

# Overseeing Controlling Shareholders: Do Independent Directors Constrain Tunneling in Taiwan?

YU-HSIN LIN\*

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\* Assistant Professor, College of Law, National Chengchi University (Taiwan). J.S.D., Stanford Law School. All translations in this article are my own, unless otherwise noted. The author is grateful for guidance and helpful comments from Ron Gilson. For insightful comments, thanks to Mike Klausner, Joe Grundfest, Rob Daines, Deborah Hensler, participants at the J.S.D. colloquium, and Corporate Governance Symposium at the University of Auckland Business School, New Zealand. To the Ministry of Education of Taiwan and the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University for financial support.

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*“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. Buffett<sup>1</sup>

## I. INTRODUCTION

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, or “the transfer of resources out of a company to its controlling shareholder.”<sup>2</sup> 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.<sup>3</sup> The divergence between control rights and cash-flow rights makes the firm more prone to tunneling by controlling shareholders, thus hampering investors’ 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.

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1. WARREN E. BUFFETT, BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 17 (2003), 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*].

Both theoretical and empirical studies are devoted to understanding tunneling and the ways through which controlling shareholders extract private benefits at a cost to investors. Related party transactions (RPTs) are 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.<sup>4</sup> In consideration of the significant impact of abusive RPTs on corporate governance, the Organisation for Economic Co-operation and Development (OECD) in the *2008 Asian Roundtable on Corporate Governance* 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.<sup>5</sup>

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.<sup>6</sup> It is possible that laws affect the development of financial markets through constraint over tunneling.<sup>7</sup> Accounting treatment and disclosure requirement of self-dealing transactions are certainly the foundation of effective legal control over tunneling.<sup>8</sup> 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.<sup>9</sup>

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4. ORG. FOR ECON. CO-OPERATION & DEV., CORPORATE GOVERNANCE SERIES: GUIDE ON FIGHTING ABUSIVE RELATED PARTY TRANSACTIONS IN ASIA 11–12 (2009), available at <http://www.oecd.org/daf/corporate/principles> [hereinafter OECD RPT Guide].

5. ORG. FOR ECON. CO-OPERATION & DEV., THE 2008 ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, CONCLUSIONS AND KEY FINDINGS NOTE (2008), available at [http://www.oecd.org/document/39/0,3343,en\\_2649\\_34813\\_40144295\\_1\\_1\\_1\\_37439,00.html](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 Economics of Self-Dealing*, 88 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 Tex. Sch. of Law Law & Econ., Working Paper No. 117, 2008), 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.

This Article intends to explore the extent to which independent directors constrain tunneling by controlling shareholders in Taiwan. Taiwan serves as an appropriate jurisdiction for research since the 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, which adds to the complexity in analyzing the effectiveness of independent directors in constraining tunneling activities.

Part II reviews relevant literature and lays the foundation for this paper. Part III details the methodology of this research study, mainly in-depth interviews. Part IV reviews the current state of corporate governance in Taiwan. Part V reports empirically the function of independent directors and their oversight of RPTs among sample Taiwanese public companies. Part VI analyzes the institutional constraints of independent directors in overseeing controlling shareholders and reviews the effect of legal transplantation. Finally, this paper concludes with a summary of findings in Part VII.

## II. INDEPENDENT DIRECTORS AS CORPORATE MONITORS

### *A. 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.<sup>10</sup> 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.<sup>11</sup> Following the Enron and Worldcom debacles, the law relied on independent directors even more in monitoring managerial irregularities.

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10. Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 311 (1983) (describing 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 . . .").

11. Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 904-12 (1996).

However, most public companies outside the United States and United Kingdom are not widely held, but are controlled by families or the state.<sup>12</sup> While the presence of a controlling shareholder reduces managerial agency problem, it suffers from private benefits agency problems where controlling shareholders extract private benefits at a cost to minority shareholders.<sup>13</sup> 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.<sup>14</sup>

Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) use the term “tunneling” to refer to the extraction of private benefits by controlling shareholders.<sup>15</sup> 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.<sup>16</sup> Mirroring the role of independent directors in widely held shareholder systems, this paper explores the extent to which independent directors, as a legal institution, reduce the private benefits agency costs in controlling shareholder systems.

## B. Independent Directors and Private Benefits Agency Problem

### 1. 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. La Porta, Lopez-de-Silanes, and Shleifer (1999) found that, except in economies with very good shareholder protection, most corporations around the world are

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

13. Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785–86 (2003).

14. This is the trade-off between discretion and accountability in corporate governance. See Alessio M. Paccos, *Controlling the Corporate Controller's Misbehaviour* 8–11 (Rotterdam Inst. of Law & Econ., Working Paper Series No. 2009/01, 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 & 1673–78 (2006).

controlled by families or the state.<sup>17</sup> 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.<sup>18</sup> Studies on regions in East Asia and Western Europe present similar results.<sup>19</sup>

In East Asia, concentration of ownership in public companies is especially 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.<sup>20</sup> Corporate control in East Asian countries is typically enhanced by pyramid structures and cross-holding among firms.<sup>21</sup> 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).<sup>22</sup> Further, family control and CMS characterize Taiwan’s public firms: Yeh and Woidtke (2005) found that 72% of Taiwanese public firms had a controlling shareholder and that, among them, 83% were controlled by a family.<sup>23</sup> In addition, there was considerable divergence between cash-flow rights and control rights in over 75% of the firms that have controlling shareholders, meaning approximately 54% of Taiwanese public companies are CMS firms.<sup>24</sup>

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

18. *Id.*

19. 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 & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 366 (2002).

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

21. 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; Claessens et al., *supra* note 20, at 93.

22. 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).

23. Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment? Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1874 (2005). Cf. Using the same 20% cut-off point, Yeh, Lee, & Woidtke (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 Woidtke, *Family Control and Corporate Governance: Evidence from Taiwan*, 2 INT’L REV. FIN. 21, 31 (2001); Claessens et al., *supra* note 20.

24. Yeh & Woidtke, *supra* note 23, at 1872.

## 2. Private Benefits Agency Problem (Tunneling)

Both dispersed-ownership structures and controlled-ownership structures suffer from less serious agency problems than CMS because CMS lacks the major mechanisms that limit agency costs in other ownership structures.<sup>25</sup> 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.<sup>26</sup> 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.<sup>27</sup>

Two major agency problems afflict CMS: (1) divergence-of-interests agency problems and (2) entrenchment agency problems.<sup>28</sup> The first type of agency problem 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).<sup>29</sup> The second type of agency problem stems from the fact that 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 these two types of agency problems simultaneously. The combination of the two agency problems provides controllers of CMS firms not only the

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25. 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 785–86.

26. Bebchuk et al., *supra* note 22, at 301; Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 677 (2005).

27. Bebchuk et al., *supra* note 22, at 301.

28. Morck et al., *supra* note 26, at 676–79.

29. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Management Behavior, Agency costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

incentives, but also the power to extract private benefits at the cost of minority shareholders—tunneling. Tunneling is a common type of corporate fraud in CMS-dominated economies, and it is apparent that Taiwan has this kind of economy.

Bebchuk, Kraakman, and Triantis (2000) further show that, in CMS contexts, the 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.<sup>30</sup> 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.<sup>31</sup> 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 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.<sup>32</sup>

Alternative corporate governance measures may help to mitigate the agency costs imbedded in CMS.<sup>33</sup> However, alternative measures, such as a market for corporate control and the presence of outside blockholders, are generally weak and cannot be implemented in Taiwan as long as one shareholder or 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.

### *3. Related Party Transaction as a Proxy for Tunneling*

To see whether board independence helps tackle tunneling, we need to first determine the ways through which tunneling occurs. Recent empirical research studies have identified related party transactions as a major channel for tunneling. Cheung, Qi, Rau, and Strouraitis (2009)

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30. Bebchuk et al., *supra* note 22, at 301–03.

31. See 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).

32. See 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 (2008).

33. Bebchuk et al., *supra* note 22, at 306.



examine asset transfer transactions between related parties in Hong Kong and finds that the prices of RPTs are unfavorable when compared to other 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.<sup>34</sup>

The minority shareholders of listed firms in China also suffer from tunneling through loans to the controlling shareholders and their affiliates. Jiang, Lee, & Yue (2008) examine the financial data of 1,377 public companies in China from 1996 to 2004 and discover that “tens of billions of RMB were siphoned from hundreds of Chinese publicly listed companies” through inter-corporate loans.<sup>35</sup> 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.<sup>36</sup>

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 spent several sessions since 2007 discussing the appropriate regulatory policy towards RPTs<sup>37</sup> and formed a special task force in 2008 to develop a practical guide to monitoring abusive RPTs.<sup>38</sup> The guide, published in September 2009, identifies abusive RPTs as “one of the biggest corporate governance challenges facing the Asian business landscape.”<sup>39</sup>

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34. Yan-Leung Cheung, Yuehua Qi, P. Raghavendra Rau & Aris Stouraitis, *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*].

35. 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* (Stanford Graduate Sch. of Bus., Working Paper 2008), available at <http://ssrn.com/paper=1154314>.

36. Henk Berkman et al., *Expropriation Through Loan Guarantees to Related Parties: Evidence from China*, 33 J. BANKING FIN. 141 (2009).

37. See ORG. FOR ECON. CO-OPERATION & DEV., *ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE* (2007), available at [http://www.oecd.org/document/48/0,3343,en\\_2649\\_34813\\_39336752\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/48/0,3343,en_2649_34813_39336752_1_1_1_1,00.html).

38. See Org. for Econ. Co-operation & Dev., *Asian Roundtable on Corporate Governance* (2008), available at [http://www.oecd.org/document/39/0,3343,en\\_2649\\_34813\\_40144295\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/document/39/0,3343,en_2649_34813_40144295_1_1_1_37439,00.html).

39. See OECD RPT GUIDE, *supra* note 4, at 9.

#### 4. Empirical Evidence

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 twenty-two-country study, Dahya, Dimitrov, and McConnell (2008)<sup>40</sup> found that a higher proportion of independent directors is associated with a lower likelihood of RPTs. 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) reported that better-governed firms enjoy higher market value; however, when trying to sort out possible sources for such correlation, they found that better-governed firms are not more profitable. Rather, they found 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 or that better-governed firms will suffer less tunneling—or both.<sup>41</sup>

Furthermore, they return to the overall governance index and try to find the predictive power of each subindex and find 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 is historically a serious problem in South Korea. Black and Kim (2008) continued with the Black, Jang, and Kim (2006) study and used 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.<sup>42</sup> In addition, several years

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40. 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).

41. Bernard Black, Hasung Jang & Woochan Kim, *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J.L. ECON. & ORG. 366, 369–70 (2006).

42. Bernard Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data* (Univ. of Tex. Sch. of Law & Econ., Working Paper No. 89, 2008), available at <http://ssrn.com/abstract=968287>.

after the reforms, large firms' profitability rose and the firms' asset sales to related parties declined. However, they did not find evidence on other types of RPTs.

Cheung, Qi, Rau, and Stouraitis (2009) directly examined the effect of board independence and the presence of audit committee on the transfer price of related-party asset transfer transactions. They found that the presence of an audit committee is the only corporate 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.<sup>43</sup> 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) examined the effect of corporate governance mechanisms on operational tunneling based on data of listed firms in China from 1998 to 2002. They determined the extent of tunneling by the difference between accounts receivables and payables that are based on RPTs and found that outsiders in the boardroom prevent operational tunneling.<sup>44</sup>

Though most of the empirical studies find correlations between board independence and tunneling, 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, these studies suffer from potential endogeneity problems because board structures are usually voluntarily chosen and are endogenous to other firm characteristics.<sup>45</sup> It may be that "good" firms, meaning those without tunneling, choose to have more outside directors on the board, or the results may just be a reflection of

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43. 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 34, at 921–22.

44. Lei Gao & Gerhard Kling, *Corporate Governance and Tunneling: Empirical Evidence from China*, 16 PAC. BASIN FIN. J. 591, 600–01 (2008).

45. 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, 14–17 (2003); Renee B. Adams, Benjamin E. Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey* 1–2 (Fisher C. Bus., Working Paper No. 2008-03-020, 2009), available at [www.ssrn.com/abstract=1299212](http://www.ssrn.com/abstract=1299212).

self-selection.<sup>46</sup> 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 are 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.<sup>47</sup> Before researchers develop better identification strategies to address this problem, analytical statisticians would find it difficult to establish a causal relationship between board independence and tunneling. To fill in the gap, this paper tackles the issue based on qualitative methods and interviews independent directors to understand their practical experience in monitoring RPTs.

### III. METHODOLOGY

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.*

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 (MOPS), a platform maintained by the Taiwan Stock Exchange that allows public companies to post relevant corporate information required by the law.<sup>48</sup> However, corporate directors in general are difficult to reach. In addition, the topic of RPTs is business sensitive. Therefore,

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46. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1532 (2005).

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

48. TAIWAN STOCK EXCH., MARKET OBSERVATION POST SYSTEM, <http://newmops.tse.com.tw> (last visited Feb. 13, 2011); Venessa Yeh, *Information Openness from a Governance Perspective*, PWC TAIWAN, <http://www.pwc.com/tw/en/challenges/corporate-governance/indissue0256.jhtml> (last visited Feb. 13, 2011).

the most practical sampling strategy for this research study is convenience sampling and snowball sampling.<sup>49</sup>

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.<sup>50</sup> The benefit of conducting semi-structured interviews, 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.<sup>51</sup> 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.<sup>52</sup> Information about corporate ownership, subsidiaries, affiliated companies, decisions of board meetings, corporate governance characteristics, and RPTs of sample firms was obtained from MOPS.

From September 2008 to December 2009, forty independent directors of Taiwanese public companies were interviewed for this study. Table 1 lists relevant information about the interviewees. Since the interviews explore the relationship between interviewees and controlling shareholders

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49. 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. However, social science research studies often examine situations where probability samples are not feasible; hence, researchers tend to rely instead on nonprobability sampling strategies. Nonprobability sampling tends to be the norm in social science qualitative research. Some of the commonly used nonprobability samples are convenience samples, purposive samples, snowball samples, and quota samples. 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. BRUCE L. BERG, *QUALITATIVE RESEARCH METHODS FOR THE SOCIAL SCIENCES* 48–52 (7th ed. 2009).

50. *Id.* at 107–09.

51. 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 & PATRICIA LEAVY, *THE PRACTICE OF QUALITATIVE RESEARCH* 125–26 (2006).

52. 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. 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).

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 interviews and the industries of the companies they served are also provided.

The average length of interviews is sixty-six minutes. On average, the interviewees 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 3% of the public companies in Taiwan have chosen the board committee system and established audit committees.<sup>53</sup> After deducting repetitive firms, a total of fifty-seven firms are represented by the interviewees. In addition, 57.5% of the interviewees serve on a single board, while 42.5% serve on multiple boards. Among those who serve on multiple boards, 82% serve on only two boards, and only three interviewees serve on more than three boards. (Table 1 and 2)

The occupations of the interviewees are quite diverse, including accountants, CEOs, law firm partners, university professors, venture capitalists, and former government officials of the 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, founders 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.

#### IV. CORPORATE GOVERNANCE IN TAIWAN

##### *A. An Overview*

The corporate environment in Taiwan greatly differs from that in the United States. In short, corporate ownership is concentrated and family-dominated.<sup>54</sup> 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 3). This

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53. As of March 2009, fifty-three out of 1776 public companies established audit committees. See *Taiwan's Listed Firms Capitalized at NT\$5 Billion to Have Auditors*, TAIWAN ECON. NEWS, Dec. 1, 2010, available at Westlaw 2010 WLNR 23871317.

54. Yeh, Lee & Woidtke, *supra* note 23, at 30–31.

TABLE 1 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

No.	DATE	INDUSTRY	EXPERIENCE (YRS)	ON MULTIPLE BOARDS	TOTAL NO. OF FIRMS	ON AUDIT COMMITTEE	LENGTH OF INTERVIEWS (MIN)
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



NO.	DATE	INDUSTRY	EXPERIENCE (YRS)	ON MULTIPLE BOARDS	TOTAL NO. OF FIRMS	ON AUDIT COMMITTEE	LENGTH OF INTERVIEWS (MIN)
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

discrepancy provides an incentive and opportunity for controlling shareholders to tunnel corporate assets at the expense of minority shareholders.<sup>55</sup>

TABLE 2  
NUMBER OF INTERVIEWEES ON MULTIPLE BOARDS

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

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.

TABLE 3  
COMPARISON OF BOARD COMPOSITION AND OWNERSHIP  
STRUCTURE BETWEEN FINANCIAL FIRMS AND  
NON-FINANCIAL FIRMS IN TAIWAN

	<b>Financial Firms</b>	<b>Non-Financial Firms</b>
<i><b>Panel A: Board Composition</b></i>		
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
<i><b>Panel B: Ownership Structure</b></i>		
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

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55. See text accompanying notes 25–33.

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], FIN. SUPERVISORY COMM'N OF TAIWAN Table 10-2 at 294–95 (January 2006).

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 the danger that minority shareholders could be expropriated. This is exactly the danger in Taiwan's corporate governance.<sup>56</sup>

Another characteristic of Taiwan's corporate ownership structure—business groups—further provides channels for expropriation.<sup>57</sup> Business groups control and contribute most to the economy of Taiwan: the top 100 business groups in Taiwan own more than 6,300 affiliated firms and hired more than 3 million employees in 2007, and the total revenue of the top 100 business groups is 7.8 times that of Taiwan's government in 2007.<sup>58</sup> Their revenue growth in 2007 of 16.01% also far exceeds that of the gross national product (GNP) of Taiwan.<sup>59</sup> Among the top ten

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56. See Yin-Hua Yeh & Chen-En Ko, *De Ri Mei Han Geguo Duli Dongshi, Shenji Weiyuan Hui ji Jita Zhuanmen Weiyuan Hui Fazhi Guifan ji Shiwu Yunzuo Qingkuang* [The Law and Practice of Independent Directors, Audit Committees and Other Functional Committees in Germany, Japan, U.S., and Korea], FIN. SUPERVISORY COMM'N TAIWAN 294–95 (2006); Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *Expropriation of Minority Shareholders in East Asia*, WORLD BANK 2, 13 (Feb. 23, 1999), available at <http://www1.worldbank.org/finance/assets/images/expropriation.pdf>.

57. TAIWAN SECURITIES & FUTURES INST., CORPORATE GOVERNANCE IN TAIWAN 5–6 (Oct. 2007).

58. Chailease Finance Co., Ltd., *Taiwan Dichu Dashing Chituan Chiye Yanjiu* [Research on Large Business Groups in Taiwan], NEWS CENTER, Oct. 16, 2008, available at [http://www.chailease.com.tw/ugC\\_NewsCenter\\_Detail1.asp?hidID=65&hidPage1=1&hidShoType=his](http://www.chailease.com.tw/ugC_NewsCenter_Detail1.asp?hidID=65&hidPage1=1&hidShoType=his).

59. 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

business groups, nine 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.<sup>60</sup>

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 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.<sup>61</sup> 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 director or statutory supervisor.<sup>62</sup> Hence, through cross-shareholding, controlling shareholders can literally appoint any people he or she wants to serve as directors and statutory supervisors and embezzle corporate resources without any internal oversight.

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2007], CENT. NEWS AGENCY, Oct. 16, 2008, *available at* <http://www.cna.com.tw/Search/News/doDetail.aspx?id=200810160059>.

60. 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.*

61. 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. Gong Si Jian Kong [Cross Shareholding v. 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).

62. GONG SI FA [Company Act] art. 27 (2009) (Taiwan), *available at* <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=J0080001>.

## B. Related Party Transactions in Taiwanese Firms

### 1. A Survey of Literature

Prior literature and 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.<sup>63</sup> 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.<sup>64</sup> 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 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.<sup>65</sup>

Some provide more direct evidence on tunneling, but all are based on data from emerging markets. For example, 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. Further, Bae et al. (2002) examine the stock market responses to merger announcements in Korea chaebols and find that the

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63. Bernard S. Black, Woochan Kim, Hasung Jang & Kyung-Suh Park, *How Corporate Governance Affects Firm Value: Evidence on Channels from Korea* 17–18 (Univ. of Tex. Sch. of Law, Working Paper No. 51, 2008), available at <http://ssrn.com/abstract=844744>.

64. Atanasov et al., *Unbundling Tunneling*, *supra* note 7, at 1–2.

65. See generally 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 31; Lins, *supra* note 31.

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.<sup>66</sup> In addition, Cheung et al. (2006) examines the stock market responses for the announcement of RPTs using data from Hong Kong and find that, on average, firms announcing RPTs with major shareholders or directors experience excess negative returns than those announcing similar arm's length transactions.<sup>67</sup> 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% of commercial loans and enjoy lower interests rates than arm's-length loans. Related loans are 33% more likely to default and have a much lower recovery rate.<sup>68</sup> 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 related parties receive a lower price compared to similar arms' length transactions.<sup>69</sup> 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.<sup>70</sup> The study suggests that the law might affect finance through regulating tunneling activities.

Although the efficiency and wealth transfer effect of RPTs cannot be determined unless the actual terms of specific transactions are available,

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66. See Kee-Hong Bae, Bae, Jun-Koo Kang & Jin-Mo Kim, *Tunneling or Value Added? Evidence From Merger by Korean Business Groups*, 57 J. FIN. 2695 (2002).

67. See Yan-Leung Cheung, P. Raghavendra Rau & Aris Stouraitis, *Tunneling, Propping, and Expropriation: Evidence From Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343 (2006). [hereinafter Cheung et al., *Hong Kong*].

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

69. Cheung et al., *Asset Transfer*, *supra* note 34.

70. Atanasov et al., *Unbundling Tunneling*, *supra* note 7, at 11–21.

growing literature shows that transactions among related parties are generally detrimental to the value of minority shareholders. The empirical research results warrant more serious policy discussions on the disclosure and approval policy of RPTs. However, the law in 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.<sup>71</sup> 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 paper.

## 2. Related Party Transactions in Sample Firms

There are a total of forty-one sample listed firms excluding financial firms. Among the forty-one sample firms, thirty-nine 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

Counterparties can be categorized into four major types—(1) controlling firms, (2) chairmen, (3) directors,<sup>72</sup> and (4) affiliated firms—and eleven sub-categories—(1) controlling firms, (2) firms affiliated with controlling firms, (3) chairman, (4) firms controlled by the chairman, (5) relatives of the chairman, (6) firms controlled by the relatives of the chairman, (7) individual directors, (8) firms affiliated with individual directors, (9) company directors, (10) firms affiliated with company directors, and finally, and (11) affiliated firms of the subject firm. A

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71. Statement of Fin. Accounting Standards No.6, § 4(c) (Fin. Accounting Standards Comm. Taiwan 1985), available at <http://www.ardf.org.tw/english/Full%20Text%20ac-2008/06.pdf>.

72. 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 GONG SI FA, *supra* note 62.

firm can only be counted once in each category as long as the firm enters into a 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 4 shows the result.

Approximately 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.<sup>73</sup> Second, the minority shareholders of the sample firm might as 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, 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.<sup>74</sup> Recent

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73. Cheung et al. (2006) and (2009) categorizes transactions between listed firms and its non-listed subsidiaries as potentially propping transactions. Cheung et al., *Hong Kong, supra* note 67, at 356; Yan-Leung Cheung, Lihua Jing, Tong Lu, Raghavendra Rau & Aris Stouraitis, *Tunneling and Propping Up: An Analysis of Related Party Transactions by Chinese Listed Companies*, 17 PAC. BASIN FIN. J. 372, 381 (2009) [hereinafter Cheung et al., *China*].

74. 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,



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.<sup>75</sup> However, not every aforementioned type of RPTs results in tunneling.

Friedman, Johnson, and Mitton (2003) acknowledges 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.<sup>76</sup> 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.<sup>77</sup>

Using multiple classification methods, Cheung, Rau, and Stouraitis (2006) pioneered efforts to categorize RPTs as tunneling or propping by examining the market-adjusted cumulative average abnormal returns (CARs) around the announcement day.<sup>78</sup> 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, and cash receipts and subsidiary relationships as propping are value-enhancing. However, only the value changes in 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.<sup>79</sup> Using the same technique, Cheung, Jing, Lu, Rau, and Stouraitis (2009) examined the valuation effect of 290 sample RPTs of Chinese listed companies during

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including any company in which the above hold a substantial shareholding. Cheung et al., *Hong Kong*, *supra* note 67, at 349, 355–56.

75. Berkman et al., *supra* note 36; Cheung et al., *Asset Transfer*, *supra* note 34; Jiang et al., *supra* note 35.

76. 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).

77. 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 36, at 141–42; Cheung et al., *Asset Transfer*, *supra* note 34, at 916–17; Jiang et al., *supra* note 35, at 13–15.

78. Cheung et al., *Hong Kong*, *supra* note 67.

79. *Id.* at 366–71.

2001 and 2002. Similar to the results of Cheung, Rau, and Stouraitis (2006), the Chinese study finds that asset acquisitions, asset swaps, trading relationships, and cash payments are value-destroying and cash receipts are value-enhancing.<sup>80</sup>

TABLE 4  
RELATED PARTY TRANSACTIONS—BY COUNTERPARTY

CONTROLLING FIRMS	NO. OF FIRMS
Controlling Firms	13
Firms Affiliated with the Controlling Firms	13
CHAIRMEN	
Chairman	6
Firms Controlled by the Chairman	11
Relatives of the Chairman	2
Firms Controlled by the Relatives of the Chairman	2
DIRECTORS	
Individual Directors	4
Firms Affiliated with Individual Directors	1
Company Directors	6
Firms Affiliated with Company Directors	5
AFFILIATED FIRMS*	
Affiliated Firms of the Subject Firm	22

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

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80. Cheung et al., *China*, *supra* note 73, at 385–87.

TABLE 5  
RELATED PARTY TRANSACTIONS—BY TRANSACTION TYPE

TRANSACTION TYPE	NO. OF FIRMS
Asset Acquisitions	5
Asset Sales	5
Equity Acquisitions	2
Equity Sales	3
Sale of Goods and Services	29
Purchase of Goods and Services	24
Loans and Guarantees	8
Rent Expenses	11
Cash Receipts	7
Others	14

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.<sup>81</sup> However, Cheung, Rau, and Stouraitis (2006) finds 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.<sup>82</sup>

Table 5 provides a classification of the RPTs of the sample firms by transaction types. Twenty-nine firms (70%) engage in sales of goods and services transactions with related parties, twenty-four (59%) engage in purchases transactions, eleven (27%) firms rent offices or warehouses from related parties, eight (20%) provide loans and guarantees (similar to cash payments in Cheung, Rau, and Stouraitis (2006)), five (12%) engage in asset transfer transactions, and twenty-two (54%) 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 6 and 7. The most common RPTs with controlling firms are trading relationships, rent

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81. RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 216–17 (2d ed. 1995).

82. Cheung et al., *Hong Kong*, *supra* note 67, at 375–79.

and asset acquisitions. Twenty-three firms (56%) sell goods to and thirteen firms (32%) purchase goods from controlling firms, nine firms (22%) rent offices or warehouses from controlling firms, and seven firms (17%) acquire assets from controlling firms. Since controlling firms have control power over sample firms, it is likely that the above transactions involve tunneling. Cheung, Rau, and Stouraitis (2006) and Cheung, Jing, Lu, Rau, and Stouraitis (2009) also found 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 or her controlled firms not only benefits from financing by the sample firms, but he or she also helps finance the sample firms by providing loans or guarantees if needed. The financing chairperson and the firms that the chairperson controls occur in two sample firms which 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 four samples firms serve as guarantors for bank loans of the sample firms. Interestingly, three 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 seven firms provide loans and guarantees to their affiliates, no sample firms receive cash or guarantees from affiliates. Six firms sell assets or equity to their subsidiaries or affiliated firms, which mirrors the results in asset acquisitions where seven 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.<sup>83</sup>

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, Rau, and Stouraitis (2006) and Cheung, Jing, Lu, Rau, and Stouraitis (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 no 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 warrant the participation of independent directors in the decision-making process.

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83. Cheung et al., *Asset Transfer*, *supra* note 34.

TABLE 6  
RELATED PARTY TRANSACTIONS—CROSS TABLE 1

	<b>Controlling Firm</b>	<b>Chairman</b>	<b>Directors</b>	<b>Affiliated Firms (not wholly-owned subsidiary) of Subject Firm</b>	<b>Total</b>
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
<b>Total</b>	<b>67</b>	<b>43</b>	<b>23</b>	<b>42</b>	

TABLE 7 RELATED PARTY TRANSACTIONS – CROSS TABLE 2 (DETAILED BREAKDOWN)										
	Asset Aquisitions	Asset Sales	Equity Acquisitions	Sale of Goods and Services	Purchase of Goods and Services	Loans and Guarantees	Rent Expenses	Cash Receipts	Other	<b>Total</b>
<b>Controlling Firms</b>										
Controlling Firm	4			11	4	1	8	2	6	<b>35</b>
Firms Affiliated with Controlling Firm	3	1	1	12	9	1	1	1	4	<b>32</b>
<b>Chairman</b>										
Chairman							1	5	1	<b>8</b>
Firms Controlled by the Chairman	1	3		8	7	2	2		3	<b>27</b>
Relatives of the Chairman							2			<b>2</b>
Firms Controlled by the Relatives of the Chairman				2	2			1	1	<b>6</b>

TABLE 7  
RELATED PARTY TRANSACTIONS – CROSS  
TABLE 2 (DETAILED BREAKDOWN) CON'T

<b>Individual Directors</b>										
Individual Directors			3				1	1		5
Firms Affiliated With Individual Directors				1	1					2
<b>Company Directors</b>										
Company Directors				4	1			1	2	8
Firms Affiliated with Company Directors				3	5					8
<b>Affiliated Firms (not wholly-owned Subsidiary) of Subject Firm</b>	2	4	2	12	9	7			6	42
<b>Total</b>	<b>10</b>	<b>8</b>	<b>3</b>	<b>53</b>	<b>38</b>	<b>11</b>	<b>15</b>	<b>13</b>	<b>42</b>	



The number in the column represents the number of sample firms that have 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 the Asset Acquisition/Controlling Firm column and one in the Sales of Goods and Services/Controlling Firm column.

### C. Corporate Board Reform

The corporate-board structure around the world has two major styles: (1) the Anglo-American style, and (2) the German style, also known as the “one-tier system” and the “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 style structure relies on a supervisory board to monitor the management board while the 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 positions in Japan and Taiwan are 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.<sup>84</sup> In addition, the statutory supervisors in Taiwan do not act collectively as a board like their German or Japanese counterpart, but rather act individually.<sup>85</sup> 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

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

85. 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.

performance of companies' boards of directors and managers.<sup>86</sup> 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."

In the aftermath of Enron and other high-profile corporate-fraud cases, the U.S. Congress, enacted the Sarbanes-Oxley Act of 2002 (SOX) which 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. Finally, in 2006, Congress revised the Securities and Exchange Act to give public companies the option to choose whether or not they have independent directors.<sup>87</sup> 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.<sup>88</sup> The amendment basically resembles the 2002 Japanese board reform, which also grants corporations the option to choose between the U.S. style board structure and traditional board structure.<sup>89</sup>

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. In March 2006, Taiwan's Financial Supervisory Commission (FSC) 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.<sup>90</sup> On March 22, 2011, the FSC further expanded the mandate to firms with

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86. GONG SI FA [Company Act] art. 218 (2009) (Taiwan) available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=J0080001>.

87. ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-2 (2010) (Taiwan), available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=G0400001>.

88. ZHENG QUAN JIAO YI FA art. 14-4.

89. Gilson & Milhaupt, *supra* note 84, at 352–54.

90. Financial Supervisory Commission, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006 (abolished on Mar. 22, 2011).

equity value over NT\$10 billion (US\$345 million).<sup>91</sup> As of March 2011, 41.79% of the Taiwan Stock Exchange (TSE) listed companies have at least one independent director on their board.<sup>92</sup>

Under current regulation, there are three types of board structures 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.

#### D. Board Reform in Japan and China

Japan and China also undertook similar corporate board reform. Japan adopted an enabling approach, which allows companies to choose between the U.S. board-governance system and the Japanese board-governance system.<sup>93</sup> 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 no clear strategy of adoption and no significant market reaction to the choice of adopting the unitary board structure. This 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 suggests that formal convergence may trigger an initial reduction in overall system productivity because the new form was perhaps not complementary with

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91. Financial Supervisory Commission, Jing-Kuan-Cheng-Fa-Tzu-1000010723-Hao, Mar. 22, 2011.

92. As of March 2011, 318 TSE-listed companies have at least one independent director. There are a total of 761 TSE-listed companies as of February 2011. TAIWAN STOCK EXCH., Statistics: Summary Data of Stock Market (by Year) [http://www.twse.com.tw/ch/statistics/statistics\\_list.php?tm=04&stm=004](http://www.twse.com.tw/ch/statistics/statistics_list.php?tm=04&stm=004); *Market Observation Post System*, TAIWAN STOCK EXCH., available at <http://mops.twse.com.tw/mops/web/t93sb05> (last visited May 5, 2011).

93. 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 84, at 358.

other existing institutions.<sup>94</sup> This study reminds us of the importance of local forces in the success of corporate-governance reform.<sup>95</sup>

Clarke (2006) is generally pessimistic about the effectiveness of independent directors' ability to police Chinese public companies.<sup>96</sup> 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) 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.<sup>97</sup>

## V. DO INDEPENDENT DIRECTORS PREVENT TUNNELING?

### A. *Who are Independent Directors?*

From where exactly do these independent directors come? This study classifies the occupation into ten 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: (1) corporate directors (29.03%), (2) professors (24.91%), and (3) managers (12.36%) (Table 8). In the United States, most independent directors are directors or CEOs of other public companies.<sup>98</sup> In Taiwan, corporate directors and CEOs account for 41.2% 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.

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

95. 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 84, at 372.

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

97. See Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 332 (1996); *id.* at 208–16.

98. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

TABLE 8  
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 categorized by the author. Source: Market Observation Post System, Taiwan Stock Exchange (October 2008).

One remarkable observation about the population of independent directors in 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 as experts 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.<sup>99</sup>

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

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99. Interview with Anonymous Independent Director No. 3 (Sept. 30, 2008) (on file with author), at 9.

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.<sup>100</sup>

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 or she is not a professor of finance or accounting, then he or she may not have enough knowledge to even understand financial statements, let alone discover fraudulent accounting practices.<sup>101</sup> An interviewee, who is a professor of engineering, admitted that:

Reviewing 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.<sup>102</sup>

One might reasonably infer, and the reality might well be, that different independent directors serve different functions. For instance, 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 industry and have significant business with government agencies.<sup>103</sup>

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100. Interview with Anonymous Independent Director No. 31 (Nov. 5, 2009) (on file with author), at 3.

101. 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 & 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>.

102. Interview with Anonymous Independent Director No. 22 (Feb. 25, 2009) (on file with author), at 5.

103. Yoshiro Miwa & J. Mark Ramseyer, *Who Appoints Them, What Do They Do? Evidence on Outside Directors From Japan*, 14 J. ECON. & MGMT. STRATEGY 299, 320–21 (2005).

*B. What Are Their Duties?*

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.<sup>104</sup> However, independent directors do not have veto rights to these decisions; they can only ask the board to keep their dissenting opinion on file. Further, 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 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 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.<sup>105</sup>

The law requires independent directors to review matters in which a director or statutory auditor bears a personal interests.<sup>106</sup> 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.

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104. ZHENG QUAN JIAO YI FA [Securities and Exchange Act] art. 14-3 (2010) (Taiwan), available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=G0400001>.

105. Interview with Anonymous Independent Director No. 25 (Mar. 1, 2009) (on file with author), at 3–4.

106. Zheng Quan Jiao Yi Fa art. 14-3(3).

### *C. 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.<sup>107</sup>

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 did not spend much time reviewing materials before the meeting. However, if attending the 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 materials,<sup>108</sup> sometimes it is because firms prefer not to provide all the detailed information outside the meeting for confidentiality reasons.<sup>109</sup> 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.<sup>110</sup> Although some with accounting backgrounds pay more attention to the internal control systems, most interviewees reveal that such a review is usually cursory and superficial. Some directors might not even have a clue how to review an internal audit report:

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107. Interview with Anonymous Independent Director No. 4 (Oct. 07, 2008) (on file with author), at 8.

108. See Interview with Anonymous Independent Director No. 29 (Oct. 21, 2009) (on file with author), at 10.

109. See Interview with Anonymous Independent Director No. 30 (Oct. 22, 2009) (on file with author), at 12.

110. GONG KAI FA HANG GONG SI JIAN LI NEI BU KONG ZHI ZHI DU CHU LI ZHUN ZE YING [Regulations Governing Establishment of Internal Control Systems by Public Companies] art. 15 (2009) (Taiwan), available at <http://eng.selaw.com.tw/FLAWDAT/0201.asp>.



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.<sup>111</sup>

In addition to directors’ individual abilities, the independence and ability of the 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. However, on December 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.<sup>112</sup> 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 RPTs, most independent director interviewees do not believe that internal auditors are able to be a check-and-balance to controlling shareholders.<sup>113</sup> 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 controlling shareholders.<sup>114</sup>

In sum, the participation of independent directors is generally limited to attending board meetings and reviewing monthly internal audit reports.

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111. Interview with Anonymous Independent Director No. 26 (Oct. 12, 2009) (on file with author), at 7–8.

112. Gong Kai Fa Hang Gong Si Jian Li Nei Bu Kong Zhi Zhi Du Chu Li Zhun Ze Ying art. 11.

113. See Interview with Anonymous Independent Director No. 26 (Oct. 12, 2009) (on file with author), at 12; Interview with Anonymous Independent Director No. 31 (Nov. 5, 2009) (on file with author), at 12.

114. See Interview with Anonymous Independent Director No. 31 (Nov. 5, 2009) (on file with author), at 12.

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.

#### *D. Empirical Evidence on Related Party Transaction Oversight*

From the analysis of RPTs in previous sections, 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.<sup>115</sup> Independent directors presumably fit this criterion and are considered to be 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 9).

In 2007, when excluding decisions on RPTs with wholly-owned subsidiaries, only nine boards of the sample firms (22%) ever reviewed and decided on RPTs. These decisions involved asset swaps, equity acquisitions, equity sales, and loans with related parties. Even among these nine firms, only very few disclosed RPTs were reviewed by the board. Apparently, trading relationships, renting relationships and cash receipts from related parties were never reviewed by the sample boards. Only a few firms submitted these RPTs for board review for asset transfer and loans.

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115. Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards* 37–38 (Harvard Law & Econ., Discussion Paper No. 633, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1374331](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1374331); Paces, *supra* note 14, at 44–49.

TABLE 9  
BOARD DECISIONS ON RELATED PARTY TRANSACTIONS

	NO. OF FIRMS
Report Decisions on RPTs	16
Decisions not Available	5
No Decision on RPTs	20
Report Decisions on RPTs (excluding decisions with regard to wholly-owned subsidiaries)	9

Interviews with independent directors further confirm this finding. Only fifteen out of forty interviewees have reviewed RPTs in board meetings. When asked about the types of RPTs they reviewed, ten recalled loans or 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 fifteen interviewees, nine 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.<sup>116</sup> Three of the remaining six interviewees who serve in non-financial firms only recalled reviewing loan or guarantee RPTs where the law also requires the boards' approval or ratification.<sup>117</sup> 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

116. JING JUNG KONG GU GONG SI FA [FINANCIAL HOLDING COMPANY ACT] art. 45 (2006) (Taiwan), available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=G0380112>.

117. See generally Regulations Governing Loaning of Funds and Making of Endorsements/Guarantees by Public Companies (2010) (Taiwan), available at <http://law.moj.gov.tw/pdaeng/NewsContent.aspx?msgid=5087>.

dominate shareholders to transfer out corporate assets.<sup>118</sup> 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 companies, they all have some kind of business transactions. So I'm not that clear about that.<sup>119</sup>

Indeed, the 2007 financial statement of this sample firm listed thirty-eight 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 [tunneling] problem.<sup>120</sup>

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 specific industry conditions. Furthermore, trading relationships with either controlling firms or affiliated firms involve conflicts of interests where independent directors should step in and

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118. Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMPANY & FIN. L. REV. 491, 495–96 (2007); Cheung et al., *China*, *supra* note 73, at 385–86.

119. Interview with Anonymous Independent Director No. 14 (Nov. 11, 2008) (on file with author), at 8.

120. Interview with Anonymous Independent Director No. 13 (Oct. 30, 2008) (on file with author), at 6.

make decisions for the best interests of the corporation.<sup>121</sup> Although independent directors may decide the level of monitoring based on industry conditions, their participation is still essential in ensuring the fairness of the transaction even if the product market is highly competitive and thus the risks of deviation from market price is relatively low.

## VI. 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.<sup>122</sup>

This interviewee tells us that when there is intentional fraud, there is nothing an independent director can do because of an 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? An interviewee, who involves deeply in the corporate board reform in Taiwan, shares the difficulties in "digging further:"

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121. Bebchuk & Hamdani, *supra* note 115, at 37.

122. Interview with Anonymous Independent Director No. 20 (Feb. 19, 2009) (on file with author), at 8.

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.<sup>123</sup>

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, then 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 unless independent directors have already obtained enough evidence about the fraud and made it public.

### *1. Related Party Transactions—The Hardest Part of All*

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.<sup>124</sup> With the complex ownership structure of Asian companies, it is usually hard to even identify “related parties” in the first place.<sup>125</sup>

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.<sup>126</sup>

When RPTs are disclosed, it is sometimes hard to decide whether the terms are fair or abusive if there is no market price for comparison.<sup>127</sup>

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123. The interviewee resigned after serving for less than a year as an independent director in a family conglomerate. Interview with Anonymous Independent Director No. 31 (Nov. 5, 2009) (on file with author), at 4.

124. ORG. FOR ECON. CO-OPERATION & DEV., 2007 ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, SYNTHESIS NOTE 6-7 (2007), available at [http://www.oecd.org/document/48/0,3343,en\\_2649\\_34813\\_39336752\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/48/0,3343,en_2649_34813_39336752_1_1_1_1,00.html) [hereinafter OECD 2007 ASIAN ROUNDTABLE].

125. *Id.* at 7.

126. Interview with Anonymous Independent Director No. 26 (Oct. 12, 2009) (on file with author), at 11.

127. OECD 2007 ASIAN ROUNDTABLE, *supra* note 124, at 7.

Even if the management provides a market price, it is still possible that the management would manipulate the information. For real estate or share purchase, we also need a well-developed appraisal industry to support the oversight needs. However, in many Asian countries, including Taiwan, a fair appraisal industry is still under development.<sup>128</sup>

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 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.<sup>129</sup>

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 RPT, but also consciously deleted Ho Hsin Company, one of the company's 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.<sup>130</sup> Of course, such collusion requires cooperation from internal legal and auditing departments. One interviewee admitted that he was once 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:

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128. "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 with Anonymous Independent Director No. 34 (Nov. 27, 2009) (on file with author), at 16.

129. Interview with Anonymous Independent Director No. 5 (Oct. 9, 2008) (on file with author), at 4.

130. Hsio-Ru Ma & 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, 41 (2007) [hereinafter Ma, Rebar Audit Failure].

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.<sup>131</sup>

## 2. *Passiveness*

In reality, independent directors in Taiwan are helpless in overseeing controlling shareholders, and are especially helpless in detecting unfair RPTs and fraud. The 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.<sup>132</sup>

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 the 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:

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131. Interview with Anonymous Independent Director No. 4 (Oct. 7, 2008) (on file with author), at 9.

132. Interview with Anonymous Independent Director No. 18 (Feb. 18, 2009) (on file with author), at 9. *See also* Interview with Anonymous Independent Director No. 19 (Feb. 19, 2009) (on file with author), 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."



To be frank, if the chairman wants to hide something, the independent directors will not know, right? After all, 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.<sup>133</sup>

Such helplessness and pessimism also shapes the way independent directors perceive themselves. Almost all of the interviewees regard themselves as corporate monitors and recognize that their major responsibility is to make sure board decisions comply with the law. However, it is surprising that only six of them view themselves as being the proper people to monitor RPTs. Others assign such tasks to other constituencies because they think that they are outsiders and believe that there is not enough 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, you have no choice but to leave.<sup>134</sup>

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

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133. Interview with Anonymous Independent Director No. 5 (Oct. 9, 2008) (on file with author), at 3, 5. *See also* Interview No. 3 (Sept. 30, 2008) (on file with author), 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.”).

134. Interview with Anonymous Independent Director No. 9 (Oct. 15, 2008) (on file with author), at 12.

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 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.<sup>135</sup>

### *B. 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 is from, that determines the success of legal transplant and in turn economic development.<sup>136</sup> Countries that receive foreign legal systems without similar predispositions are much more constrained in developing an effective legal system, and thus suffer from the so-called “transplant effect.”<sup>137</sup> Borrowing the legal institution of “independent directors” alone from the United States 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.<sup>138</sup> Hence, from the beginning, the board is not meant to play a monitoring role. The institutional design of the board of directors and statutory supervisors complement each other. Complementarities could contribute to the path dependence of the corporate structure in a given country.<sup>139</sup>

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

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135. Interview with Anonymous Independent Director No. 29 (Oct. 21, 2009) (on file with author), at 3.

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

137. *Id.* at 168.

138. GONG SI FA [COMPANY ACT] art. 202 (2009) (Taiwan), available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=J0080001>.

139. 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).

elected at the shareholders meeting, which is controlled by the controlling shareholders. The way supervisors are elected results in the dependence of supervisors to controlling shareholders, which leads to the failure of internal governance.<sup>140</sup>

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.<sup>141</sup> 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.<sup>142</sup> Japan also experiences such transplant effect when introducing the board committee system.<sup>143</sup>

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—37.06% of TSE-listed companies adopted such strategy.<sup>144</sup> 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 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

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140. 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, 194 (2000) (Opposing the introduction of independent directors and purporting to strengthen the independence and monitoring function of statutory supervisors).

141. See Lin, *supra* note 11, at 904–12.

142. Gilson, *supra* note 94, at 339.

143. Gilson & Milhaupt, *supra* note 84, at 369–72.

144. As of March 2011, 318 TSE-listed companies have at least one independent director and only thirty-six companies established audit committees and abolished the institution of statutory supervisors. There are a total of 761 TSE-listed companies as of March 2011. See *Summary Data of Stock Market*, TAIWAN STOCK EXCH., available at [http://www.twse.com.tw/ch/statistics/statistics\\_list.php?tm=04&stm=004](http://www.twse.com.tw/ch/statistics/statistics_list.php?tm=04&stm=004); *Market Observation Post System*, TAIWAN STOCK EXCH., available at <http://mops.twse.com.tw/mops/web/t93sb05> and <http://mops.twse.com.tw/mops/web/t135sb02> (last visited May 5, 2011).

minority shareholders.<sup>145</sup> However, 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 paper exemplifies the “transplant effect” coined by Berkowitz, Pistor, and Richard (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.<sup>146</sup> 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 involve 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 to have independent directors on their board in order to mislead the public.

Companies with bad corporate governance retain independent directors to camouflage the truth.<sup>147</sup> Investors could not know the true independence of directors merely from their resumes.<sup>148</sup> Similar concerns were expressed towards the corporate board reform in Japan. Gilson and Milhaupt (2005) write:

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145. ZHENG QUAN JIAO YI FA [SECURITIES AND EXCHANGE ACT] art. 14-3 (2010) (Taiwan), available at <http://law.moj.gov.tw/eng/LawClass/LawAll.aspx?PCode=G0400001>.

146. Financial Supervisory Commission, *supra* note 91.

147. The controlling shareholder of Universal ABIT, Yu-Tsun Lu, started tunneling corporate assets through hundreds of paper companies from 2002. In 2002, he invited advisors of his thesis for the executive master program, 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. 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, available at <http://shenyun.epochtimes.com/b5/7/5/31/n1727895.htm>.

148. Interview with Anonymous Independent Director No. 31 (Nov. 5, 2009) (on file with author), 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.”).

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.<sup>149</sup>

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

## VII. CONCLUSION

One of the most important challenges to modern corporate governance is to constrain controlling shareholders from tunneling corporate resources at a cost to non-controlling shareholders. This paper 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. Overall, independent directors' oversight on RPTs or tunneling is generally weak. In addition, most RPTs 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 participation of independent directors in Taiwan is 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 be sure, Taiwan's capital market needs more transparency and better enforcement of related regulations in conflicts of interest matters that jeopardize the interests of minority shareholders. This includes a more detailed financial disclosure on RPTs and a call for public companies to revamp their internal procedures to prevent unfair dealings. How to structure the tasks of independent directors and statutory auditors in

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149. Gilson & Milhaupt, *supra* note 84, at 371.

conflicts of interest matters is also an important issue for companies that have both legal institutions.