governance studies, this study is also subject to the limitation of endogeneity problem.

B. CMS and Board Independence

Yeh and Woidtke (2005) find that the divergence between cash-flow rights and voting rights correlated with board composition. The researchers find that the divergence between cash-flow rights and control rights had a statistically significant

¹⁸² Board seats are counted as affiliated when they are held by the firm’s largest shareholder, by the largest shareholder’s identifiable relatives, or by legal representatives from other companies or entities controlled by the largest shareholder. Yeh & Woidtke, *supra* note 38, at 1868.

¹⁸³ Yeh & Woidtke, *supra* note 38, at 1879-82.

correlation with director affiliation, suggesting that, as the divergence between their cash-flow rights and their control rights increases, controlling shareholders are more likely to select directors and supervisors who are affiliated with the controlling shareholders.¹⁸⁴ In addition, the two researchers found that this divergence was more pronounced in family-controlled firms and that family-controlled firms were more likely to retain affiliated directors than were non-family-controlled firms.¹⁸⁵ However, the actual divergence between ownership and control appeared to be more important in determining board affiliation than was the family or non-family status of the controlling shareholder.¹⁸⁶ With respect to the relation between firm value and board composition, the study in question found that, in family-controlled firms, firm value decreased as director affiliation increased.¹⁸⁷

C. Firm Characteristics and Board Structure

On the basis of 2001 annual reports of Taiwan's public firms, Yeh et al. (2003) examined the characteristics attributable to firms that voluntarily retained independent

¹⁸⁴ *Id.* at 1870, 1873.

¹⁸⁵ *Id.* at 1874.

¹⁸⁶ *Id.* at 1877.

¹⁸⁷ *Id.* at 1882. Similar results are found in Yin-Hua Yeh, *Do Controlling Shareholders Enhance Corporate Value?*, 13 CORP. GOVERNANCE: AN INT'L REV. 313 (2005).

directors.¹⁸⁸ The study found that firms with higher market value and better performance tended to voluntarily retain independent directors, so as to maintain the high market valuation. In addition, firms with concentrated ownership and smaller asset value tended to voluntarily retain independent directors as well, so as to signal to the investors that the controlling shareholders or the management team were willing to be supervised.¹⁸⁹

D. The Causes of Voluntary Resignation of Independent Directors

Yeh, Shu and Su (2007) present a comparison, ranging over the 2002-2006 period, between the characteristics attributable to Taiwanese firms from which independent directors resigned and the characteristics attributable to Taiwanese firms from which independent directors did not resign. Based on a sample of 82 listed firms, the study found that firms experiencing resignation were more likely than firms from the other category to have (1) related party transactions; (2) higher controlling-shareholder ownership; (3) a CEO who also served as chairman of the board; and (4) qualified

¹⁸⁸ Yin-Hua Yeh et al., *Duli Dong Jian de Qushi Yilu yu Shidi DiaoCha [The Trend, Suspicion, and Empirical Study of Independent Directors]*, 213 KUAI JI YAN JUI YUE KAN [ACCT. RES. MONTHLY] 86, 90-93 (2003).

¹⁸⁹ Another study finds similar results. See Liu-Qing Tsai, *Dong Jian Shi Dulixing zhi Shizheng Fenxi — Jianlun Dulixing zixun Jielu de Jiazhi Youguanxing [Empirical Study of the Independence of Directors and Supervisors — The Value of Mandatory Disclosure]*, 99 ZHENG QUAN GUI TAI YUE KAN [OTC MONTHLY REV.] 27, 34-35 (2004).

accountants' opinions.¹⁹⁰ The findings suggest that, in general, resignation of a firm's independent directors signals improper corporate-governance practices by the firm.

¹⁹⁰ Yin-Hua Yeh, P. G. Shu & Y. H. Su, *The Causes of Voluntary Resignation of Independent Directors*, 5(4) CORP. OWNERSHIP & CONTROL 112 (2008).

CHAPTER 4. DO INDEPENDENT DIRECTORS PREVENT TUNNELING?

I. Definition of Independence

The Financial Supervisory Commission (“FSC”) of Taiwan issued a ruling, “Regulations Governing Appointment of Independent Directors and Compliance Matters for Public Companies” (“Independent Directors Appointment Rule”), governing the appointment of independent directors in March 2006.¹⁹¹ The ruling requires independence tests, professional qualifications, and election for independent directors. In general, an independent director should have at least five years of working experience in business, law, finance, accounting or other relevant fields.¹⁹² In the past two years and during their tenure, the directors and their immediate family members should not hold substantial shares of the firm or maintain employment relationships with the firm, affiliated firms, major shareholders, firms that have substantial business or financial relationships with the firm, and firms that provide business, legal, financial or accounting services or consultation to the firm.¹⁹³ To ensure adequate participation, an independent director can serve on no more than three

¹⁹¹ GongKai Fashing Gongsì Douli Dongshi Shezhi ji Ying Zunxun Shixiang Banfa [Regulations Governing Appointment of Independent Directors and Compliance Matters for Public Companies] (Taiwan) (2006) [hereinafter INDEPENDENT DIRECTORS APPOINTMENT RULE, TAIWAN], *available at* <http://eng.selaw.com.tw/FLAWDAT01.asp?LSID=FL038791>.

¹⁹² *Id.*, art. 2 § 1.

¹⁹³ *Id.*, art. 3 § 1, 3.

corporate boards.¹⁹⁴ In response to the criticism about the nomination process and to promote shareholder participation, the rule further provides that any shareholder who holds more than 1% of the shares can submit a nomination list of independent directors to the board.¹⁹⁵

The independence tests in Taiwan are somewhat different from that in the U.S. The text of Sarbanes-Oxley Act contains no concrete definition for the “independence” of directors. However, Section 301 of Sarbanes-Oxley Act requires listed companies to have audit committees comprised entirely of independent directors.¹⁹⁶ Pursuant to Section 301, the Securities Exchange Act of 1934 was amended to further require the audit committee members not receive compensation from and not affiliate with the issuer.¹⁹⁷ Section 301 also requires SEC to direct national securities exchange associations to adopt rules regarding director independence. Subsequently, the New York Stock Exchange (“NYSE”) and NASDAQ went further than Sarbanes-Oxley Act to define independence being independent from the company in terms of employment, financial, and business relationships.¹⁹⁸ Both listing agencies also require majority of

¹⁹⁴ *Id.*, art. 4.

¹⁹⁵ *Id.*, art. 5 § 3.

¹⁹⁶ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

¹⁹⁷ 15 U.S.C. §78j-1 (m)(3) (2009).

¹⁹⁸ NYSE LISTED COMPANY MANUAL, Section 303A.02, *available at* <http://nysemanual.nyse.com/LCM/Sections/>; NASDAQ LISTING RULES, Rule 5605(a)(2), *available at*

the board members of their listed firms be independent as well.¹⁹⁹

However, in an economy where corporate ownerships are mostly concentrated, like Taiwan, the emphasis should be on independence from the controlling shareholders.²⁰⁰ Hence, the independence tests in Taiwan stress the relationship between independent directors and the firm's major shareholders.²⁰¹ The Independent Director Appointment Rule stipulates that a director will not qualify as "independent" if, in the past two years before appointment or during the term of office, he/she was or is:²⁰²

1. An employee of the company or any of its affiliates.
2. A director or statutory 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.

http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F

¹⁹⁹ NYSE LISTED COMPANY MANUAL, Section 303A.01; NASDAQ LISTING RULES, Rule 5605-1.

²⁰⁰ Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards* 37-38 (Working Paper, April 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1374331.

²⁰¹ The Securities Exchange Act of South Korea, where corporations are mostly controlled by specific family business groups, the *Chaebol*, also defines independence being independent from major shareholders. YEH & KO, *supra* note 91, at 227.

²⁰² INDEPENDENT DIRECTORS APPOINTMENT RULE, TAIWAN, *supra* note 191, art. 3.

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.
5. A director, statutory supervisor, or employee of a corporate shareholder that directly holds five percent or more of the total number shares issued by the company or that holds shares ranking in the top five in holdings.
6. A director, statutory 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, statutory supervisor, or officer of a sole proprietorship, partnership, company, or institution that, provides commercial, legal, financial, accounting, or consultation services to the company or to any affiliate of the company, or a spouse thereof.

Compared to the NYSE and NASDAQ rules, the independence tests in Taiwan have a shorter look-back period, focusing on activities and positions within the last two years, while the NYSE and NASDAQ look back three years. The Independent Director Appointment Rule cuts the ties between the firm and its professional consultants, ranging from accounting to law; by contrast, the NYSE and NASDAQ rules only cut off ties with auditors.

Despite the recent laws and regulations, the U.S. Delaware Courts has traditionally played a dominant role in shaping the internal composition of U.S. corporate boards. The deference of Delaware Courts to the decisions of independent or disinterested directors encourage companies to add outside directors to their boards.²⁰³ Such *ex post* judicial review of director independence provides a strong check on the true independence of directors in specific cases, which is absent in the Taiwan's context.²⁰⁴ Therefore, independent directors in Taiwan, so far, are only subject to formality checks. Absent substantive judicial review of director independence, independent director could be a tool used by controlling shareholders to eliminate

²⁰³ Lin, *supra* note 18, at 904-912.

²⁰⁴ In determining independence, the Delaware Courts' inquiry goes beyond the strict type of financial ties to the more subjective types of ties — "a sense of beholdenness". See *Rales v. Blasband*, 634 A.2d 927 (Del. 1993); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2003); *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003); and *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

investors' concerns over potential extraction of private benefits.²⁰⁵

II. Who are Independent Directors?

Following the Independent Director Appointment Rule, 275 TSE-listed companies (38.30%) elected a total of 549 independent directors as of March 2009. No firms in the Cement, Food, Glass, Pulp & Paper, Hotels and Department Stores industries chose to introduce independent directors. (Table 15 and Figure 7) Financial and Insurance (70.27%), Electronics (57.14%), and Chemical, Pharmaceutical and Biotech (34.29%) are among the top industries that have the highest percentage of firms choosing to have independent directors on their boards.

²⁰⁵ See *infra* text Chapter 5 II.

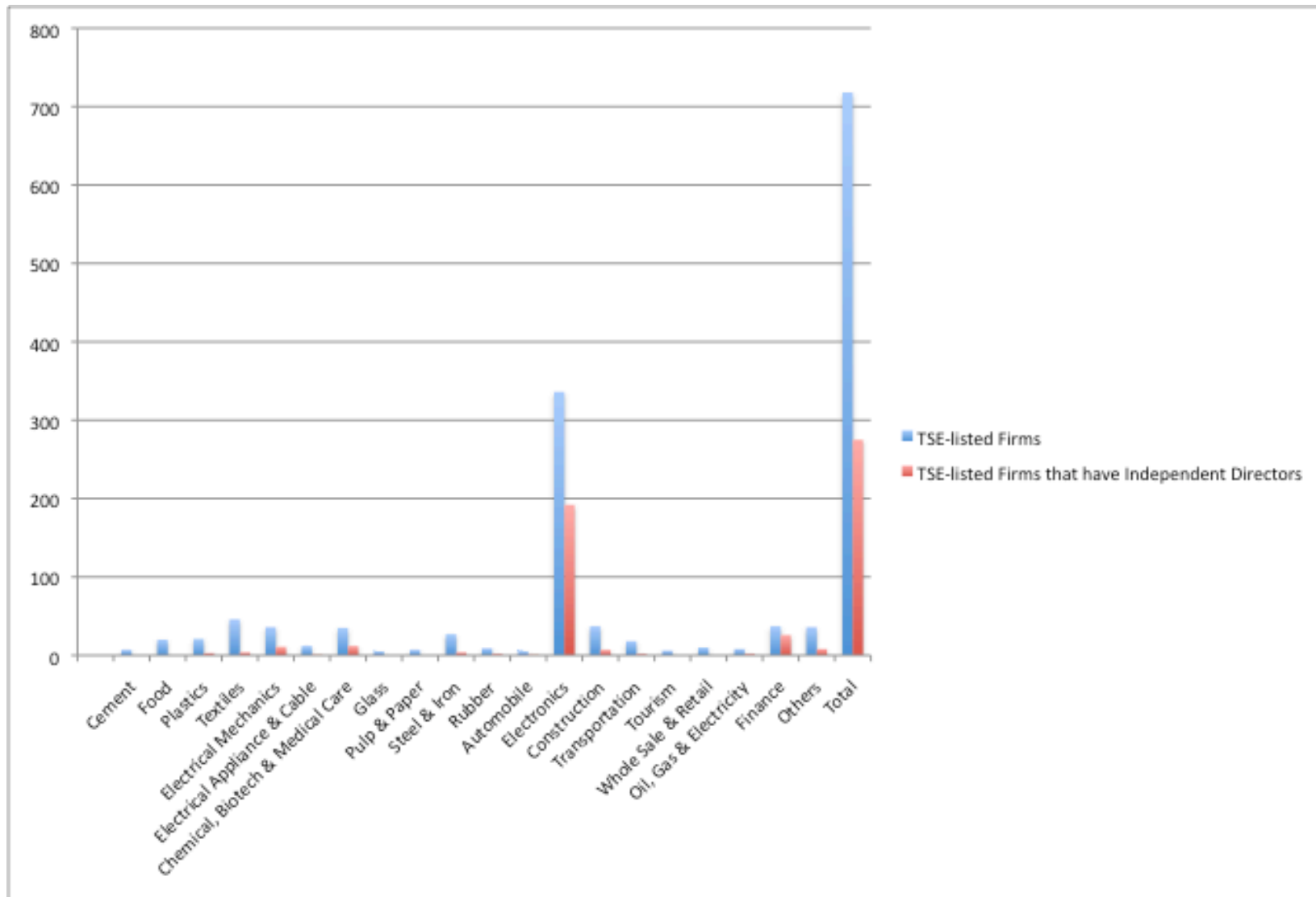
Table 15 Industry Distribution of TSE-Firms with Independent Directors

Industry	Number of TSE- Firms	TSE-Firms with Independent Directors	Percentage
Cement	7	0	0.00
Food	20	0	0.00
Plastics	21	3	14.29
Textile & Fiber	46	4	8.70
Electrical Mechanics	36	11	30.56
Electric Wire & Cable	12	1	8.33
Chemical, Pharmaceutical & Biotech	35	12	34.29
Glass	5	0	0.00
Pulp & Paper	7	0	0.00
Steel	27	4	14.81
Rubber	9	2	22.22
Automobile	5	1	20.00
Electronics	336	192	57.14
Real Estate & Construction	37	7	18.92
Transportation	18	2	11.11
Hotels	6	0	0.00
Department Stores	10	0	0.00
Petroleum & Gas	8	2	25.00
Financial & Insurance	37	26	70.27
Others	36	8	22.22
Total	718	275	38.30

Summarized by the author.

Source: Market Observation Post System, Taiwan Stock Exchange (March 2009).

Figure 7 Industry Distribution of TSE-Firms that Have Independent Directors



As of October 2009, only 26 (3.6%) TSE-listed companies established audit committees to replace statutory supervisors.

Table 16 List of TSE-listed Companies with Audit Committees

Company Name	Establishment Date	Industry	Total Number of Independent Directors	Total Number of Directors
Darfon	01/01/07	Electronics	3	8
Tsann Kuen	01/01/07	Electronics	3	7
TSMC	01/01/07	Electronics	4	8
AU Optronics	06/13/07	Electronics	3	9
Lite-On IT	06/13/07	Electronics	3	11
Cathay Financial	06/15/07	Financial	3	13
LiteOn	06/21/07	Electronics	3	11
Yuanta Financial	06/29/07	Financial	3	11
Sinyi Real Estate	09/12/07	Real Estate	3	7
Cosmos Bank	03/04/08	Financial	3	13
Green Energy	06/10/08	Electronics	3	9
Global Unichip	06/11/08	Electronics	3	9
E.Sun Financial	06/13/08	Financial	4	13
Fubon Financial	06/13/08	Financial	4	12
Qisda	06/13/08	Electronics	3	9
Taiwan Mobile	06/13/08	Electronics	4	11
MOSEL	06/19/08	Electronics	3	9
WPG Holding	06/25/08	Electronics	5	15
Neo Solar Power	06/30/08	Electronics	3	9
MXIC	06/10/09	Electronics	3	15
Nano Op	06/10/09	Electronics	3	7
UMC	06/10/09	Electronics	4	9
AV Tech	06/16/09	Electronics	3	6
Wistron	06/23/09	Electronics	4	9
Wellypower	06/24/09	Electronics	3	9
ChinaTrust Financial	06/26/09	Financial	3	9

Source: Market Observation Post System, Taiwan Stock Exchange (October 2009).

So from where exactly do these independent directors come? This Study classifies the occupation into 10 categories and compiles data from MOPS where descriptions of each independent director's current full-time job are available. The top three occupations for independent directors are Corporate Directors (29.03%), Professors (24.91%) and Managers (12.36%). (Table 17) In the U.S., most independent directors are directors or CEOs of other public companies.²⁰⁶ In Taiwan, Corporate Directors and CEOs account for 41.2 percent of all independent directors, which is still a significant number. Together with Managers, people from the corporate world make up over half (53.56%) of this population.

Table 17 Occupations of Independent Directors

Occupations	Number	Percentage
Corporate Directors	155	29.03
Professors	133	24.91
Managers	66	12.36
CEO	65	12.17
Accountants	39	7.30
Others	30	5.62
Lawyers	24	4.49
Government Officials	10	1.87
Politicians	10	1.87
Physicians	2	0.37
Total	534	

Analyzed and catagorized by the author. Source: Market Observation Post System, Taiwan Stock Exchange (October 2008).

One remarkable observation about the population of independent directors in

²⁰⁶ Gilson and Kraakman, *supra* note 60, at 875.

Taiwan is that “Professors” is a significant group, accounting for 24.91%. No doubt, the public image of professors fits perfectly well with the concept of “independent.” Professors are generally thought of as having some degree of expertise in their chosen field. Having professors on the board certainly helps to enhance corporate image; however, as an interviewee pointed out:

Although professors might not knowingly cover up for the firms, they usually are not sophisticated enough to discover fraud.²⁰⁷

Another interviewee also questioned the ability of professors to oversee public firms.

They [the professors] can only do the so-called “oversight” from the documents given by the firm. In fact, they are incapable of doing any substantive oversight because they do not have the business knowledge. Therefore, I think professors being independent directors is a disaster for our society because they know so little about what they are doing.²⁰⁸

Such statements further point out the limitation of professors being independent directors. To be sure, most professors are not familiar with business operations and if he/she is not a professor of finance or accounting, he/she may not have enough knowledge to even understand financial statements, let alone discover fraudulent

²⁰⁷ Interview No. 3 (Sept. 30, 2008), at 9.

²⁰⁸ Interview No. 31 (Nov. 5, 2009), at 3.

accounting practices.²⁰⁹ An interviewee, who is a professor of engineering, admitted that:

[r]eviewing financial reports is not my expertise.....I am able to contribute more towards devising the company's strategy and its future direction. To be honest, I don't understand financial reports very well. I do not have a complete understanding of the impact or the meaning of some of the specific numbers (on the reports). Other directors might be more knowledgeable about that. During meetings, the directors would bring in aides, such as their chief financial officer to discuss the company's finance. From these discussions, I can more or less grasp the overall picture of the company's financial status. However, I would be unable to discover any fraud by merely looking at the numbers.²¹⁰

One might reasonably infer, and the reality might well be, that different independent directors serve different functions. A professor of engineering might contribute to the firm more on technical consultation than on internal auditing improvement. In practice, firms will choose directors who can contribute in some way to the firm. For example, evidence shows that Japanese firms that tend to appoint retired government bureaucrats as outside directors are those in the construction

²⁰⁹ In China, many economists or law professors serve as independent directors of public companies. Commentators have also concerned about their lack of business knowledge. Yang Chou and Chiang Kong, *Woguo kaiban duli dongshi zeren baoxian pingjing fenshi ji xianzhong sheji* [*Bottleneck Analysis and Policy Design for D&O Insurance in China*] Feb. 4, 2009, available at <http://www.chinarm.cn/Insurance/2009/0204/20572.html>.

²¹⁰ Interview No. 22 (Feb. 25, 2009), at 5.

industry and have significant business with government agencies.²¹¹

III. What Are Their Duties?

A. Statutory Responsibilities

In general, Taiwanese law requires independent directors to pay attention to internal audit procedures, material corporate transactions, matters on which directors or statutory supervisors have conflicts, securities offerings, and the retention or dismissal of outside auditors or internal accounting, financial, and auditing officers.²¹²

However, independent directors do not have veto rights to these decisions. They can only ask the board to keep their dissenting opinion on file. The board can still decide by majority votes even if independent directors have dissenting opinions.

In practice, dissenting opinions from independent directors are rare. Nevertheless, once the companies make such opinions public, the market and the government will watch carefully. Such opinions usually bear signaling effects. For example, one interviewee (and only one), who serves in the financial industry, reported that he once filed a dissenting opinion for the appointment of the CEO of a subsidiary. Although a

²¹¹ Yoshiro Miwa & J. Mark Ramseyer, *Who Appoints Them, What Do They Do? Evidence on Outside Directors From Japan*, 14 J. ECON. & MGMT. STRATEGY 299, 320-321 (2005).

²¹² ZHENG QUAN JIAO YI FA art. 14-3.

majority of the board members voted for that candidate, the government authority in charge of the financial industry asked the firm to reconsider the appointment after reviewing the dissenting opinion. In the end, the firm withdrew the appointment.²¹³

Item 3 of Article 14-3 requires independent directors to review matters in which a director or statutory auditor bears a personal interests. In short, this clause deals with self-dealing transactions pertaining to directors and statutory auditors. Literally speaking, for public companies that have independent directors, any matter that bears on the personal interests of directors or statutory auditors should be approved by the board of directors, and if independent directors have any opposing opinion, the board minutes should record them. Therefore, the law does require independent directors to participate in the review of RPTs with directors or statutory auditors.

²¹³ Interview No. 25 (Mar. 1, 2009), at 3-4.

B. The Laws Regarding RPTs

In this section, I will present a summary of a preliminary survey of current laws and regulations that stipulate the approval procedure and disclosure of related party transactions.

1. Corporation Law

The Corporation Law of Taiwan does not have a complete set of rules governing the disclosure of RPTs, the procedure of approving RPTs, and directors' liability arising from unfair RPTs. Article 223 of Corporation Law only provides minimum regulation for self-dealing. The article states "*In case a director of a company transacts a 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.*"²¹⁴ However, Article 223 only applies to directors, not to other related parties. In addition, it only applies to the situation in which the director acts "on his own account or for any other person." As long as the director does not represent any party in the transaction, Article 223 will not apply.²¹⁵ Furthermore, the

²¹⁴ GONG SI FA [Corporation Law] art. 223 (2009) (Taiwan).

²¹⁵ Wen-Yeu Wang, *Lun dongshi yu gongsi jian jiaoyi zhi guifan (Essay on the Regulation of Self-Dealing)*, in XIN GONG SI YU QI YE FA (NEW CORPORATION AND BUSINESS ORGANIZATION LAWS) 95,

only consequence of self-dealing is that the supervisor shall act as the representative of the company. In practice, most statutory supervisors are controlled by the controlling shareholders or managers. Besides, this article does not stipulate any procedure for approval, disclosure, or the liability of directors arising therefrom. Hence, the impact of this article on constraining self-dealing is very limited. Corporate scholars have suggested that amendment should be made to include more detailed regulations concerning self-dealing.²¹⁶

Another related regulation under the Corporation Law is the Affiliated Company Chapter, which was added in 1997 as Article 369-1 to 369-12. However, not a single article in this chapter deals with the approval procedure or disclosure of transactions between affiliated companies. In addition, this chapter only governs the conducts of companies that are established under Taiwan's Corporation Law, it does not apply to individuals, foreign companies, nonprofit organizations, political party or the government. This limitation creates a big loophole in the regulation of related party transactions in Taiwan.²¹⁷

Two further articles that relates to related party transaction is Article 178 and 206

127-28 (2003).

²¹⁶ *Id.* at 135-36.

²¹⁷ Lawrence S. Liu, *A Commentary on Affiliated Company Law*, 21 SOCIOECONOMIC L. INSTITUTION REV.1, 7-9 (1998).

II. These two articles prohibit shareholders or directors from voting on matters in which they have conflicted interests in the shareholders' or board of directors' meeting. Hence, when a board of directors votes on related party transactions, the director of interest cannot vote on that matter.

2. Securities Regulations

For public companies, securities regulations also do not provide a blanket rule governing all types of RPTs. Three regulations promulgated by Taiwan's securities authority touch upon related party transactions. First of all, "Regulations Governing Establishment of Internal Control Systems by Public Companies" provides that the internal control system of public companies must include the management of related party transactions and that the internal control system must be approved by the board of directors.²¹⁸ In addition, the regulation further states that when approving the internal control system, the board meeting should consider and the board minutes should record the opposing opinions of the independent directors, if any.²¹⁹ Therefore, every public company should have a control procedure for related party transactions and that procedure should be reviewed by the independent directors. In this regard,

²¹⁸ Regulations Governing Establishment of Internal Control Systems by Public Companies art. 4 and 8 section 10 (2007).

²¹⁹ *Id.* art. 4.

independent directors have the opportunity to review the internal control procedure pertaining to related party transactions. However, independent directors do not have veto right if they do not agree with the proposed procedure, although his/her opposing opinion will be recorded in the board minutes and posted on a market observation post system website maintained by the Taiwan Stock Exchange.²²⁰

Secondly, “Regulations Governing the Acquisition and Disposal of Assets by Public Companies” requires a special approval process for the acquisition of real property from related parties. To acquire real property from related parties, public companies need approval from the board of directors and supervisors. In addition, the board meeting should consider and the board minutes should record the opposing opinions of the independent directors, if any.²²¹ The acquisition process should conform to the internal control procedure for the acquisition and disposal of assets and the acquisition price should be evaluated by the method stipulated in Article 15 of the regulation.

Finally, “Regulations Governing Loaning of Funds and Making of Endorsements/Guarantees by Public Companies” allows public companies to make

²²⁰ Taiwan Stock Exchange Corporation Procedures for Verification and Disclosure of Material Information of Listed Companies art. 2 section 44 (2007).

²²¹ Regulations Governing the Acquisition and Disposal of Assets by Public Companies art. 13 to 17 (2007).

loans to companies with which they have business relationships or that have short-term financing needs, or to provide endorsements/guarantees for their parent companies or subsidiaries. Therefore, it is possible for public companies to make loans to related parties as long as the related party is a company or business entity and the related party either has a business relationship with the public company or has short-term financing needs.

To make loans or provide endorsements/guarantees, public companies should stipulate to a special internal control procedure that needs to be approved by the board of directors as well as the shareholders' meeting. Similarly, the board meeting should consider and the board minutes should record the opposing opinions of the independent directors, if any. What is different for these two types of activities is that all loan makings should be approved by the board in advance while each endorsement/guarantee within authorized amounts may be decided solely by the chairman as long as it is approved by the board afterwards.²²²

3. Disclosure

Statement of financial accounting standards No. 6 announced by Taiwan's

²²² Regulations Governing Lending of Funds and Making of Endorsements/Guarantees by Public Companies art. 3, 5, 8, 11, 14, 17 (2009).

Financial Accounting Standards Board (FASB) governs the disclosure of RPTs. According to Taiwan's FASB Statement No. 6 "Disclosure of Related Party Transactions", related parties are defined as "any business entity and individual party, if one side has a control power over or has significant influence on the other side in terms of operating or financing decisions, the two parties will be construed as related parties. Business entities that are controlled by the same person or company will also be deemed as related parties." When determining whether a party is a "related party" defined by Statement No. 6, we should consider the substantive relationship between the parties in addition to its legal formality. Thus, anyone who wields influence or control over corporate decision-making or behavior could be regarded as a related party. A related party transaction is defined as the transfer of resources or duties among related parties, no matter whether there is a fund transfer or not. Information related to RPTs is required to disclose in the footnotes of the financial statements. (see Appendix C)

4. Summary

From the above review, only when the public company acquires real property from related parties or when the public company make loans to related parties or

endorsements/guarantees for its parent companies or subsidiaries should the law requires such transaction be approved by the board of directors. Otherwise, public companies may design their own internal procedure for related party transactions. In sum, a preliminary survey of the laws shows that the *ex ante* monitoring function of independent directors about related party transactions is very weak.

IV. What Do They Really Do?

Most of the independent directors I know actively participate in corporate matters. However, their participation usually limits to attending all the board meetings, actively participate in board meetings and reading materials in preparation for the meetings. I think most of the independent directors just do that much. I don't think anyone would visit the firm if nothing comes up. And I don't think anyone would look into details of the pre-meeting materials.²²³

The above quote fairly reflects the reality of independent director participation in Taiwan. The standard tasks of independent directors are to attend board meetings, review meeting materials before the meeting, and review internal audit reports every month. In general, board meetings of firms in the financial industry are held once a month, while those in other industries are usually held every two to three months. Most interviewees admit that they didn't spend much time reviewing materials before the meeting. However, if attending board meeting is the only major task for independent directors, the effectiveness of board meetings becomes crucial. Despite the fact that some independent directors are just too busy to preview the materials²²⁴, sometimes it is because firms prefer not to provide all the detailed information outside

²²³ Interview No. 4 (Oct. 07, 2008), at 8.

²²⁴ i.e. Interview No. 29 (Oct. 21, 2009), at 10.

the meeting for confidentiality reasons.²²⁵ Nevertheless, the confidentiality concerns could compromise the readiness of independent directors, who already are not that familiar with daily corporate matters, to effectively judge the fairness of board decisions.

In addition to attending board meetings, independent directors in Taiwan also review internal audit reports every month.²²⁶ Although some with accounting backgrounds pay more attention to the internal control systems, most interviewees reveal that such review is usually cursory and superficial. Some directors might not even have a clue how to review an internal audit report.

To be honest, I personally feel that the system of requiring independent directors to review internal audit report does not achieve much of its goal. For example, one company provides me with a report that lists every item as “no material irregularity” every month. To be honest, I really don’t know what to question further. On the other hand, the other company provides me with a very detailed report about what the internal auditor found and what he plans to do. My feeling is that on the one hand, I feel much better when I see the more detailed report; on the other, I don’t know what to question because you already handled all the issues.²²⁷

In addition to directors’ individual abilities, the independence and ability of the

²²⁵ i.e. Interview No. 30 (Oct. 22, 2009), at 12.

²²⁶ Regulations Governing Establishment of Internal Control Systems by Public Companies art. 15 (2009.3.16), available at <http://eng.selow.com.tw/FLAWDAT0201.asp>.

²²⁷ Interview No. 26 (Oct. 12, 2009), at 7-8.

internal auditor also influences the effectiveness of independent directors in overseeing the internal control process. Traditionally, the internal audit departments of most public companies in Taiwan are supervised by general managers and thus are not as independent. On Dec. 19, 2005, the FSC of Taiwan revised the “Regulations Governing Establishment of Internal Control Systems by Public Companies” requiring the internal audit departments of all public companies to be directly supervised by the board.²²⁸ The revision formally enhances the status and independence of internal auditors and provides a better structure for internal auditors to ensure the functioning of the internal control system.

However, when facing related-party transactions, most independent director interviewees do not believe that internal auditors are able to be a check-and-balance to controlling shareholders.²²⁹ After all, internal auditors are still employees. To challenge a decision of your boss and to blow the whistle, you are risking your entire career and that requires extraordinary courage. In addition, internal auditors are not highly regarded in most Taiwanese public companies; very few public companies have built a culture that provides internal auditors the power and courage to challenge

²²⁸ Regulations Governing Establishment of Internal Control Systems by Public Companies art. 11 (2009.3.16), *available at* <http://eng.selaw.com.tw/FLAWDAT0201.asp>.

²²⁹ i.e. Interview No. 26 (Oct. 12, 2009), at 12; Interview No.31 (Nov. 5, 2009), at 12.

controlling shareholders.²³⁰

In sum, the participation of independent directors generally limits to attending board meetings and reviewing monthly internal audit reports. In companies that adopted the board committee system, independent directors, as members of the audit committee, play a more active role in overseeing the financial condition of the company. Nomination committee and compensation committee are still few in Taiwan. In addition, since the Taiwanese court has not adopted the business judgment rule and deferred to the decisions of independent board committees in situations involving conflicts of interest, such as mergers and acquisitions and shareholder derivative suits, independent directors in Taiwan have not played an active role in reconciling matters that involve conflicts of interest. Therefore, the contribution of independent directors to the company is less valued in Taiwan than in the United States.

²³⁰ i.e. Interview No.31 (Nov. 5, 2009), at 12.

V. Empirical Evidence on RPT Oversight

From the analysis of RPTs in previous chapter, we can reasonably infer that sample firms have engaged in tunneling transactions with related parties. If this is likely to be the case, shareholders will, of course, want someone to stop these value-destroying transactions. And this person should be the one who is independent from the controlling shareholders (in the case of concentrated ownership) and can use their independent judgment to review these transactions for the best interests of the corporations.²³¹ Independent directors presumably fit this criteria and have been considered a proper post to review conflict-of-interest transactions impartially on behalf of minority shareholders under U.S. Delaware law.

However, a review of published board decisions of sample Taiwanese firms reports stunningly opposing results (Table 18). In 2007, when excluding decisions on RPTs with wholly-owned subsidiaries, only 9 boards of the sample firms (22 percent) ever reviewed and decided on RPTs. These decisions involved asset swaps, equity acquisitions, equity sales, and loans with related parties. Even among these 9 firms, only very few disclosed RPTs were reviewed by the board. Apparently, trading

²³¹ Bebchuk and Hamdani, *supra* note 200, at 37-38; Paccos, *supra* note 14, at 44-49.

relationships, renting relationships and cash receipts from related parties were never reviewed by the sample boards. Even for asset transfer and loans, only a few firms submitted these RPTs for board review.

Table 18 Board Decisions on RPTs

No. of Firms	Decisions on RPTs	Decisions not Available	No decision on RPTs	Decisions on RPTs (excluding wholly-owned subsidiaries)
	16	5	20	9

Interviews with independent directors further confirm this finding. Only 15 out of 40 interviewees have reviewed RPTs in board meetings. When asked about the types of RPTs they have reviewed, ten recalled loans/guarantees, two mentioned asset transfers, one mentioned equity acquisition, and two mentioned sales and purchases of goods. None mentioned renting and cash receipts relationships. Among the 15 interviewees, 9 of them serve in financial firms where the law requires their boards to review and approve RPTs with controlling shareholders or chairpersons by super-majority vote.²³² 3 of the remaining 6 interviewees who serve in non-financial firms only recalled reviewing loans/guarantees RPTs where the law also requires the boards'

²³² JING JUNG KONG GU GONG SI FA [Financial Holding Company Act] art. 45 (2006) (Taiwan).

approval or ratification.²³³ Therefore, independent directors' participation in monitoring RPTs is largely influenced by the laws and regulations promulgated by the government.

One major area where the law does not require boards' participation is in RPTs that involve purchases and sales of goods and services (trading RPTs). From previous analysis of sample RPTs, we know that trading transactions are the most common sample RPTs. The majority of trading RPTs are conducted with the controlling firms or the affiliated firms of the sample firms. These intra-group transactions, while often serving legitimate business purposes, might provide opportunities for dominate shareholders to transfer out corporate assets.²³⁴ However, the vast majority of the sample firms' boards have never reviewed trading transactions with controlling or affiliated firms.

In one of the interviews where the listed company belongs to a famous family-controlled group in Taiwan, the interviewee admitted that:

In terms of this business group, it has too many companies. I do not know the exact relationships between each subsidiary or affiliate. And among group

²³³ Regulations Governing Loaning of Funds and Making of Endorsements/Guarantees by Public Companies (2005) (Taiwan).

²³⁴ Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4(4) EUR. COMPANY & FIN. L. REV. 491, at 495-96; Cheung et al., *China*, *supra* note 154, at 385-386.

companies, they all have some kind of business transactions. So I'm not that clear about that.²³⁵

Indeed, the 2007 financial statement of this sample firm listed 38 related parties (excluding wholly-owned subsidiaries), including controlling firm, major shareholder of the controlling firm, chairman, firms controlled by the chairman's relatives, firms controlled by the controlling firm, and affiliated firms of the sample firm. The transaction types include asset transfer, sales of goods and services, cost sharing for administrative support services, and loan guarantees. In addition, the 2007 annual report only reflects one board decision on increasing investment in one of the wholly-owned subsidiaries. Even though the interviewee has served on the board for more than five years, he did not recall any experience in reviewing RPTs.

In addition to the complexity of RPTs, fierce market competition is another reason provided by the interviewees for not reviewing the terms of related-party trading transactions.

It's not possible to have any deviation on pricing because if the price of a specific product is above the market price, then we cannot get the order or [if the sale price is too low,] our margin would be low. If the margin falls below the normal range, everyone will pay attention to that. Therefore, there won't be any

²³⁵ Interview No. 14 (Nov. 11, 2008), at 8.

[tunneling] problem.²³⁶

The idea that market competition can serve as a monitor for trading RPTs may work in a competitive industry where margins are relatively low, for example, the personal computer industry. However, markets change. A good corporate governance measure should not be altered simply based on unstable market conditions. Furthermore, trading relationships with either controlling firms or affiliated firms involve conflicts of interests where independent directors should step in and make decisions for the best interests of the corporation.²³⁷ Although independent directors may decide the level of monitoring based on industry conditions, the participation of independent directors in ensuring the fairness of the transaction should not be omitted simply because the risks of deviation from market price is relatively low in certain industries.

As will be discussed in the following chapter, most independent directors in Taiwan join the board because they personally trust the controlling shareholders or managers. Sometimes independent directors also rely on such personal trust to monitor (or not monitor) trading RPTs.

Our chairman owns other companies. He commissions his other companies to act as vendors to supply

²³⁶ Interview No. 13 (Oct. 30, 2008), at 6.

²³⁷ Bebchuk & Hamdani, *supra* note 200, 37.

components for our company's products. The chairman would usually ask these vendors to keep their prices down, resulting in their low profit margin. We also know the managers at these other companies; they confirm that the chairman is keeping the prices low. Based on this, we all trust him (the chairman) and believe that he did not siphon the money out to his other companies or relatives.²³⁸

²³⁸ Interview No. 15 (Jan. 14, 2009), at 7.

CHAPTER 5. WEAK INDEPENDENT DIRECTORS, STRONG CONTROLLING SHAREHOLDERS

I. Overseeing Controlling Shareholders: Mission Impossible?

A. Information Asymmetry

There exists a serious information asymmetry problem between independent directors and controlling shareholders. An opinion leader in Taiwan's corporate governance policy, who has personally been involved in a securities fraud lawsuit as an independent director, points to the weakness of independent directors based on information asymmetry problem.

We (the independent directors) work on a meeting basis, on a gathering basis; whereas the management team is there (at the company) 24 hours a day. Therefore, there exists an unequal distribution of information (between the independent director and the management team). The independent director needs to adapt the company's internal policy to ensure the correctness of the transaction. However, if 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 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.²³⁹

This interviewee basically tells us that when there is intentional fraud, there is nothing an independent director can do because of information asymmetry problem. In this case, one might wonder why independent directors would not dig further to uncover the fraud. Is it true that controlling shareholders could hide everything from the eyes of independent directors? A banker, who also involves deeply in the corporate board reform in Taiwan, shares the difficulties in “digging further.” He resigned after serving for less than a year as an independent director in a family conglomerate.

Independent directors invited by the controlling shareholders, including myself, cannot really do what they want. You’ll find that they (the controlling shareholders) only want you to be the rubber stamp. I worked very hard and asked many questions. Of course, everyone will respect you and let you say what you want to say. But when you ask too many questions, they do not know what to do. Then they will start to screen or control the data they give you. In the beginning, I will call those insiders I know and ask more questions. But in the end, you’ll find that it’s very annoying and troublesome in terms of maintaining relationship with people. So I think the role of independent directors is very limited.²⁴⁰

Another interviewee points to the difficulty of uncovering accounting

²³⁹ Interview No. 20 (Feb. 19, 2009), at 8.

²⁴⁰ Interview No. 31 (Nov. 5, 2009), at 4.

irregularities.

My personal feeling is that the [accounting] records relating to tunneling or embezzlement are typically created at the base level of the company by entry-level employees. Frankly, if you are not an accounting employee or the chief financial officer, I think your chances of discovering fraud in documents which falsify sales transactions, invoices, and certificates is zero. For an outsider of the company like me, I think the chances of me discovering fraud is definitely zero.²⁴¹

Independent directors are at the very top of the corporate structure; therefore, they need cooperation from the company to obtain information. On the other hand, controlling shareholders control the information. In particular, most controlling shareholders in Taiwan also manage the company. In this case, these shareholder managers even produce the information independent directors need. If shareholder managers intentionally hold up or manipulate the information, there is nothing independent directors can do but resign. Of course, resignation of independent director sends out a signal to the market. But in most cases, the market still will not have a clear picture about what's going on unless independent directors have already obtained enough evidence about the fraud and make it public.

B. Related Party Transactions — The Hardest Part of All

²⁴¹ Interview No. 19 (Feb. 19, 2009), at 10.

Independent directors face even higher barriers in seeking information about irregular RPTs. It is widespread among Asian countries that insiders deliberately conceal abusive RPTs to the public to avoid scrutiny.²⁴² With the complex ownership structure of Asian companies, it is usually hard to even identify “related parties” in the first place.²⁴³

I think the problem is not so much about whether the information is enough; what’s more important is that the company did not tell you that this is a related party transaction in the first place.²⁴⁴

Even for related transactions that are disclosed, it is sometimes hard to decide whether the terms are fair or abusive if there is no market price to compare.²⁴⁵ Even if the management provides a market price, it is still possible that the management would manipulate the information. For example, to procure products produced by related parties, the management might compare the price with a more expensive product that is of higher quality and claim that these two products are of the same quality.²⁴⁶ For real estate or share purchase, we also need a well-developed appraisal

²⁴² OECD, THE 2007 ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, SYNTHESIS NOTE 6-7 (June 27-28 2007, Singapore), *available at* http://www.oecd.org/document/48/0,3343,en_2649_34813_39336752_1_1_1_1,00.html. [hereinafter OECD 2007 ASIAN ROUNDTABLE]

²⁴³ *Id.*, at 7.

²⁴⁴ Interview No. 26 (Oct. 12, 2009), at 11.

²⁴⁵ OECD 2007 ASIAN ROUNDTABLE, at 7.

²⁴⁶ Interview No. 31 (Nov. 5, 2009), at 12-13.

industry to support the oversight needs. However, in many Asian countries, including Taiwan, a fair appraisal industry is still under development.²⁴⁷

Furthermore, since the identification of related parties hinges on “relationships,” which are usually subjective, controlling shareholders might easily hide those paper companies that are in fact under their control. The Statement of Financial Accounting Standards No. 6 of Taiwan defines “related party” as “.....any business entity and individual party, if one side has a control power over or has significant influence on the other side in terms of operating or financing decisions.”²⁴⁸ The key terms “control power” and “significant influence” require subjective judgments of the professionals, creating loopholes for controlling shareholders to cover up tunneling RPTs.

An ethical accounting profession is also necessary to enhance the transparency of RPTs. In many tunneling cases in Taiwan, the controlling shareholders colluded with outside accountants during the auditing process to cover up abusive RPTs.

Honestly, perhaps because the Taiwanese society places more emphasis on personal relations, if the transaction is made between related parties, some of the accounting

²⁴⁷ “Taiwan does not have a well-developed appraisal industry. There are some appraisal companies in Taiwan providing real estate appraisal service. Some are ethical, like China Credit Information Services Ltd., while most are not as ethical as long as you pay. That’s very bad. Without the support of a fair appraisal industry, the legal requirement of independent appraisal report for RPTs is useless.” Interview No. 34 (Nov. 27, 2009), at 16.

²⁴⁸ See Appendix C.

firms in Taiwan will help the company conceal related party transactions during the auditing process. They won't report those transactions in the official financial statements. What I mean by the concept of transactions made between related parties is that, those transactions that I refer to are illegal transactions between the company and those paper companies established by the controlling shareholders, not those regular related party transactions.²⁴⁹

The 2006 Reba Group debacle exemplifies such collusion. The accountant of the Reba Group, Si-Da Shan, not only did not correct the omission of the disclosure of certain related party transaction but also consciously deleted Ho Hsin Co., one of the company controlled by the controlling shareholder of the Reba Group, from the audit working paper prepared by his assistant at the request of the controlling shareholder of the Reba Group.²⁵⁰ Of course, such collusion requires cooperation from internal legal and auditing departments. However, what's more surprising is that the independent directors in Taiwan also passively tolerate such practices. They are well aware that there might be gray areas in determining "related parties," but they choose to turn a blind eye and trust the firms.

I do not know whether those suppliers and customers own shares of the firm and can be defined as "related parties." At least, I have not encountered a situation where such transaction exists and needs the board's

²⁴⁹ Interview No. 5 (Oct. 9, 2008), at 4.

²⁵⁰ Ma, *Rebar Audit Failure*, *supra* note 124, at 41.

approval.²⁵¹

One interviewee admitted that he once had been aware of a potential tunneling RPT, but since the firm did not specify the counterparty as a related party, he chose to trust the firm and approved the transaction without actively verifying the information.

I myself have approved some related party transactions that are questionable.Many family businesses in Taiwan are conducting related party transactions.....Sometimes it's hard to tell if the party is a related party or not. And we, independent directors, would not verify whether the counter party is a related party or not.Even the legal department or internal audit department won't tell you whether it is a related party. If you ask them, they will tell you it is not and then you will approve the transaction. But in fact, the counter party could be an indirect related party. So I guess the internal audit department is also covering up for the controlling shareholder.²⁵²

C. Helplessness Results in Passiveness

In reality, independent directors in Taiwan are helpless in overseeing controlling shareholders, especially in detecting unfair RPTs and fraud. The

²⁵¹ Interview No. 11 (Oct. 25, 2008), at 7.

²⁵² Interview No. 4 (Oct. 7, 2008), at 9.

unfavorable environment makes most of them pessimistic about their ability to detect corporate fraud. They usually view themselves as outsiders. As one interviewee, who used to serve as a director in Procomp, which filed reorganization in 2004 because of fraudulent accounting practices, stated:

I do not think independent directors are able to uncover fraudulent transactions merely by viewing the company from an outsider's standpoint. One has to either work in the company or be very persistent in asking questions (like me), to find out the truth. Otherwise, there's no way of uncovering the truth.²⁵³

In addition to the outsider mentality, in reality, independent directors may find it hard to access inside information. Such situations can be worse in a concentrated ownership economy where chairman usually dominates the board and corporations tend to be less transparent. Taiwan's corporate environment is in exactly such a situation. Several interviewees share the same feeling that in a situation where the chairman or the corporation engages in fraudulent activities, independent directors are not capable of discovering the truth.

To be frank, if the chairman wants to hide something, the independent directors will not know, right? After all,

²⁵³ Interview No. 18 (Feb. 18, 2009), at 9. See also Interview No.19 (Feb. 19, 2009), at 10. "My personal feeling is that the (accounting) records relating to tunneling or embezzlement are typically created by entry-level employees. Frankly, if you are not an accounting employee or the chief financial officer, I think your chances of discovering fraud in documents which falsify sales transactions, invoices, and certificates is zero. For an outsider of the company like me, I think the chances of me discovering fraud is definitely zero."

you [the independent directors] do not work in the firm everyday....Independent director is not an employee of the company. What he does is just to question those issues that come up from the information provided by the company. I believe that if the chairman wants to cover up any wrongdoing and avoid any suspicion, he can do that.²⁵⁴

Such helplessness and pessimism also shape the way independent directors perceive themselves. Almost all the interviewees regard themselves as corporate monitors and recognize that making sure board decisions comply with the law is their major responsibility. However, what is surprising is that only six of them view themselves as the proper people to monitor RPTs. Others assign such task to other constituencies because they think that they are outsiders and there is no information available to them to fairly judge the RPTs.

Those (related party transactions) are typically very complicated. In addition, independent directors merely play a small role in the whole business. Related party transactions are typically associated with (major) shareholders' interests.....I think independent directors are outsiders and it's hard for them to become deeply involved..... If the management wants you to leave,

²⁵⁴ Interview No. 5 (Oct. 9, 2008), at 3, 5. *See also* Interview No. 3 (Sept. 30, 2008), at 6 (“I don’t think all the board members will cover up for wrong doings. Most of the board members are knowledgeable of ethics and want this company to be well-managed. However, if the CEO deliberately wants to do something that negatively impacts the company, I don’t think the board would be able to stop him.”).

you have no choice but to leave.²⁵⁵

Apparently, public companies and independent directors in Taiwan have not come to a consensus that an independent director is the proper constituency to monitor RPTs. Most independent directors have yet to recognize their role in solving conflicts of interest between controlling shareholders and outside investors, especially in transactions with related parties. Part of the reason may be that most Taiwanese companies do not have a truly independent internal control department, which could help independent directors identify related parties. The absence of an independent internal control department makes independent directors feel like outsiders who do not have access to crucial inside information about related parties and transaction terms. In addition, without the capacity of an audit committee, independent directors alone do not have resources to initiate an investigation should they think that there might be problems with certain transactions. Even if they do, the enormous amount of time and effort they have to put in makes such investigation unattractive given the limited time and financial incentives.

Honestly speaking, if they (the controlling shareholders) want to hide something from you, they definitely can. I do not have extra time to seek further information unless someone already passed inside information to me or someone sued the company. If you

²⁵⁵ Interview No. 9 (Oct. 15, 2008), at 12.

expect an independent director to actively dig out problems inside the firm, first, I do not believe that independent directors have the incentives to do that; second, without the assistance from public accountants and lawyers, I do not believe that he has the time and ability to do that.²⁵⁶

D. Business Ethics as a Screening Criterion

Adverse selection problems may arise when controlling shareholders control the information about a firm's financial and business conditions where independent directors do not have easy access. A controlling shareholder who engages in fraudulent activities may want to invite high-profile independent directors in order to signal the market that the firm is still promising. For example, the Universal ABIT Co., Ltd. ("Sheng-Ji") invited two leading scholars in corporate governance to join the board just few months before the scandal erupted. Although one independent director quickly resigned from the board right before the debacle, the joining of leading scholars sent misleading signals to the market about the true condition of the firm.

Screening is an economic strategy to combat the adverse selection problem.²⁵⁷ To

²⁵⁶ Interview No. 29 (Oct. 21, 2009), at 3.

²⁵⁷ Joseph E. Stiglitz & Andrew Weiss, *Sorting out the Differences Between Screening and Signalling* (NBER Working Paper No. t0093, November 1990).

avoid joining a “bad” company, independent directors would screen the firms beforehand. The key criterion used by independent directors in Taiwan is the integrity of the controlling shareholders and managers.

How do I decide whether to take on the position? First thing is the integrity of the leader. If the leader or the management team always follows the rules, the job of the independent director becomes easier because the cost of monitoring is not high.²⁵⁸

They usually judge such integrity from the personal relationship between them. More than 55% of the interviewees have personally known the chairman/CEO or major shareholder of the firm for more than ten years. The trust is built on a long-term understanding of each other. The strong personal trust of controlling shareholders alleviates the concern of independent directors over transparency and information asymmetry.

If you doubt every report presented to you, it would be endless. If everything needs to redo, the cost would be too high. I think the trust towards the management should be built on the long-term personal understanding and trust on the integrity of that person. In addition, the company should perform well. Based on these two

²⁵⁸ Interview No. 7 (Oct. 12, 2008), at 1. See also Interview No. 14 (Nov. 11, 2008), at 2. (“I have my own criteria, that is that person must be the one who I can trust and has good reputation, otherwise, I do not dare to join..... I think the attitude of the key leader is very important. Basically, it is the personal trust towards the key leader.”); Interview No. 3 (Sept. 30, 2008), at 5. (“When I’m considering accepting this position (as an independent director), I will first see who invites me to join the board. He should be the one whom I can trust because I need to be extra cautious when taking on such responsibility.”)

assumptions, the independent directors can monitor (the company) and make reasonable judgment.²⁵⁹

The strong personal ties between independent directors and controlling shareholders may be an inevitable result of the introduction of a new outside institution to a controlled or family-dominated board. However, such close relationships in turn raise concerns over the independence of the “independent” directors.

E. *Guan Xi* and Structural Bias

Just as an independent director is afraid of joining a “bad” company, a controlling shareholder is also worried about inviting a “bad” outsider to the board. Different controlling shareholders might provide different definitions for a “bad” independent director. Controlling shareholders would then, according to their own criteria, screen their own “good” independent directors. A firm that truly honors corporate governance would seek a truly “independent” director and provides him/her with abundant resources to do his/her job. For example, Taiwan Semiconductor Manufacturing Company (TSMC), a leading company in promoting corporate governance, searches

²⁵⁹ Interview No. 7 (Oct. 12, 2008), at 3.

for candidates through law firms and accounting firms, instead of finding someone they personally know; they look for candidates who are established in their respective fields of practice and have expertise that is helpful to the company. On the contrary, a firm that only wants a window-dressing director would find someone who is willing to be a rubber stamp for board decisions.

The reality is that, except in a few large companies, most leaders of the public companies in Taiwan generally seek independent directors of whom they personally know. As mentioned, controlling shareholders would seek for their own “good” independent directors. There also exists information asymmetry between candidates and controlling shareholders about the quality of independent director candidates. *Guan xi* (relationship) has been an important source of reliable information in Chinese society. Therefore, it is no surprise that controlling shareholders would first invite someone who has the *guan xi* to join the board.

Nevertheless, *guan xi* might compromise independence. Commentators in several regions, such as China, India and Taiwan, have cast doubt on the independence of independent directors.²⁶⁰ Their close relationship with controlling shareholders is

²⁶⁰ Hui-Hsin Wang & Guo-Dong Huang, *Lai Yin-Zhao: Duli Dongshi Weibi Duli [Independent Directors are not Necessarily Independent]*, JINGJI RIBAO [ECONOMIC DAILY], Feb. 5, 2007 (Taiwan), http://pro.udnjob.com/mag2/fn/storypage.jsp?f_ART_ID=31087. Editorial, *Wanshan Shangshi Gongsi Duli Dongshi Zhidu de Jianyi [Suggestions For The Institution of Independent Directors for Public*

definitely one of the major concerns.

In many companies, the so-called independent directors are invited by the controlling shareholders. In addition, many of them maintain good relationship with the major shareholders and executives. They (the independent directors) might politely remind the management (of some pitfalls) to a certain point. However, I think the role of these (independent) directors is limited.²⁶¹

Among the 40 independent director interviewees, 19 of them used the term “very close friend” to describe their relationship with the controlling shareholders or CEOs and 14 of them personally know the controlling shareholders or directors but are not very close friends. Only 7 of the interviewees did not know the controlling shareholders or other inside directors before they were invited to join the board. Although the statistical results cannot be generalized due to limited number of samples, most interviewees agree that a majority of the independent directors have some *guan xi* with the controlling shareholders.²⁶² Then the question presented would be “Does *guan xi* matter with regard to director independence?”

Companies], ZHANGQUAN SHIBAO [SECURITIES TIMES], April 18, 2009 (China), <http://news.cnyes.com/dspnewsS.asp?cls=listnews24hr&fi=\NEWSBASE\20090418\WEB357.D>. Murali, *Truly Independent Directors, A Rarity*, THE HINDU BUSINESS LINE, Jan. 22, 2009 (India), <http://www.thehindubusinessline.com/2009/01/22/stories/2009012250220900.htm>.

²⁶¹ Interview No. 18 (Feb. 18, 2009), at 2.

²⁶² Interview No. 3 (Sept. 30, 2008), at 1; Interview No. 4 (Oct. 7, 2008), at 1; Interview No. 18 (Feb. 18, 2009), at 2; Interview No. 20 (Feb. 19, 2009), at 1; Interview No. 21 (Feb. 25, 2009), at 1.

Structural Bias

It is a common concern that an independent director might be biased in making decisions if he/she has *guan xi* with controlling shareholders. Such concern is underpinned by the theory of structural bias which suggests that even if an independent director does not have financial or employment ties with the firm, he might still be biased in making decisions because of the social pressures generated from his personal relationship with the management or controlling shareholders.²⁶³

The U.S. scholars have long been aware of the social and psychological causes of bias that could impair independent directors' impartiality.²⁶⁴ Hwang and Kim (2009) examine the social ties among board directors of Fortune 100 firms and the impact of social ties to executive compensation.²⁶⁵ They identify social ties by mutual alma mater, military service, regional origin, discipline and industry, and find that the percentage of independent boards drop from 87% to 62% when screening by social ties.²⁶⁶ In addition, the CEOs of socially independent boards receive significantly lower compensation than those of non-independent boards, suggesting that social ties

²⁶³ Victor Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 611-612 (1982).

²⁶⁴ *Id.*; James D. Cox and Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985).

²⁶⁵ Byoung-Hyoun Hwang and Seoyoung Kim, *It Pays to Have Friends*, 93(1) J. FIN. ECON. 138 (2009).

²⁶⁶ *Id.*, at 139-44.

and structural bias do matter in corporate governance.²⁶⁷

However, the U.S. Delaware courts believe that most friendships are not to a level where they create bias towards decision-making.²⁶⁸ In determining the independence of directors in shareholder derivative actions, the Delaware courts apply a case-by-case approach²⁶⁹, presumed the independence of a director, and posed a demanding standard in refuting such independence. However, in addition to financial interests, the Delaware courts do rebut the independence of directors if they find close social or professional relationships among directors.²⁷⁰ More challenges based on personal relationship have been raised recently to question the independence of directors in cases involving demand excusal in a derivative suit or the application of the business judgment rule. It is expected that the extent to which personal relationship

²⁶⁷ *Id.*, at 145-48.

²⁶⁸ “But, to render a director unable to consider demand, a relationship must be of a bias-producing nature....Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence.... [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend. Not all friendships, or even most of them, rise to this level....” Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).

²⁶⁹ “Independence is a fact-specific determination made in the context of a particular case.” *Id.* at 1049. See also Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 29-41 (2007).

²⁷⁰ See *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003) (questioning the independency of the two members of the special litigation committee due to their longstanding personal ties with the defendant director); *In re Oracle Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (finding a lack of independence of the members of special litigation committee because of the Stanford ties among several directors).

compromise director independence will continue to develop in Delaware case law.²⁷¹

Furthermore, scholars have also called for more judicial power in reviewing the substantive merits of independent directors' decisions in cases involving structural bias.²⁷²

However, from the economists' point of view, directors would try hard to avoid such bias in order to preserve their reputation in the independent director market. Therefore, even if bias could arise from friendship, it is avoidable.²⁷³ While the above reputation argument is based on an assumption that directors are well aware of their biases, contemporary psychological research studies recognize another prototype of bias — “unintentional bias”.²⁷⁴ Unintentional bias concerns bias that results from unconscious cognitive processes.²⁷⁵ Because such bias is “involuntary” and “unconscious,” it can occur even when the decision maker intentionally seeks to avoid

²⁷¹ Justice Randy J. Holland, *Delaware Director Independence*, Speech at the Taiwan Law Society 17 (Dec. 4, 2009).

²⁷² Kenneth B. Davis, *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 82 (2004). *c.f.* Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate “Rubber-Stamping” Boards*, 79 S. CAL. L. REV. 455 (2006) (looking to stock exchanges, instead of Delaware courts, to examine the social ties among board members by proposing to require all listed firms to have board-rating agencies score the independence of director nominees).

²⁷³ Fama & Jensen, *supra* note 10, at 315. See also *Beam*, 845 A.2d at 1052.

²⁷⁴ Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 258-59 (2009).

²⁷⁵ Unconscious bias could exist in every stage of the cognitive processes, from the starting point, reasoning, to information processing. *Id.*, at 259-285.

biases.²⁷⁶ Commentators argue that since decision makers are not aware of such bias, the reputation argument supported by economists thus could not be sustained.²⁷⁷

Given the existence of unintentional bias and the increasing awareness of the impact of personal relationship on director independence in the Delaware courts, the issue of structural bias deserves more attention in countries which have transplanted the institution of independent directors from the U.S. The close relationship between independent directors and controlling shareholders is not a unique phenomenon in Taiwan, rather it is a common issue faced by most Asian countries. Commentators have also claimed “truly independent directors are rarely found in Indian companies” based on the fact that “board members are selected by the promoters on the basis of existing contacts.”²⁷⁸

In Taiwan, as in many other Asian countries, there does not exist a sophisticated commercial court and complementing legal system to provide the kind of *ex post* judicial review found in the U.S.²⁷⁹ For example, a shareholder derivative suit is almost unheard of in practice due to the various procedural hurdles set in the Company Law of Taiwan. In addition, the business judgment rule has yet to be accepted by the

²⁷⁶ *Id.*, at 258.

²⁷⁷ *Id.*, at 285-286.

²⁷⁸ THE HINDU BUSINESS LINE, *supra* note 260.

²⁷⁹ Gilson and Milhaupt, *supra* note 165, at 369-372.

Taiwanese court. Because of these very different local conditions, *ex post* judicial review of director independence not only does not exist in the current legal system but also is unforeseeable in the near future. On the flip side, the Taiwanese legal system has yet to recognize the role of independent committees in resolving conflicts of interests, which in turn limit the function of independent directors and the value they could have created. This is exactly the danger of legal transplantation. While the transplanted country has yet to have the soil to nurture the precious seed, it must either fertilize the soil or plant another seed that would fit in order to enjoy the flower blossom.

F. Incentivize Weak Independent Directors?

Providing proper incentives for independent directors has been a long-standing issue in corporate research. While independent directors, by definition, are financially independent from the firms, they do need proper financial incentives to induce cautious monitoring. There is no set formula for optimal independent director compensation. Commentators have expressed concern that too much pecuniary reward

would compromise directors' independence.²⁸⁰ Some independent directors in Taiwan, especially those in the financial industry, suffer from criticism that they receive too much to properly monitor the firms.²⁸¹

Some independent directors do not dare to say a word during board meetings because they are paid too well. I've observed some lawyers who are eloquent during practice, when they serve as independent directors, they are completely silent during board meetings. The firm pays so well that they do not need to practice law anymore. It is possible that they receive tens of millions [NTD] each year.²⁸²

However, most independent directors in Taiwan are paid modestly. Table 19 provides the average annual compensation for independent directors in Taiwan. For TSE-listed companies, the average annual compensation for each independent director is NT\$1,173,000 (US\$35,545.46 or Euro 24,510.69), which is about half of that for a non-independent director. However, for independent directors of companies that have audit committees, their average compensation is about four times of average compensation of companies without audit committees. It might be because those

²⁸⁰ Gilson and Kraakman, *supra* note 60, at 875.

²⁸¹ Independent directors in financial industry receive highest pay than those in other industries. They are paid roughly NT\$ 160,000 (US\$4,848.48 or Euro 3,337.08) to NT\$ 400,000 (US\$12,121.21 or Euro 8,342.70) per month, which is 4 to 10 times of the average pay. Wei-Ju Kuo, Kaoyin Duli Dongshi Pinren Fenpo Chen Ju Yunren WeiCai [Appointment of Kaohsiung Bank Independent Directors — Chen Ju: We Retain Them For Their Expertise], INDEPENDENT NIGHT REPORTER, Apr. 9, 2009, available at

http://59.120.145.210/news/news_content.php?catid=1&catsid=2&catdid=0&artid=20090409abcd014.

²⁸² Interview No. 2 (Sept. 29, 2008), at 5.

companies that voluntarily establish audit committees tend to be larger and thus can afford to pay higher salaries, or because the workload of independent directors is heavier in companies with audit committees.²⁸³

²⁸³ LEN-YU LIU, XIANXING SHANGSHI SHANGQI GONGSI DULI DONGSHI ZHIDU ZHI JIANTAO JI GAIJIN FANGAN (A REIVEW AND REFORM PROPOSAL FOR CURRENT INDEPENDENT DIRECTOR INSTITUTION OF TSE-LISTED AND OTC COMPANIES), TAIWAN STOCK EXCHANGE 49 (Oct. 13, 2009) (on file with the author) (hereinafter LIU, REFORM PROPOSAL OF INDEPENDENT DIRECTOR).

Table 19 Average Annual Compensation for Each Independent Director of TSE-listed Companies²⁸⁴

Unit: NT\$ (US\$)

Average Annual Compensation	2004	2005	2006	2007
Independent Director	612,000 (18,545)	801,000 (24,273)	923,000 (27,970)	1,173,000 (35,545)
Growth Rate	NA	30.88%	15.23%	27.09%
Non-Independent Director	NA	1,828,000 (55,394)	1,941,000 (58,818)	2,146,000 (65,030)
Growth Rate	NA	NA	6.18%	10.56%
Independent Director of Companies that Have Audit Committees	2,656,000 (80,485)	3,364,000 (101,939)	4,440,000 (134,545)	4,199,000 (127,242)
Growth Rate	NA	26.66%	31.99%	-5.43%

Source: Taiwan Stock Exchange.

On the other hand, the director compensation of Over-the-Counter (OTC) companies is substantially lower. The average compensation of independent directors of OTC companies is only NT\$353,000 (US\$10,696.97 or Euro 7,376.19), which is less than one-third of that of TSE-listed companies (Table 20). The obvious reason for the discrepancy is that OTC companies in general have much smaller capitalization than TSE-listed companies.²⁸⁵

²⁸⁴ *Id.* at 49.

²⁸⁵ *Id.* at 50.

Table 20 Average Annual Compensation for Each Independent Director of OTC

Companies²⁸⁶

Unit: NT\$ (US\$)

Average Annual Compensation	2004	2005	2006	2007
Independent Director	233,000 (7,060.60)	309,000 (9,363.64)	343,000 (10,393.94)	353,000 (10,696.97)
Growth Rate	NA	32.62%	11.00%	2.92%
Non-Independent Director	595,000 (18,030.30)	639,000 (19,363.63)	773,000 (23,424.24)	745,000 (22,575.76)
Growth Rate	NA	7.39%	20.97%	3.62%
Independent Director of Companies that Have Audit Committees	208,000 (6,303.03)	1,734,000 (52,545.46)	1,641,000 (49,727.27)	344,000 (10,424.24)
Growth Rate	NA	734.00%	-5.40%	-79.00%

Source: Taiwan Stock Exchange.

As reported, most independent directors in Taiwan receive relatively modest compensation. Some interviewees attribute their passivity in monitoring to lack of proper financial incentives.

The problem lies in compensation. Independent directors are paid only NT\$ 20,000 (US\$606.06 or Euro 417.14) to NT\$ 30,000 (US\$909.09 or Euro 625.70) per month. It's hard to expect them to spend substantial hours to review related party transactions. I've asked some of my friends who are also independent directors. They all told me that it's impossible because they don't have much time for that.²⁸⁷

Commentators propose that companies should consider paying more to

²⁸⁶ *Id.* at 49-50.

²⁸⁷ Interview No. 9 (Oct. 15, 2008), at 14.

independent directors in order to increase their monitoring incentives and to match the legal responsibilities they take.²⁸⁸ However, if an independent director were meant to be a weak institution under a concentrated ownership structure, would increased compensation alone enhance its oversight function? Furthermore, the current compensation level of independent directors is decided by each company and that reflects how companies value their directors. Those who receive lower compensation might be compensated less generously because they do not contribute much to the firm or the firm does not value their contribution. To persuade the firm to pay more, independent directors would have to demonstrate their value to the firm.

II. Complementarities, Transplant Effect, and Camouflage

Berkowitz, Pistor and Richard (2003) find that it is the readiness of domestic communities to a new legal device, rather than the legal family where the new legal device are from, that determines the success of legal transplant and in turn economic development.²⁸⁹ Countries that received foreign legal systems without similar

²⁸⁸ In Taiwan, the legal responsibility of independent directors is the same as that of non-independent directors. LIU, REFORM PROPOSAL OF INDEPENDENT DIRECTOR, *supra* note 283, at 50.

²⁸⁹ Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165 (2003).

predispositions are much more constrained in developing an effective legal system and thus suffer from the so-called “transplant effect.”²⁹⁰ Borrowing the legal institution of “independent directors” alone from the U.S. incurs various externalities on corporate governance in Taiwan.

Under traditional Taiwanese corporate law which originates from Japan, the board of directors is a managing board, instead of a monitoring board, and the oversight function is assigned to another internal institution, the statutory supervisor.²⁹¹ Hence, from the beginning, the board is not meant to play a monitoring role. The institutional design of board of directors and statutory supervisors complement each other. Complementarities could contribute to the path dependence of the corporate structure in a given country.²⁹²

In practice, the internal governance function of statutory supervisors in Taiwan is not efficient. The oversight function of statutory supervisors has long been undermined mainly because the statutory supervisors are also elected by the shareholders meeting, which is controlled by the controlling shareholders. The way supervisors are elected results in the dependence of supervisors to controlling

²⁹⁰ *Id.* at 168.

²⁹¹ GONG SI FA [Corporation Law] art. 202 (2009) (Taiwan).

²⁹² Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance* in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 69, 80 (JEFFREY N. GORDON & MARK J. ROE EDS., 2004).

shareholders, leading to the failure of internal governance.²⁹³

The long malfunctioning of local governance system provides an opportunity to transplant U.S.-style independent director and board committee systems to Taiwan. Nonetheless, the operation of U.S. board committee system also complements other existing local attributes, such as diffuse ownership structure and the deference of judicial review to the decisions of independent board committees.²⁹⁴ Without transplanting all remaining complementary institutions, it is no surprise to find that the new legal institution did not fully integrate into the existing system.²⁹⁵ Japan also experiences such transplant effect when introducing the board committee system.²⁹⁶

The friction between independent directors and existing local institutions is most apparent in companies who on the one hand, introduce the new institution, and on the other, preserve the existing institution of statutory supervisors. 37% of TSE-listed companies adopted such strategy.²⁹⁷ Both institutions are designed to serve the oversight function but with very different complementary institutions. Such regulatory reform strategy puts independent directors in a managing board without granting them

²⁹³ Huang, *supra* note 168, at 194.

²⁹⁴ Lin, *supra* note 11, at 904-12.

²⁹⁵ Gilson, *supra* note 177, at 339.

²⁹⁶ Gilson and Milhaupt, *supra* note 165, at 369-372.

²⁹⁷ As of November 2009, 289 TSE-listed companies have at least one independent director and only 26 companies established audit committee and abolished the institution of statutory supervisors. There are a total of 718 TSE-listed companies as of December 2008.

a platform (board committee) to exercise the tasks needed to oversee the board. Yet in the meantime, independent directors are assigned tasks that are of an oversight nature and are expected to serve as a voice for minority shareholders.²⁹⁸ On the other hand, the law still requires the pre-existing statutory supervisors to perform their oversight job. The failure of independent directors to oversee controlling shareholders as found by this Dissertation exemplifies the “transplant effect” coined by Berkowitz et al. (2003).

In addition, introducing a new legal device to a local environment without corresponding complementarities could contrarily cloud the true face of corporate governance. In Taiwan, all newly listed companies, public financial firms, and large listed firms are required by the law to have independent directors.²⁹⁹ However, although all independent directors meet the legal definition of “independence,” the true independence of most independent directors is highly dubious. Furthermore, Taiwanese courts have not established a practice of *ex post* judicial review of the “independence” of directors in board decisions that involves conflicts of interests. Hence, in some way, the new legal institution serves as a camouflage for bad corporate governance. Even some companies that do not honor corporate governance will strive

²⁹⁸ ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-3 (2006) (Taiwan).

²⁹⁹ Financial Supervisory Commission, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006.

to have independent directors on their board in order to mislead the public.

Universal ABIT scandal provides an example. The controlling shareholder of Universal ABIT, Yu-Tsun Lu, started tunneling corporate assets through hundreds of paper companies from 2002. In the same year, Mr. Lu graduated from the EMBA program of National Taiwan University and completed a master paper named “The Study of Implement Corporate Governance System in Taiwanese Enterprise” where he made a case study of his own company.³⁰⁰ After he graduated, he invited both of his advisors, who are famous business professors on corporate governance, to serve as independent director and statutory supervisor respectively. In the latter half of 2004, rumors about Mr. Lu’s involvement in tunneling Universal ABIT were widespread and one of his advisors resigned from the post of independent director in October 2004. The scandal erupted at the end of 2004 and Mr. Lu was charged with several crimes and sentenced to 20 years of imprisonment in May 2007.³⁰¹

Universal ABIT is an example of reverse selection. Companies with bad corporate governance retain independent directors to camouflage the truth. The investors would not know the true independence of directors merely from their resume.

³⁰⁰ http://etds.ncl.edu.tw/theabs/site/sh/detail_result.jsp.

³⁰¹ Sho-De Hu, *Sheng-Ji Bi An Fu Ze Ren Qiu Xing 20 Nang [Universal ABIT Scandal: CEO Was Indicted For 20 Years]*, LIBERTY TIMES, May 31, 2007, <http://shenyun.epochtimes.com/b5/7/5/31/n1727895.htm>.

Forcing companies to have independent directors is like forcing students to wear uniforms, where the uniforms make it harder for the teachers to identify one student from the other.³⁰²

In the case of Universal ABIT, at least one of the professors resigned right before the scandal was made public. Although we do not know for sure whether that professor had found something before resignation, in some way, the resignation sent out a signal to the market. We would imagine that the situation might be worse if the independent director is in fact beholden to the controlling shareholder.

Similar concerns were expressed towards the corporate board reform in Japan.

Gilson and Milhaupt (2005) write:

Thus, without the complement of exacting ex post judicial review, the new committee system--in tandem with the Code's expansive definition of outside director-- could actually become a potent new governance technology for stakeholder tunneling and managerial entrenchment.³⁰³

Therefore, the transplant effect not only affects the efficiency of the transplanted legal institution but also extends externalities on the whole society.

³⁰² Interview No. 31 (Nov. 5, 2009), at 9. ("I think in many ways, it's worse than when we didn't have any corporate governance concept. In the past, people have better ideas about what this organization is doing. Now you force everyone to put on the uniforms. In this way, people instead cannot see your true face.")

³⁰³ Gilson and Milhaupt, *supra* note 165, at 371.

III. Future Roadmap

To be sure, Taiwan needs more transparency and better enforcement of related regulations in conflicts of interest matters that would jeopardize the interests of minority shareholders. That includes a more detailed financial disclosure on RPTs and a call for public companies to revamp their internal procedures to prevent unfair dealing. How to structure the tasks of independent directors and statutory auditors in conflicts of interest matters is also an important issue for companies that have both legal institutions.

How to constrain a controlling shareholder is an essential concern in corporate governance.³⁰⁴ The legal institution of independent director or statutory auditor is only one of the measures that provide checks and balances. No matter in which form such balance schemes are designed, in the end, it is the people who participate in the scheme governing the results. No matter how many rules and regulations are in place, people can always find a way to circumvent them. Even with a majority of independent directors on the board, Enron executives still embezzled hundreds of

³⁰⁴ See Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633 (2007). See also Gilson, *Complicating the Controlling Shareholder Taxonomy*, *supra* note 16; Gilson and Gordon, *supra* note 40.

millions of dollars from the company.

The tone at the top has been viewed as the main driver of corporate ethical conduct.³⁰⁵ Corporate leaders set the tone and govern the corporate culture, which may eventually lead to the success or failure of the corporation. Enron's failure was partially attributed to the "push limits" culture set by Jeffrey Skilling, former CEO, by creating "an atmosphere of deliberately breaking the rules."³⁰⁶ WorldCom and HealthSouth both had a corrupt corporate culture set by the top executives emphasizing making the numbers rather than doing things right.³⁰⁷

The relationship between corporate leaders and corporate culture is even more salient in companies that have controlling shareholders. Gilson (2007) articulates the importance of controlling shareholders' reputation to business success and argues that family reputation helps controlling family shareholders succeed in the product market where commercial law is ineffective.³⁰⁸ In Taiwan, seven major families control almost 40% of the total assets of the top 100 groups.³⁰⁹ Each family business group bears a distinct reputation that is closely attached to the family leader. For example,

³⁰⁵ MARIANNE MOODY JENNINGS, *BUSINESS: ITS LEGAL, ETHICAL AND GLOBAL ENVIRONMENT* 64-65 (7th Ed. 2005).

³⁰⁶ Howard Rockness and Joanne Rockness, *Legislated Ethics: From Enron to Sarbanes-Oxley, the Impact on Corporate America*, 57 J. BUS. ETHICS 31, 38 (2005).

³⁰⁷ *Id.* at 39-40.

³⁰⁸ Gilson, *supra* note 304.

³⁰⁹ See *infra* text from footnote 108 to footnote 111.

Yung-Ching Wang, the family leader of the most profitable enterprise in Taiwan — Formosa Plastics Corporation, is characterized by industriousness, thrift, honesty, humbleness and great patience. The Formosa Plastics Group also bears the same reputation. On the other hand, You-Tseng Wang of the already bankrupted Rebar Group is well known for his good relation with politicians and his love affairs with movie stars and singers.

In addition to investors, independent directors also rely on the reputation of the controlling shareholders to judge a firm. The integrity of the corporate leaders is the most important factor independent directors in Taiwan take into account when considering joining the board.³¹⁰ In considering the ways to regulate RPTs and constrain controlling shareholders, an interviewee, who has also been the CEO of a large family-controlled bank in Taiwan, said,

It all depends on the management team or, in the case of Taiwan, the shareholder manager. What exactly is in their minds? If he does not intend to adhere to business ethics, no one could constrain him.³¹¹

What this interviewee saw from his practical experience is that as a CEO or an independent director, he was not able to stop tunneling by controlling shareholders.

³¹⁰ See *infra* text Chapter 5 I. D.

³¹¹ Interview No. 31 (Nov. 5, 2009), at 9.

The analysis of the *chaebol* in Korea presents similar results. Kim et al. (2005) find that group headquarters rather than independent director affects the compensation of group affiliated executives.³¹² The Korean *chaebol* structure might be beneficial in policing managers but there yet to have an effective regulatory measure to constrain controlling shareholders.³¹³ A market for corporate control may be a solution for policing controlling shareholders, as in the United States. Before that market has matured, the bottom line is to enhance awareness of conflicts of interest transactions and to promote business ethics in public corporations.

³¹² Juncheol Kim et al., *The Influence of Board Structure and Group Headquarter on Executive Compensation*, Korean Strategic Management Journal 21 (2005)

³¹³ Jeong Soe, *Who Will Control Frankenstein? The Korean Chaebol's Corporate Governance*, 14 CARDOZO J. INT'L & COMP. L. 21, 47-50 (2006).

CONCLUSION

“America’s boards of directors have, more often than not, failed to protect shareholders’ interests. In one respect, this was inevitable. We demand too much of corporate boards. They (the independent directors) are selected, compensated, and informed by those they are supposed to oversee.”

Robert Monks and Nell Minow in CORPORATE GOVERNANCE (2008).³¹⁴

One of the most important challenges to modern corporate governance is to constrain controlling shareholder from tunneling corporate resources at a cost to non-controlling shareholders. This Dissertation serves an initial attempt to empirically assess the extent to which independent directors in Taiwan constrain tunneling. RPTs have been proved by empirical studies as a major channel for tunneling. OECD has also stressed the challenge of abusive RPTs to Asian corporate governance.

Nevertheless, the results are daunting. RPTs among Taiwanese public companies are common but rarely monitored by the board. Interview results further confirm this finding. Overall, independent directors’ oversight on RPTs or tunneling is generally weak. In addition, most RPTs that are sent for board review are explicitly required by the law to do so. The law plays a decisive role in constraining RPTs. Self-

³¹⁴ MONKS AND MINOW, *supra* note 98, at 286.

regulation by firms of self-dealing transactions is rare.

As compared with the independent directors in the U.S., the participation of independent directors in Taiwan is relatively limited. The value of independent directors in reconciling conflicts of interest matters has not been recognized by Taiwanese public companies. The existence of statutory supervisors further weakens the monitoring function of independent directors. Furthermore, there exists tremendous information asymmetry between independent directors and controlling shareholders, in particular, the shareholder managers. The information needed to uncover abusive RPTs is among the hardest to obtain. To overcome information asymmetry, independent directors in Taiwan generally choose to join a board with which they are familiar. The interview results reveal that independent directors generally maintain close social relationships with the controlling shareholders. Thus, there is concern that bias arising from the social ties could hinder the independence of directors.

Finally, this Dissertation evaluates the effectiveness of legal transplantation of independent directors from a single board system to a dual board system. Transplantation is a long process where new legal measures grind against pre-existing local conditions. Taiwan is still in a transition period where one-third of listed

companies operate under a dual board system with independent directors on the board. Independent directors were put on an advising board for some monitoring tasks while there exists another institution, the statutory supervisor, still in charge of corporate oversight. In addition, without complementary judicial deference to the decisions of independent boards, the value of independent directors to the firm greatly diminished. All these existing local conditions present challenges to the new legal device and hinder the transplantation process.

APPENDIX A: EMPIRICAL STUDIES ON BOARD INDEPENDENCE AND FINANCIAL STATEMENT MISCONDUCTS

Study	Region	Sample	Performance Measure	Findings	Correlation
Beasley (1996)	U.S. (dispersed ownership, high level of legal protection)	75 pairs of firms, 1980-1991	Financial Statement Fraud (SEC enforcement actions & Wall Street Journal Index)	<ol style="list-style-type: none"> 1. Non-fraud firms have boards with significantly higher percentage of outside members than fraud firms. 2. No significant correlation between audit committee and financial statement fraud. 3. Other factors correlate with fraud: OD ownership (-), OD tenure (-), and number of outside directorships in other firms (+) 	√
Dechow et al. (1996)	U.S.	92 pairs of firms, 1982-1992	Financial Statement Fraud (SEC enforcement actions)	This study finds factors correlate with fraud are: board dominated by management (+), CEO serves as chairman (+), CEO is also the founder (+), the presence of an audit committee (-), presence of an outside blockholder (-).	√
Klein (2004)	U.S.	346 S&P 500 firms, 1992-1993	Abnormal Accruals	<ol style="list-style-type: none"> 1. Firms with boards and/or audit committees composed of less than a majority of independent directors are more likely to have larger abnormal accruals. 2. However, this study does not find an association between an all-independent audit committee and abnormal accruals. 3. Firms with boards that move from majority-independent to a minority-independent structures experience large increase in abnormal accruals in the year of the change. 	√

Study	Region	Sample	Performance Measure	Findings	Correlation
Park & shin (2004)	Canada (concentrated ownership, high level of legal protection)	202 firms, 1991-1997	Abnormal Accruals	<ol style="list-style-type: none"> 1. Outside directors, as a whole, do not reduce earnings management. 2. Directors from financial intermediaries reduce earnings management. 3. This paper does not find correlation between OD tenure and prevention of abnormal accruals. 	X
Uzun et al. (2004)	U.S.	133 pairs of firms, 1978-2001	Financial Statement Fraud (Wall Street Journal Index)	Percentages of outside and independent directors are lower for fraud companies than non-fraud companies.	√
Anderson et al. (2004)	U.S.	252 firms, 1993-1998	Cost of debt	<ol style="list-style-type: none"> 1. Board independence and board size are both associated with a lower cost of debt financing. 2. Fully independent audit committees are associated with a significantly lower cost of debt financing. 3. This study provides market-based evidence that boards and audit committees are important elements affecting the reliability of financial reports. 	√
Peasnell et al. (2005)	U.K.	559 firms, 1993-1996	Abnormal Accruals	<ol style="list-style-type: none"> 1. Firms with a higher proportion of outside directors are associated with less income-increasing earnings management when pre-managed earnings fall below either zero or last year's reported earnings. 2. This study finds no evidence on the correlation between the presence of audit committee and earnings management. 	√

Study	Region	Sample	Performance Measure	Findings	Correlation
Agrawal & Chadha (2005)	U.S.	159 pairs of firms, 2000-2001	Earnings Restatements	<ol style="list-style-type: none"> 1. This study finds no relation between the probability of restatement and board independence, audit committee independence or auditor conflicts. 2. However, this study finds that the probability of restatement is lower in companies whose boards or audit committees have an independent director with financial expertise; it is higher in companies in which the CEO belongs to the founding family. 	X
Helland & Sykuta (2005)	U.S.	692 pairs of observations, 1988-2000	Securities Fraud or Shareholder Litigation	<ol style="list-style-type: none"> 1. Boards with a higher proportion of inside directors and gray directors are more likely to be the target of shareholder litigation. 2. The results suggest that boards with higher insider concentration are less effective in monitoring management. 	√
Carcello et al. (2006)	U.S.	226 firms, 2003	Abnormal Accruals	<ol style="list-style-type: none"> 1. This study finds positive association between audit committee financial expertise and the reduction of earnings management. 2. More importantly, this study further finds that alternative corporate governance mechanisms are an effective substitute for audit committee financial expertise in constraining earnings management. 	√
Chen et al. (2006)	China (concentrated ownership, low level of legal protection)	169 pairs of firms, 1999-2003	Financial Statement Fraud (CSRC enforcement actions)	<ol style="list-style-type: none"> 1. This study finds factors correlate with fraud are: proportion of outside directors (-), number of board meetings (+), chairman's tenure (-). 2. Ownership structure is less important than board characteristics in preventing fraud. 	√
Ahmed & Duellman (2007)	U.S.	306 firms, 1999-2001	Accounting Conservatism (may lead to reduction in agency cost)	<ol style="list-style-type: none"> 1. The percentage of inside directors is negatively related to conservatism. 2. The percentage of outside directors' shareholdings is positively related to conservatism. 	√

APPENDIX B: INTERVIEW PROTOCOL

Relationship with the firm

1. How did the firm contact you for the position of independent director? How did the firm hear about you?
2. How well do you know other directors, major shareholders or managers in the company before you become the independent director?

Power

3. What do you think is your responsibility as an independent director?
4. In addition to the power granted by law, do you negotiate additional monitoring power with the controlling shareholders or managers prior to your appointment? What's the content? Is the understanding included in the contract?

Altruism

5. What factors affect your decision in taking this position?
6. Who do you think you are responsible for as an independent director?
7. Does holding independent directorship benefit your own career in any way? Please provide an example.

Reputation

8. How many other directorships do you hold? (If no other directorship, then skip to No. 11)
9. How do these other companies hear about you?
10. What's the reason for you to take multiple directorships?

Equity Ownership

- 11. Can you describe your shareholding in the firm?
- 12. Did you increase your shareholding during your term?
- 13. What is the firm's attitude toward your shareholding?
- 14. Do you think shareholding is important for independent directors in performing their duty to monitor management? Please provide an example.

Board Meetings and Board Culture

- 15. How many board meetings were held during the past accounting year?
- 16. Among them, how many board meetings did you attend?
- 17. How would you describe the discussion during a board meeting? Who leads the discussion?
- 18. When was your last time communicating with other board members other than on board meetings?
- 19. How would you describe your relationship with other directors?
- 20. How would you describe the culture of the board meeting? Is it collegial or adversarial? Please provide an example.

Related Party Transactions

- 21. Who do you think should be responsible for scrutinizing and monitoring related party transactions? Please name one in the company and one outside the company.
- 22. When was the last time the board meeting approves the financial statement? Did the board discuss the related party transactions listed in the footnote during that meeting? (If yes, even answer no to No. 23, still go to No. 24)
- 23. Did the board ever review/approve any related party transaction during your term of service? (If no, go directly to No. 32)
- 24. What type of related party transactions were they?

25. What type of information (related to related party transactions) was provided to you before the meeting?
26. When was the information provided?
27. How much time did you spend on evaluating the information regarding related party transactions?
28. How would you describe the information provided to you, in terms of adequacy in evaluating the fairness of the related party transactions?
29. Did you ask the firm to provide further information about the subject related party transactions?
30. How did the firm respond to your request?
31. Can you talk about the difficulties in evaluating the fairness of related party transactions?
32. Related party transactions have been the most common vehicle for controlling shareholders to siphon out corporate assets, do you think that requiring all related party transactions to be approved by the board in advance is a good policy? Why?

APPENDIX C: STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 6: DISCLOSURE OF RELATED PARTY TRANSACTIONS

(EXCERPT)

1. This statement governs the financial accounting disclosure standards for related party transactions.
2. For any business entity and individual party, if one side has a control power over or has significant influence on the other side in terms of operating or financing decisions, the two parties will be construed as related parties. Business entities that are controlled by the same person or company will also be deemed as related parties. Any entity or individual falls within the following categories will be considered as a related party of a corporation (but not including the one who is proven to have no control power or significant influence):
 - (a) The target company invested by the corporation under the assessment of equity method
 - (b) The investor who invest in the corporation under the assessment of equity method.
 - (c) A corporation whose chairman or general manager also serves as the chairman or general manager of the corporation, or a corporation whose chairman or general manager is the spouse or second-degree relatives of the chairman or general manager of the corporation.
 - (d) A nonprofit organization who receives donation from the corporation and the amount of the donation exceeds one third of the nonprofit's paid-in capital.
 - (e) The corporation's directors, supervisors, general managers, deputy general managers, assistant managers, and section chief directly reporting to the general managers.
 - (f) The spouse of the corporation's directors, supervisors, and general managers.
 - (g) The second-degree relatives of the corporation's chairman or general managers.When determining whether a party is a "related party" defined by Statement No. 6, we should consider the substantive relationship between the parties in addition to the legal formality.
3. A related party transaction is defined as the transfer of resources or duties among related parties, no matter whether there

is a fund transfer or not.

4. During every accounting period, if there are material transactions between the corporation and related parties, the corporation should disclose the following information in the footnotes of the financial statements:

- (a) Name of related party
- (b) Relationship with the related party
- (c) Information regarding significant transactions with each related party, such as price and payment term, and other information which helps investors understand the impact of related party transaction on financial statements, including
 - (1) Amount or percentage of purchases of goods
 - (2) Amount or percentage of sales of goods
 - (3) Amount of property trading and the gains or losses generated
 - (4) Period-end balance or percentage of bills or account receivables
 - (5) Period-end balance or percentage of bills or account payables
 - (6) The highest outstanding balance, interest rate range, period-end outstanding balance, and accrued interest payment in the period of financing activities
 - (7) Period-end outstanding balance of CP endorsement, guarantees, or collateral provided
 - (8) Other significant matters which have major impact on profits, losses and financial conditions, such as significant agency issues, giving or receiving labor service, leasing, charter granting, transfer of research plan, and service or management contract.

APPENDIX D: SELECTED ARTICLES

GONG SI FA [Corporation Law]

Article 27 § I & II

[I] Where a government agency or a juristic person acts as a shareholder of a company, it may be elected as a director or statutory supervisor of the company provided that it shall designate a natural person as its proxy to exercise, on its behalf, the duties of a director or statutory supervisor.

[II] Where a government agency or a juristic person acts as a shareholder of a company, its authorized representative may also be elected as a director or statutory supervisor of the company; and if there is a plural number of such authorized representatives, each of them may be so elected.

Article 167 § III & IV

[III] Where a majority of the total number of outstanding voting shares or of the total amount of the capital stock of a subordinate company are held by its holding company, the shares of the holding company shall not be purchased nor be accepted as a security in pledge by the said subordinate company.

[IV] Where the holding company and its subordinate company as referred to in the preceding Paragraph 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.”

Article 179

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 in accordance with the laws;

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(ies) 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(ies) directly or indirectly represents more than one half of the total number of voting shares or the total share equity of such a company.

Article 202

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 shareholders' meeting as required by this Act or the Articles of Incorporation of the company.

Article 206 § I

Unless otherwise provided for in this Act, resolutions of the Board of Directors shall be adopted by a majority of the directors at a meeting attended by a majority of the directors.

Article 218 § I

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.

Article 223

In case a director of a company transacts a 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.

Article 14- 2

A company that has issued stock in accordance with this Act may appoint independent directors in accordance with its articles of incorporation. The Competent Authority, however, shall as necessary in view of the company's scale, shareholder structure, type of operations, and other essential factors, require it to appoint independent directors, not less than two in number and not less than one-fifth of the total number of directors.

Independent directors shall possess professional knowledge and there shall be restrictions on their shareholdings and the positions they may concurrently hold. They shall maintain independence within the scope of their directorial duties, and may not have any direct or indirect interest in the company. Regulations governing the professional qualifications, restrictions on shareholdings and concurrent positions held, assessment of independence, method of nomination, and other matters for compliance with respect to independent directors shall be prescribed by the Competent Authority.

Given any of the following circumstances, a person may not act as an independent director, or if already acting in such capacity, shall be dismissed:

1. Any circumstance set out in a subparagraph of Article 30 of the Company Act.
2. The director is a government agency, juristic person, or representative thereof, and was elected in accordance with Article 27 of the Company Act.
3. The person fails to meet the qualifications for independent director set forth in the preceding paragraph.

Transfer of an independent director's shareholdings is not subject to the provisions of the latter part of paragraph 1 or of paragraph 3, Article 197, of the Company Act.

When an independent director is dismissed for any reason, resulting in a number of directors lower than that required under paragraph 1 or the company's articles of incorporation, a by-election for independent director shall be held at the next following shareholders meeting. When all independent directors have been dismissed, the company shall convene a special shareholders meeting to hold a by-election within 60 days from the date on which the situation arose.

Article 14- 3

When a company has selected independent directors as set forth in paragraph 1 of the preceding article, then the following matters shall be submitted to the board of directors for approval by resolution unless approval has been obtained from the Competent Authority; when an independent director has a dissenting opinion or qualified opinion, it shall be noted in the minutes of the directors meeting:

1. Adoption or amendment of an internal control system pursuant to Article 14-1.
2. Adoption or amendment, pursuant to Article 36-1, 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 interest 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 so required by the Competent Authority.

Article 14- 4

A company that has issued stock in accordance with this Act shall establish either an audit committee or a supervisor. The Competent Authority may, however, in view of the company's scale, type of operations, or other essential considerations, order it to establish an audit committee in lieu of a supervisor; the relevant regulations shall be prescribed by the Competent Authority.

The audit committee shall be composed of the entire number of independent directors. It shall not be fewer than three persons in number, one of whom shall be convener, and at least one of whom shall have accounting or financial expertise. For a company that has established an audit committee, the provisions regarding supervisors in this Act, the Company Act, and other laws and regulations shall apply mutatis mutandis to the audit committee.

The following provisions of the Company Act shall apply mutatis mutandis with regard to independent directors who are members of the audit committee: Article 200; Articles 213 - 215; Article 216, paragraphs 1, 3, and 4; Article 218, paragraphs 1 and 2; Article 218-1; Article 218-2, paragraph 2; Article 220; Articles 223 - 226; the proviso of Article 227; and Article 245, paragraph 2.

Regulations governing exercise by the audit committee and its independent director members of the powers set out in the preceding two paragraphs, and matters related thereto, shall be prescribed by the Competent Authority.

A resolution of the audit committee shall have the concurrence of one-half or more of all members.

Article 14- 5

For a company that has issued stock in accordance with this Act and established an audit committee, the provisions of Article 14-3 shall not apply to the following matters, which 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:

1. Adoption or amendment of an internal control system pursuant to Article 14-1.
2. Assessment of the effectiveness of the internal control system.
3. Adoption or amendment, pursuant to Article 36-1, 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 interest 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 so required by the company or the Competent Authority.

With the exception of subparagraph 10, 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.

A company that has established an audit committee is not subject to the provisions of Article 36-1 requiring that its financial reports be recognized by a supervisor.

"All audit committee members" as used in paragraph 1 and the preceding article's paragraph 6, and "all directors" as used in paragraph 2, shall mean the actual number of persons currently holding those positions.

Article 26-3

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 the Company Act 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.

JING JUNG KONG GU GONG SI FA [Financial Holding Company Act]

Article 45

When a Financial Holding Company or its Subsidiary(ies) engages in transactions other than credit extension with the following persons, the terms of such transactions shall not be more favorable than offered to similarly situated customers, and such transactions require the concurrence of at least three-quarters of all of such Financial Holding Company's or Subsidiary(ies)'s directors present at a board of directors meeting attended by at least two-thirds of the directors:

- 1.A responsible person and Major Shareholder of the Financial Holding Company;
- 2.An enterprise solely invested in by or a partnership invested in by a responsible person or Major Shareholder of the Financial Holding Company or an organization in which such responsible person or Major Shareholders concurrently acts as the responsible person or representative;
- 3.An Affiliate and its responsible person and Major Shareholder of the Financial Holding Company; or
- 4.The Financial Holding Company's Bank Subsidiary, Insurance Subsidiary, Securities Subsidiary, and any such Subsidiary's responsible persons.

Transactions other than credit extension mentioned in the preceding paragraph shall consist of the following:

- 1.Investment in or purchase of securities issued by any of the persons mentioned in the preceding paragraph;
- 2.Purchase of real estate or other assets from any of the persons mentioned in the preceding paragraph;
- 3.Sale of securities, real estate or other assets to any of the persons mentioned in the preceding paragraph;
- 4.Entering into agreements regarding payment of money or provision of services with any of the persons mentioned in the preceding paragraph;
- 5.[Arrangements involving] any of the persons mentioned in the preceding paragraph acting as an agent or broker of a Financial Holding Company or its Subsidiary(ies) or providing other services which charge commission or fees; and
- 6.Engaging in transactions with third parties having a relationship with any of the persons mentioned in the preceding paragraph or engaging in transactions with third parties in which transaction, persons mentioned in the preceding paragraph are involved.

The securities mentioned in Subparagraphs 1 and 3 of the preceding paragraph shall not include negotiable certificates of deposits issued by a Bank Subsidiary. When a Financial Holding Company's Bank Subsidiary engages in the transactions described in Paragraph 2 with any of the persons mentioned in Paragraph 1, the amount of such transactions with any single related person shall not exceed ten percent (10%) of all the net worth of the Bank Subsidiary, and the aggregate amount of transactions with all related persons shall not exceed twenty percent (20%) of the net worth of the Bank Subsidiary.

REGULATIONS GOVERNING APPOINTMENT OF INDEPENDENT DIRECTORS AND COMPLIANCE MATTERS FOR PUBLIC COMPANIES (2006)

Article 1

These Regulations are adopted pursuant to Article 14-2, paragraph 2, of the Securities and Exchange Act (the "Act").

Article 2

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.

A person to whom any of the following circumstances applies may not serve as an independent director, or if already serving in such capacity, shall ipso facto be dismissed:

1. Any of the circumstances in the subparagraphs of Article 30 of the Company Act.

2. Elected in the capacity of the government, a juristic person, or a representative thereof, as provided in Article 27 of the Company Act.
3. Any violation of the independent director qualification requirements set out in these Regulations.

Article 3

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.
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.

The requirement of the preceding paragraph in relation to "during the two years before being elected" does not apply where an independent director of a public company has served as an independent director of the company or any of its affiliates, or of a specified company or institution that has a financial or business relationship with the company, as stated in

subparagraph 2 or 6 of the preceding paragraph, but is currently no longer in that position.

The term "specified company or institution" as used in paragraph 1, subparagraph 6, means a company or institution that has one of the following relationships with the company:

1. It holds 20 percent or more and no more than 50 percent of the total number of issued shares of the public company;
2. It holds shares, together with those held by any of its directors, supervisors, and shareholders holding more than 10 percent of the total number of shares, in an aggregate total of 30 percent or more of the total number of issued shares of the public company, and there is a record of financial or business transactions between it and the public company. The shareholdings of any of the aforesaid persons include the shares held by the spouse or any minor child of the person or by the person under others' names.
3. It, together with any of its affiliates, serves as a source of 30 percent or more of the operating revenue of the public company.
4. It, together with any of its affiliates, serves as a source of 50 percent or more of the total volume or total purchase amount of principal raw materials (those that account for 30 percent or more of total procurement costs, and are indispensable and key raw materials in product manufacturing) or principal products (those accounting for 30 percent or more of total operating revenue) of the public company.

For the purposes of paragraph 1 and the preceding paragraph, the terms "parent" and "affiliate" shall have the meaning given in Statement of Financial Accounting Standards Nos. 5 and 7 issued by the Accounting Research and Development Foundation of the Republic of China.

Article 4

No independent director of a public company may concurrently serve as an independent director of more than three other public companies.

Article 5

The election of independent directors at a public company is subject to the provisions of Article 192-1 of the Company Act in that a candidate nomination system shall be adopted, that such system shall be expressly stated in the articles of

incorporation of the company, and that shareholders shall elect independent directors from among the those listed in the slate of independent director candidates.

The public company shall, prior to the book closure date before the convening of the shareholders' meeting, publish a notice specifying a period for receiving nominations of independent director candidates, the number of independent directors to be elected, the place for receiving such nominations, and other necessary matters; the period for receiving nominations shall be not less than 10 days.

The public company may present a slate of independent director candidates nominated by the methods set out below, and, upon evaluation by the board of directors that all candidates so nominated are qualified independent director candidates, submit it to the shareholders' meeting for elections:

1. A shareholder holding one percent or more of the total number of issued shares may present a slate of independent director candidates in writing to the company; the number of nominees may not exceed the number of independent directors to be elected.
2. The board of directors presents a slate of independent director candidates; the number of nominees may not exceed the number of independent directors to be elected.
3. Otherwise as designated by the competent authority.

When providing a recommended slate of independent director candidates under the preceding paragraph, a shareholder or the board of directors shall include in the documentation attached thereto each nominee's name, educational background, work experience, a written undertaking indicating the nominee's consent to serve as an independent director if elected as such, a written statement that none of the circumstances in Article 30 of the Company Act exists, and other relevant documentary proof.

When calling a shareholders' meeting for the purpose of independent director elections, the board of directors, or other person having the authority to call a shareholders' meeting, shall review the qualifications of each independent director nominee; except under any of the following circumstances, all qualified nominees shall be included in the slate of independent director candidates:

1. Where the nominating shareholder submits the nomination at a time not within the published period for receiving nominations.

2. Where the shareholding of the nominating shareholder is less than one percent at the time of book closure by the company under Article 165, paragraph 2 or 3 of the Company Act.
3. Where the number of nominees exceeds the number of independent directors to be elected.
4. Where the relevant documentary proof required under the preceding paragraph is not attached.

The directors of the public company shall be elected in accordance with Article 198 of the Company Act, with independent and non-independent directors elected at the same time, but in separately calculated numbers. If the public company has established an audit committee under the Act, at least one of its independent directors is required to have accounting or financial expertise.

Article 6

If an independent director elected at a shareholders' meeting, or appointed by a financial holding company, the government, or a corporate shareholder under Article 7, is required to be dismissed during the term of office for reason of a violation of Article 2 or 3, it is prohibited to change the status of the person from independent director to non-independent director. A non-independent director elected at a shareholders' meeting, or appointed by a financial holding company, the government, or a corporate shareholder under Article 7, likewise may not be arbitrarily changed from a non-independent director to an independent director during the term of office.

Article 7

In the case of a subsidiary whose issued shares are held entirely by the parent financial holding company, or a public company constituted by the government or by one sole corporate shareholder, the independent directors of the company may be appointed by the financial holding company, government, or corporate shareholder, as the case may be, provided that such appointment shall be made in compliance with the provisions of these Regulations, excluding Article 5.

Article 8

Where a company that has created independent director positions under the Act has also created managing director positions on the board of directors, the managing directors shall include not less than one independent director member, and not less than one-fifth of the managing director seats shall be held by independent directors.

Article 9

A public company that has created independent director positions under the Act is excused from application of the provisions hereof before the expiration of the term of office of the incumbent directors.

Article 10

These Regulations shall be enforced from 1 January 2007.

REGULATIONS GOVERNING ESTABLISHMENT OF INTERNAL CONTROL SYSTEMS BY PUBLIC COMPANIES (2009)

Article 4

A public company shall set out its internal control systems, including internal audit implementation rules, in writing, and have them passed by the board of directors. If any director expresses dissent, where stated in minutes or in a written statement, the public company shall submit the dissenting opinions to each supervisor together with the internal control systems approved by the board of directors; the same shall apply to any amendment thereto.

Where a public company has established the position of independent director, when it submits its internal control systems for discussion by the board of directors pursuant to the preceding paragraph, the board of directors shall take into full consideration each independent director's opinions; the independent directors' specific opinions of assent or dissent and the reasons for dissent shall be included in the minutes of the board of directors' meeting.

Article 8

In addition to control activities for different types of transaction cycles as set out in the preceding article, a public company shall include controls for the activities listed below in its internal control systems:

1. management of the use of seals.
2. management of the receipt and use of negotiable instruments.

3. management of the budget.
4. management of assets.
5. management of endorsements and guarantees.
6. management of liabilities, commitments, and contingencies.
7. implementation of authorization and deputy systems.
8. management of loans to others.
9. management of financial and non-financial information.
10. management of related party transactions.
11. management of the procedures for preparation of financial statements.
12. supervision and management of subsidiaries.
13. management of operation of board meetings.

The internal control system of a company whose stock is exchange-listed or traded over the counter shall also include measures to prevent insider trading.

Article 11

A public company shall establish an internal audit unit under the board of directors, and shall appoint qualified persons in an appropriate number as full-time internal auditors according to size, business condition, management needs, and other applicable laws and regulations.

A public company shall report any appointment or discharge of internal audit officers for passage by the board of directors, and shall report such information to the FSC for recordation via the Internet-based information system by the 10th day of the month next following passage by the board of directors.

The requirements for the qualified full-time internal auditors referred to in paragraph 1 shall be as prescribed separately by the FSC.

Article 15

After having presented the audit and follow-up reports, a public company shall submit the same for review by the

supervisors by the end of the month next following the completion of the audit items.

A public company's internal auditors discovering any material violation or any likelihood of material damage to the company shall promptly prepare and present a report and notify the supervisors.

If a public company has independent directors or an audit committee, when complying with the preceding two paragraphs, it shall simultaneously submit the materials or notification to the independent directors or the audit committee.

REGULATIONS GOVERNING THE ACQUISITION AND DISPOSAL OF ASSETS BY PUBLIC COMPANIES (2007)

Article 13

A public company that acquires real property from a related party through purchase or swap shall ensure that the necessary resolutions are adopted the reasonableness of the transaction terms is appraised, and other relevant matters are carried out, in compliance with the provisions of the preceding Section and this Section.

When judging whether a trading counterparty is a related party, in addition to legal formalities, the substance of the relationship shall also be considered.

Article 14

A public company that intends to acquire real property from a related party may not proceed with the transaction until the following matters have been approved by the board of directors and recognized by the supervisors:

1. The purpose, necessity and anticipated benefit of the real property acquisition.
2. The reason for choosing the related party as a trading counterparty.
3. Information regarding appraisal of the reasonableness of the preliminary transaction terms in accordance with the provisions of Article 15 and Article 16.
4. The date and price at which the related party originally acquired the real property, the original trading counterparty, and that trading counterparty's relationship to the company and the related party.
5. Monthly cash flow forecasts for the year commencing from the anticipated month of signing of the contract, and

evaluation of the necessity of the transaction, and reasonableness of the funds utilization.

6. Restrictive covenants and other important stipulations associated with the transaction.

Where the position of independent director has been established in accordance with the provisions of the Act, when an acquisition of real property from a related party is submitted for discussion by the board of directors pursuant to the preceding paragraph, the board of directors shall take into full consideration each independent director's opinions. If an independent director objects to or expresses reservations about any matter, it shall be recorded in the minutes of the board of directors meeting.

Where an audit committee has been established in accordance with the provisions of the Act, the matters for which paragraph 1 requires recognition by the supervisors shall first be approved by more than half of all audit committee members and submitted to the board of directors for a resolution, and shall be subject to mutatis mutandis application of the provisions of Article 6, paragraphs 4 and 5.

Article 15

A public company that acquires real property from a related party shall evaluate the reasonableness of the transaction costs by the following means:

1. Based upon the related party's transaction price plus necessary interest on funding and the costs to be duly borne by the buyer. "Necessary interest on funding" is imputed as the weighted average interest rate on borrowing in the year the company purchases the property; provided, it may not be higher than the maximum non-financial industry lending rate announced by the Ministry of Finance.
2. Total loan value appraisal from a financial institution where the related party has previously created a mortgage on the property as security for a loan; provided, the actual cumulative amount loaned by the financial institution shall have been 70 percent or more of the financial institution's appraised loan value of the property and the period of the loan shall have been one year or more. However, this shall not apply where the financial institution is a related party of one of the trading counterparties.

Where land and structures thereupon are combined as a single property purchased in one transaction, the transaction costs for the land and the structures may be separately appraised in accordance with either of the means listed in the preceding

paragraph.

A public company that acquires real property from a related party and appraises the cost of the real property in accordance with the provisions of paragraph 1 and paragraph 2 shall also engage a CPA to check the appraisal and render a specific opinion.

Where a public company acquires real property from a related party and one of the following circumstances exists, the acquisition shall be conducted in accordance with the provisions of Article 14 and the provisions of the preceding three paragraphs do not apply:

1. The related party acquired the real property through inheritance or as a gift.
2. More than five years will have elapsed from the time the related party signed the contract to obtain the real property to the signing date for the current transaction.
3. The real property is acquired through signing of a joint development contract with the related party.

Article 16

When the results of a public company's appraisal conducted in accordance with the provisions of paragraph 1 and paragraph 2 of the preceding Article are uniformly lower than the transaction price, the matter shall be handled in compliance with the provisions of Article 17. However, where the following circumstances exist, objective evidence has been submitted and specific opinions on reasonableness have been obtained from a professional real property appraiser and a CPA have been obtained, this restriction shall not apply:

1. Where the related party acquired undeveloped land or leased land for development, it may submit proof of compliance with one of the following conditions:
 - (1) Where undeveloped land is appraised in accordance with the means in the preceding Article, and structures according to the related party's construction cost plus reasonable construction profit are valued in excess of the actual transaction price. The "Reasonable construction profit" shall be deemed the average gross operating profit margin of the related party's construction division over the most recent three years or the gross profit margin for the construction industry for the most recent period as announced by the Ministry of Finance, whichever is lower.
 - (2) Completed transactions by unrelated parties within the preceding year involving other floors of the same property or

neighboring or closely valued parcels of land, where the land area and transaction terms are similar after calculation of reasonable price discrepancies in floor or area land prices in accordance with standard property market practices.

(3) Completed leasing transactions by unrelated parties for other floors of the same property from within the preceding year, where the transaction terms are similar after calculation of reasonable price discrepancies among floors in accordance with standard property leasing market practices.

2. Where a public company acquiring real property from a related party provides evidence that the terms of the transaction are similar to the terms of transactions completed for the acquisition of neighboring or closely valued parcels of land of a similar size by unrelated parties within the preceding year.

Completed transactions for neighboring or closely valued parcels of land in the preceding paragraph in principle refers to parcels on the same or an adjacent block and within a distance of no more than 500 meters or parcels close in publicly announced current value; transaction for similarly sized parcels in principle refers to transactions completed by unrelated parties for parcels with a land area of no less than 50 percent of the property in the planned transaction; within one year refers to one year from the actual date of acquisition of the real property.

Article 17

Where a public company acquires real property from a related party and the results of appraisals conducted in accordance with the provisions of Article 15 and Article 16 are uniformly lower than the transaction price, the following steps shall be taken:

1. A special reserve shall be set aside in accordance with the provisions of Article 41, paragraph 1 of the Act against the difference between the real property transaction price and the appraised cost, and may not be distributed or used for capital increase or issuance of bonus shares. Where a public company uses the equity method to account for its investment in another company, then the special reserve called for under Article 41, paragraph of the Act shall be set aside pro rata in a proportion consistent with the share of public company's equity stake in the other company.

2. Supervisors shall comply with the provisions of Article 218 of the Company Act.

3. Actions taken pursuant to subparagraph 1 and subparagraph 2 shall be reported to a shareholders meeting, and the details of the transaction shall be disclosed in the annual report and any investment prospectus.

A public company that has set aside a special reserve under the preceding paragraph may not utilize the special reserve until it has recognized a loss on decline in market value of the assets it purchased at a premium, or they have been disposed of, or adequate compensation has been made, or the status quo ante has been restored, or there is other evidence confirming that there was nothing unreasonable about the transaction, and the FSC has given its consent.

When a public company obtains real property from a related party, it shall also comply with the provisions of the preceding two paragraphs if there is other evidence indicating that the acquisition was not an arms length transaction.

REGULATIONS GOVERNING LOANING OF FUNDS AND MAKING OF ENDORSEMENTS/GUARANTEES BY PUBLIC COMPANIES (2009)

Article 3

Under Article 15 of the Company Act, a public company shall not loan funds to any of its shareholders or any other person except under the following circumstances:

- (1) Where an inter-company or inter-firm business transaction calls for a loan arrangement; or
- (2) Where an inter-company or inter-firm short-term financing facility is necessary, provided that such financing amount shall not exceed 40 percent of the lender's net worth.

The term "short-term" as used in the preceding paragraph means one year, or where the company's operating cycle exceeds one year, one operating cycle.

The term "financing amount" as used in paragraph 1, sub-paragraph 2 of this Article means the cumulative balance of the public company's short-term financing.

The restriction in paragraph 1, subparagraph 2 shall not apply to inter-company loans of funds between foreign companies in which the public company holds, directly or indirectly, 100% of the voting shares.

Article 5

A public company may make endorsements/guarantees for the following companies:

1. A company with which it does business.

2. A company in which the public company directly and indirectly holds more than 50 percent of the voting shares.

3. A company that directly and indirectly holds more than 50 percent of the voting shares in the public company.

Companies in which the public company holds, directly or indirectly, 100% of the voting shares may make endorsements/guarantees for each other.

Where a public company fulfills its contractual obligations by providing mutual endorsements/guarantees for another company in the same industry or for joint builders for purposes of undertaking a construction project, or where all capital contributing shareholders make endorsements/ guarantees for their jointly invested company in proportion to their shareholding percentages, such endorsements/guarantees may be made free of the restriction of the preceding two paragraphs.

Capital contribution referred to in the preceding paragraph shall mean capital contribution directly by the public company, or through a company in which the public company holds 100% of the voting shares.

Article 8

A public company intending to loan funds to others shall formulate its Operational Procedures for Loaning Funds to Others in compliance with these Regulations, and, after passage by the board of directors, submit the Procedures to each supervisor and submit them for approval by the shareholders' meeting; where any director expresses dissent and it is contained in the minutes or a written statement, the company shall submit the dissenting opinion to each supervisor and for discussion by the shareholders' meeting. The same shall apply to any amendments to the Procedures.

Where a public company has established the position of independent director, when it submits its Operational Procedures for Loaning Funds to Others for discussion by the board of directors under the preceding paragraph, the board of directors shall take into full consideration each independent director's opinion; independent directors' opinions specifically expressing assent or dissent and their reasons for dissent shall be included in the minutes of the board of directors' meeting.

A public company without the intention of loaning funds to others may, after passage by the board of directors, be relieved from the obligation of formulating the Operational Procedures for Loaning Funds to Others. If such a company subsequently intends to loan funds to others, it shall still comply with the preceding two paragraphs.

Article 11

A public company intending to make endorsements or guarantees for others shall formulate its Operational Procedures for Endorsements/Guarantees in compliance with these Regulations, and, after passage by the board of directors, submit the same to each supervisor and for approval by the shareholders' meeting. Where there any director expresses dissent and it is contained in the minutes or a written statement, the company shall submit the dissenting opinions to each supervisor and for discussion by the shareholders' meeting. The same shall apply to any amendments to the Procedures.

Where a public company has established the position of independent director, when it submits the Operational Procedures for Endorsements/Guarantees for discussion by the board of directors pursuant to the preceding paragraph, the board of directors shall take into full consideration each independent director's opinions; the independent directors' opinions specifically expressing assent or dissent and the reasons for dissent shall be included in the minutes of the board of directors' meeting.

A public company without the intention of making endorsements or guarantees for others may, after passage by the board of directors, be relieved from the obligation of formulating the Operational Procedures for Endorsements/Guarantees. If such a company subsequently intends to make endorsements or guarantees, it shall still comply with the preceding two paragraphs.

Article 14

Before making a loan of funds to others, a public company shall carefully evaluate whether the loan is in compliance with these Regulations and the company's Operational Procedures for Loaning Funds to Others. The company may loan funds to others only after the evaluation results under this paragraph and Article 9, paragraph 6 have been submitted to and resolved upon by the board of directors. The company shall not empower any other person to make such decision.

Where a public company has established the position of independent director, when it loans funds to others, it shall take into full consideration each independent director's opinions; independent directors' opinions specifically expressing assent or dissent and their reasons for dissent shall be included in the minutes of the board of directors' meeting.

Article 17 Before making an endorsement/guarantee for others, a public company shall carefully evaluate whether the endorsement/guarantee is in compliance with these Regulations and the company's Operational Procedures for Endorsements/Guarantees for Others. The company may make an endorsement/guarantee only after the evaluation results under this paragraph and Article 12, paragraph 5 have been submitted to and resolved upon by the board of directors, or approved by the chairman of the board, where empowered by the board of directors under Article 12, paragraph 8 to grant endorsements/guarantees within a specific limit, for subsequent submission to and ratification by the next board of directors' meeting.

Where a public company has established the position of independent director, when it makes endorsements/guarantees for others, it shall take into full consideration each independent director's opinions; independent directors' opinions specifically expressing assent or dissent and their reasons for dissent shall be included in the minutes of the board of directors' meeting. A public company shall use the corporate chop registered with the Ministry of Economic Affairs as the dedicated chop for endorsements/guarantees. The chop shall be kept in the custody of a designated person approved by the board of directors and may be used to seal or issue negotiable instruments only in prescribed procedures.

When making a guarantee for a foreign company, a public company shall have the Guarantee Agreement signed by a person authorized by the board of directors.