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

Yu-Hsin Lin, Stanford Law School
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Yu-Hsin Lin*

Abstract

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

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

Keywords: Independent Directors, Controlling Shareholders, Tunneling, Related Party Transactions.

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INTRODUCTION

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

Warren E. Buffett

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

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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]
4 OECD, CORPORATE GOVERNANCE SERIES: GUIDE ON FIGHTING ABUSIVE RELATED PARTY TRANSACTIONS IN ASIA 11-12, September 2009, at http://www.oecd.org/daf corporate/principles. [hereinafter OECD RPT GUIDE]
develop a practical guide to monitoring abusive RPTs.\textsuperscript{5}

The “law and finance” literature has demonstrated that law, in particular legal protection of investors against tunneling or self-dealing of controlling shareholders, plays an important role in the development of financial markets.\textsuperscript{6} It is possible that laws affect the development of financial markets through constraint over tunneling.\textsuperscript{7} Accounting treatment and disclosure requirement of self-dealing transactions are certainly the foundation of effective legal control over tunneling.\textsuperscript{8} In addition to fair accounting treatment and disclosure, corporate boards should be the major institution in monitoring RPTs. Therefore, the independent director, being presumably independent from controlling shareholders, is an appropriate institution in policing RPTs on behalf of non-controlling shareholders.\textsuperscript{9}

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

Section 1 reviews relevant literature and lays the foundation for this paper. Section 2 details the methodology of this research study, mainly in-depth interviews. Section 3 reviews the current state of corporate governance in Taiwan. Section 4 reports empirically the function of independent directors and their oversight of RPTs among sample Taiwanese public companies. Section 5 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.

\textsuperscript{5} OECD, CONCLUSIONS AND KEY FINDINGS NOTE, 2008 Asian Roundtable on Corporate Governance, May 13-14, 2008, Hong Kong, at http://www.oecd.org/document/39/0,3343,en_2649_34813_40144295_1_1_1_37439,00.html.
\textsuperscript{8} Id., at 31-34.
\textsuperscript{9} OECD RPT GUIDE, supra note 4, at 8.
I. 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.¹⁰ In the United States where corporate ownerships are mostly widely held, the principal agency cost problem is managerial indiscretion arising from the conflicts of interests between managers and shareholders. The legal system has relied on outside independent directors to monitor managerial abuses on behalf of dispersed owners and to render impartial judgments in situations involving conflicts of interests.¹¹ Following the Enron and Worldcom debacles, the law relied on independent directors even more in monitoring managerial irregularities.

However, most public companies outside the United States and United Kingdom are not widely held but are controlled by families or the state.¹² While the presence of a controlling shareholder reduces managerial agency problem, it suffers from private benefits agency problems where controlling shareholders extract private benefits at a cost to minority shareholders.¹³ Insofar as the costs of private benefits agency problem are greater than the benefits of reduction in managerial agency problem, the challenges of corporate governance in a controlling shareholder system would be to minimize the extraction of private benefits by controlling shareholders while preserving managerial discretions for making business decisions.¹⁴

Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) use the term “tunneling” to refer to the extraction of private benefits by controlling shareholders.¹⁵ One way to constrain tunneling

¹⁰ They describe boards of directors as “the common apex of the decision control systems of organizations, large and small, in which decision agents do not bear a major share of the wealth effects of their decisions.” Eugene Fama & Michael Jensen, Separation of Ownership and Control, 26 J. L. & ECON. 301, 311 (1983).
¹² La Porta et al., Corporate Ownership, supra note 3, at 511.
¹⁵ Johnson et al., Tunneling, supra note 2, at 22.
(or self-dealing) is to improve the legal system, whether by setting stricter substantive standards of review, requiring more disclosures or enhancing enforcement mechanisms. 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. Rafael La Porta, Lopez-de-Silanes and Shleifer (1999) found that, except in economies with very good shareholder protection, most corporations around the world are controlled by families or the state. 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. Studies on regions in East Asia and Western Europe present similar results.

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. Corporate control in East Asian countries is typically enhanced by pyramid structures and cross-holding among firms.

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

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

8 Id.

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


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
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).\textsuperscript{22} 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.\textsuperscript{23} 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.\textsuperscript{24}

2. Private Benefits Agency Problem (Tunneling)

Both dispersed-ownership structures and controlled-ownership structures suffer from less serious agency problems than does CMS because CMS lacks the major mechanisms that limit agency costs in other ownership structures.\textsuperscript{25} 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.\textsuperscript{26} 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.\textsuperscript{27}

Two major agency problems afflict CMS: (1) divergence-of-interests agency problems, and

\begin{itemize}

\item \textsuperscript{23} Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment? Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1874 (2005). C.f. Using the same 20% cut-off point, Yeh, Lee & 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.

\item \textsuperscript{24} Yeh & Woidtke, *supra* note 23, at 1872.

\item \textsuperscript{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 785-786.

\item \textsuperscript{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).

\item \textsuperscript{27} Bebchuk et al., *supra* note 22, at 301.
\end{itemize}
(2) entrenchment agency problems.\textsuperscript{28} 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). The controller in a CMS firm is freer to extract private benefits of control than are the managers in firms with dispersed-ownership structures because the controller controls the firm. This phenomenon is called the entrenchment agency problem. Whereas firms with dispersed-ownership structures are vulnerable chiefly to divergence-of-interest agency problems and whereas firms with controlled-ownership structures are vulnerable chiefly to entrenchment agency problems, CMS firms are vulnerable to the two types of agency problems simultaneously. The combination of the two agency problems provides controllers of CMS firms not only the incentives but also the power to extract private benefits at the cost of minority shareholders. Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) use the term ‘tunneling’ to refer to “the transfer of resources out of a company to its controlling shareholder.”\textsuperscript{29} Tunneling is a common type of corporate fraud in CMS-dominated economies. Taiwan apparently has this kind of economy.

Bebchuk, Kraakman and Triantis (2000) further show that, in CMS contexts, the 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.\textsuperscript{30} 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.\textsuperscript{31} Lemmon and Lins (2003) and Bozec and Laurin (2007) further support this suggestion by noting that, according to their respective findings, a CMS firm’s firm value exhibits relatively steep declines when the firm experiences either a decline in investment opportunities or a relatively high free cash flow, either of which provides incentives for firm insiders to expropriate minority shareholders.\textsuperscript{32}

\textsuperscript{28} Morck et al., supra note 26, at 676-79.
\textsuperscript{29} Johnson et al., Tunneling, supra note 2.
\textsuperscript{30} Bebchuk et al., supra note 22, at 301-05.
\textsuperscript{32} Michael L. Lemmon & Karl V. Lins, Ownership Structure, Corporate Governance, and Firm Value: Evidence
Alternative corporate governance measures may help to mitigate the agency costs imbedded in CMS. However, alternative corporate-governance 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/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 find out the ways through which tunneling happens. Recent empirical research studies have identified related party transactions as a major channel for tunneling. Cheung et al. (2009) examines asset transfer transactions between related parties in Hong Kong and finds that the prices of RPTs are unfavorable compared to those of similar arm’s length deals. That is, firms pay higher prices when acquiring assets from related parties and receive lower prices when selling assets to related parties.

The minority shareholders of listed firms in China also suffer from tunneling through loans to the controlling shareholders and their affiliates. Jiang et al. (2008) examines the financial data of 1,377 public companies in China from 1996 to 2004 and discovers that “tens of billions of RMB were siphoned from hundreds of Chinese publicly listed companies” through inter-corporate loans. 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.

Beyond academia, policy makers and practitioners from around the world also recognize

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33 Bebchuk et al., supra note 22, at 306.
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 (working paper, May 2008), available at http://ssrn.com/paper=1154314.
RPTs as a major channel for misappropriation of non-controlling shareholders. The OECD Asian Roundtable on Corporate Governance has since 2007 spent several sessions to discuss the appropriate regulatory policy towards RPTs and formed a special task force in 2008 to develop a practical guide to monitoring abusive RPTs. The guide, published in September 2009, identifies abusive RPTs as “one of the biggest corporate governance challenges facing the Asian business landscape.”

4. Empirical Evidence

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

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

Furthermore, they return to the overall governance index and try to find the predictive power of each subindex. They found strong evidence that greater board independence predicts

39 OECD RPT GUIDE, supra note 4, at 9.
higher share prices in South Korea and the result is likely to be causal. The authors suspect that such result could be because outside directors may help to control self-dealing by insiders, which historically has been a serious problem in South Korea. Black and Kim (2008) continue with the Black, Jang, and Kim (2006) study and use multiple identification strategies to further address the endogeneity problem faced by the prior study. Black and Kim (2008) found evidence that share-price increases are associated with boards in which 50% or more of the directors are outside directors.\footnote{Bernard Black & Woochan Kim, \textit{The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data} (Working Paper March 2008), available at http://ssrn.com/abstract=968287.} In addition, several years after the reforms, large firms’ profitability rose and the firms’ asset sales to related parties declined. However, they do not find evidence on other types of related party transactions.

Cheung et al. (2009) directly examine the effect of board independence and the presence of audit committee on the transfer price of related-party asset transfer transactions. They find that the presence of an audit committee is the only corporate 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.\footnote{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., \textit{Asset Transfer, supra} note 34, at 921-22.} From these two studies, we might conclude that a majority independent board or an audit committee could constrain tunneling through asset transfer between related parties.

Additional evidence from China supports the notion that more outsiders on the board help prevent tunneling through operational activities. Gao and Kling (2008) examine the effect of corporate governance mechanisms on operational tunneling based on data of listed firms in China from 1998 to 2002. They determine the extent of tunneling by the difference between accounts receivables and payables that are based on RPTs. They find that outsiders in the boardroom prevent operational tunneling.\footnote{Lei Gao & Gerhard Kling, \textit{Corporate Governance and Tunneling: Empirical Evidence From China}, 16(5) PAC.-BASIN FIN. J. 591, 600-601 (2008).}

Even though most of the empirical studies found 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. It may be that “good” firms, meaning those without tunneling, choose to have more outside directors on the board; the results may just be a reflection of self-selection. In other words, it may not be a causal relationship but simply an association. Even though most empirical studies of corporate governance have tried to address potential endogeneity problems, commentators argue that such efforts have been inadequate because these studies fail to build theoretical models that clarify the sources and effects of endogeneity problems and thus overlook the possibility of disparate treatment effects across firms. 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.

II. 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”) maintained by the Taiwan Stock Exchange. However, corporate directors in general are difficult to reach. In addition, the topic of related party transactions is business sensitive. Therefore, the most practical sampling strategy for this research study is convenience sampling and snowball sampling.

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. The benefit of conducting semi-structured, instead of structured, interviews is that semi-structured interviews allow more latitude and freedom for respondents to talk about what is of interest or importance to them. 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. Information about corporate ownership, subsidiaries, affiliated companies, decisions of board meetings, corporate governance characteristics, and related party transactions of sample firms was obtained from MOPS, a platform for public companies to post relevant corporate information required by the law.

From September 2008 to December 2009, 40 independent directors of Taiwanese public companies were interviewed for this research. Table 1 lists relevant information about the interviewees. Since the interviews explore the relationship between interviewees and controlling shareholders as well as RPTs in specific companies, which are confidential, all interviewees are kept anonymous and represented by numbers according to the sequence of interviews. The date of the interviews and the industries of the companies they served are also provided.

The average length of interviews is sixty-six minutes. The interviewees on average have 4.2 years of experience in serving as independent directors. Only eleven of them also serve on audit committees. The small number of interviewees serving on audit committees is due to the fact that only three percent of the public companies in Taiwan have chosen the board committee system and established audit committees. After deducting repetitive firms, a total of fifty-seven (57) firms are represented by the interviewees. 57.5 percent of the interviewees serve on a single board while 42.5 percent serve on multiple boards. Among those who serve on multiple boards, 82 percent serve on two boards. Only few interviewees serve on more than three boards. (Table 1 and 2)

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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).

Table 1 List of Interviews.

<table>
<thead>
<tr>
<th>No.</th>
<th>Date</th>
<th>Industry</th>
<th>Experience (Yrs)</th>
<th>On Multiple Boards</th>
<th>Total No. of Firms</th>
<th>On Audit Committee</th>
<th>Length of Interviews (min)</th>
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<td>1</td>
<td>Sept. 28, 2008</td>
<td>Electronics (Computer, Electric Optical)</td>
<td>5</td>
<td>1</td>
<td>2</td>
<td>66</td>
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<td>2</td>
<td>Sept. 29, 2008</td>
<td>Others</td>
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<td></td>
<td>1</td>
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<td></td>
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<td>3</td>
<td>Sept. 30, 2008</td>
<td>Oil, Gas &amp; Electricity</td>
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<td></td>
<td>1</td>
<td>88</td>
<td></td>
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<td>4</td>
<td>Oct. 7, 2008</td>
<td>Electronics (Semiconductor); Finance</td>
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<td>2</td>
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<td></td>
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<tr>
<td>5</td>
<td>Oct. 9, 2008</td>
<td>Chemical, Biotech &amp; Medical Care; Electronics (Electric Optical, Telecom and Internet, Computer, Others)</td>
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<td>1</td>
<td></td>
<td>40</td>
<td></td>
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<td>Oct. 10, 2008</td>
<td>Electronics (Semiconductor)</td>
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<td></td>
<td>1</td>
<td>50</td>
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<td>Electronics (Computer)</td>
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<td>8</td>
<td>Oct. 13, 2008</td>
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<td>17</td>
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<td>Oct. 15, 2008</td>
<td>Electronics (Computer)</td>
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<td>1</td>
<td>2</td>
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<td>Oct. 22, 2008</td>
<td>Electronics (Semiconductor, Electric optical)</td>
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</tr>
<tr>
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<td>Nov. 11, 2008</td>
<td>Electronics (Electric Optical, Information Services)</td>
<td>8</td>
<td>1</td>
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<td>Jan. 14, 2009</td>
<td>Chemical, Biotech &amp; Medical Care</td>
<td>6</td>
<td>1</td>
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<td>16</td>
<td>Feb. 12, 2009</td>
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<td>1</td>
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<td>Feb. 18, 2009</td>
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<td></td>
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<td>Feb. 26, 2009</td>
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<td>2</td>
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<tr>
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<td>Date 1</td>
<td>Date 2</td>
<td>Date 3</td>
<td>Date 4</td>
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<tr>
<td>27 Oct. 16, 2009</td>
<td>Electronics (Semiconductor)</td>
<td>8</td>
<td>1</td>
<td></td>
<td>21</td>
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<td>28 Oct. 16, 2009</td>
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<td>2</td>
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<td></td>
<td>120</td>
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<td>29 Oct. 21, 2009</td>
<td>Finance</td>
<td>2</td>
<td>1</td>
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<td>50</td>
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<td>30 Oct. 22, 2009</td>
<td>Electronics (Computer, Others), Finance</td>
<td>4</td>
<td>1</td>
<td>3</td>
<td>98</td>
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<td>31 Nov. 5, 2009</td>
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<td>2</td>
<td>1</td>
<td></td>
<td>100</td>
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<tr>
<td>32 Nov. 13, 2009</td>
<td>Electronics (Semiconductor, Electric optical)</td>
<td>5</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>63</td>
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<td>33 Nov. 26, 2009</td>
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<td></td>
<td>90</td>
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<td>34 Nov. 27, 2009</td>
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<td>1</td>
<td>1</td>
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<td>35 Dec. 1, 2009</td>
<td>Finance; Electronics (Electric Optical)</td>
<td>9</td>
<td>1</td>
<td>2</td>
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<td>36 Dec. 2, 2009</td>
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<td></td>
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<td>38 Dec. 3, 2009</td>
<td>Tourism</td>
<td>6</td>
<td>1</td>
<td></td>
<td>100</td>
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<td></td>
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<td>39 Dec. 14, 2009</td>
<td>Oil, Gas &amp; Electricity</td>
<td>2</td>
<td>1</td>
<td></td>
<td>143</td>
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<tr>
<td>40 Dec. 15, 2009</td>
<td>Others</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>120</td>
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<td></td>
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<tr>
<td><strong>Average (Total)</strong></td>
<td></td>
<td><strong>4.2</strong></td>
<td><strong>(18)</strong></td>
<td><strong>(63)</strong></td>
<td><strong>(11)</strong></td>
<td><strong>66</strong></td>
<td></td>
</tr>
</tbody>
</table>
Table 2 Number of Interviewees on Multiple Boards.

<table>
<thead>
<tr>
<th>No. of Boards</th>
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<th>2</th>
<th>3</th>
<th>4</th>
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<tr>
<td>No. of Interviewees</td>
<td>23</td>
<td>14</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Percentage</td>
<td>57.5%</td>
<td>35.0%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

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.
A. An Overview

The corporate environment in Taiwan is very different from that in the U.S. In short, corporate ownership is concentrated and family-dominated. 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 discrepancy provides an incentive and opportunity for controlling shareholders to tunnel corporate assets at the expense of minority shareholders.

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

<table>
<thead>
<tr>
<th>Panel A: Board Composition</th>
<th>Financial Firms</th>
<th>Non-Financial Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of Largest Shareholder as Directors</td>
<td>59.18</td>
<td>62.69</td>
</tr>
<tr>
<td>Percentage of Largest Shareholder as Statutory Supervisors</td>
<td>57.48</td>
<td>49.55</td>
</tr>
<tr>
<td>Number of Board Members</td>
<td>11.80</td>
<td>7.13</td>
</tr>
<tr>
<td>Number of Statutory Supervisors</td>
<td>3.29</td>
<td>2.57</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Ownership Structure</th>
<th>Financial Firms</th>
<th>Non-Financial Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control (Voting) Rights of Largest Shareholders</td>
<td>24.95</td>
<td>29.81</td>
</tr>
<tr>
<td>Cash-Flow Rights of Largest Shareholders</td>
<td>17.17</td>
<td>22.13</td>
</tr>
<tr>
<td>Excess Control (Control Rights – Cash-Flow Rights)</td>
<td>7.78</td>
<td>7.68</td>
</tr>
<tr>
<td>Pyramidal Structure</td>
<td>0.46</td>
<td>0.18</td>
</tr>
<tr>
<td>Cross-Shareholding</td>
<td>0.34</td>
<td>0.33</td>
</tr>
</tbody>
</table>

Source: YIN-HUA YEH AND CHEN-EN KO, DE RI MEI HAN GEGUO DULI DONGSHI, SHENJI WEIYUAN HUI JI JITA

54 Yeh, Lee & Woidtke, supra note 23, at 30-31.
55 See text accompanying note 25-33.
In theory, controlling shareholders, with major shareholdings, monitor the management more effectively and reduce agency costs greatly as long as their interests are in line with outside investors. Under this scenario, the interests of minority shareholders would not be sacrificed when the controlling shareholders dominate the board. However, if the control rights of the controlling shareholders exceed their cash-flow rights, as in the case of Taiwan and most other countries, the interests of controlling shareholders deviate from those of minority shareholders, creating a danger that minority shareholders could be expropriated. This is exactly the danger in Taiwan’s corporate governance.\(^{56}\)

Another characteristic of Taiwan’s corporate ownership structure — business group — further provides channels for expropriation.\(^{57}\) 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 hire more than 3 million employees in 2007. The total revenue of the top 100 business groups is 7.8 times that of Taiwan’s government in 2007.\(^{58}\) Their revenue growth in 2007, 16.01%, also far exceeds that of the GNP of Taiwan.\(^{59}\) Among the top 10 business groups, 9 are in the financial industry. Family business continues to dominate Taiwan’s economy. In terms of total asset value, family business groups account for 73.56% of the top 100 business groups. Seven major families in Taiwan control almost 40% of the total assets of the top 100 groups.\(^{60}\)

Given the importance of business groups to Taiwan’s economy, the corporate governance of

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56 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 Yunzu Qiongkuang [The Law and Practice of Independent Directors, Audit Committees and Other Functional Committees in Germany, Japan, United States, and Korea], Financial Supervisory Commission of Taiwan Table 10-2 at 294-95 (January 2006).
57 Taiwan Securities & Futures Institute, Corporate Governance in Taiwan 5-6 (October 2009).
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.
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. 61 Controlling shareholders can further control the board by electing subsidiaries as institutional directors or statutory supervisors, providing that the subsidiary assigns an individual representative to perform its duty. Individual representatives of such subsidiaries can also be elected as directors or statutory supervisors. Furthermore, more than one such individual representative can be elected as directors or statutory supervisors. 62 Hence, through cross-shareholding, controlling shareholders can literally appoint anyone he/she wants to serve as directors and statutory supervisors and embezzle corporate resources without any internal oversight.

B. RPTs 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. 63 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.

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.s. Gong Si Jian Kong [Cross Shareholding v.s. Corporate Governance], in GONG KAI FA SHIN GONG SH FA ZHI YU GONG SI JIAN KONG [PUBLIC COMPANY REGULATION AND CORPORATE GOVERNANCE] 185, 194-203 (2001).


Tunneling is by nature not easily observable by mere public information.\textsuperscript{64} 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.\textsuperscript{65}

Some provide more direct evidence on tunneling, but all are based on data from emerging markets. Bertrand, Mehta and Mullainathan (2002) report evidence on tunneling in an Indian business group which is characterized with pyramidal ownership structures by measuring the responsiveness of firm profitability to shocks in industry profitability. In theory, a low-cash-flow-right firm will be less responsive to industry shocks than a high-cash-flow-right firm assuming that controlling shareholders tunnel resources from a low-cash-flow-right firm to a high-cash-flow-right firm. Bae et al. (2002) examine the stock market responses to merger announcements in Korea chaebols and find that the stock prices of chaebol-affiliated firms on average fall when announcing acquisition of group firms, suggesting that controlling shareholders expropriate wealth from minority shareholders through intra-group acquisitions.\textsuperscript{66} 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.\textsuperscript{67} Berkman et al. (2009) provide further evidence on tunneling through loan guarantees to the controlling blockholders in Chinese firms by testing whether the issuance is negatively related to firm value and firm performance.

While these studies manifest specific channels of tunneling, they do not provide evidence on exactly how controlling shareholders extract private benefits through these transactions. La Porta et al. (2003), using data set from Mexico where banks can be controlled by nonfinancial firms, examine the terms of bank loans with related parties and find that related lending accounts for 20 percent of commercial loans and enjoys lower interests rates than arm’s-length loans.

\textsuperscript{64} Atanasov et al., \textit{Unbundling Tunneling}, supra note 7, at 1-2.

\textsuperscript{65} Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, \textit{Investor Protection and Corporate Valuation}, 57 J. Fin. 1147 (2002); Claessens et al., supra note 31; Lins, supra note 31.

\textsuperscript{66} Kee-Hong Bae et al., \textit{Tunneling or Value Added? Evidence From Merger by Korean Business Groups}, 57 J. Fin. 2695 (2002).

\textsuperscript{67} Yan-Leung Cheung et al., \textit{Tunneling, Propping, and Expropriation: Evidence From Connected Party Transactions in Hong Kong}, 82 J. Fin. Econ. 343 (2006). [hereinafter Cheung et al., \textit{Hong Kong}].
Related loans are 33 percent more likely to default and have a much lower recovery rate.\(^{68}\) 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.\(^{69}\) 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.\(^{70}\) 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, a growing literature shows that transactions among related parties are generally detrimental to the value of minority shareholders. The empirical research result warrants more serious policy discussions on the disclosure and approval policy of RPTs. However, the law in 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.\(^{71}\) 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. RPTs in Sample Firms

There are a total of 41 sample listed firms excluding financial firms. Among 41 sample firms, 39 have disclosed RPTs in their 2007 financial statements. I exclude transactions with

\(^{68}\) Rafael La Porta, Florencio López-De-Silanes, Guillermo Zamarrripa, Related Lending, 118(1) 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.
\(^{71}\) See Appendix C Statement of Financial Accounting Standards No. 6: Disclosure of Related Party Transactions, Section 4.
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: controlling firms, chairmen, directors, and affiliated firms; and eleven sub-categories: controlling firms, firms affiliated with controlling firms, chairman, firms controlled by the chairman, relatives of the chairman, firms controlled by the relatives of the chairman, individual directors, firms affiliated with individual directors, company directors, firms affiliated with company directors, and finally, affiliated firms of the subject firm. A firm can only be counted once in each category as long as the firm enters into transaction with the subject type of party no matter how many transactions it conducts. On the other hand, a firm can be counted once in each and every category as long as it enters into transactions with each type of party. Table 4 shows the result.

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

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 Company Law of Taiwan art. 27 I (2009).

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 et al., Tunneling and propping up: An analysis of related party transactions by Chinese listed companies, 17(3) PAC.-BASIN FIN. J. 372, 381 (2009). [Hereinafter Cheung et al., China]
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.74 Recent empirical studies have also looked into specific types of RPTs and found that controlling shareholders in Hong Kong and China have embezzled corporate assets through asset acquisitions, asset sales, intercorporate loans, and loan guarantees.75 However, not every aforementioned type of RPTs results in tunneling.

Friedman et al. (2003) acknowledge that while it is widely recognized that controlling shareholders tunnel assets out of the firms, sometimes they also prop up the firms using their private funds.76 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.77

Using multiple classification methods, Cheung et al. (2006) pioneered efforts to categorize RPTs as tunneling or propping by examining the market-adjusted cumulative average abnormal returns (CARs) around the announcement day.78 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

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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, including any company in which the above hold a substantial shareholding. Cheung et al., Hong Kong, supra note 67, at 349, 355-356.
75 Berkman et al., supra note 36; Cheung et al., Asset Transfer, supra note 34; Jiang, 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 intercorporate 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.
connected persons which are categorized as tunneling are value-destroying; cash receipts and subsidiary
Table 4 Related Party Transactions - By Counterparty

<table>
<thead>
<tr>
<th>Controlling Firms</th>
<th>Chairman</th>
<th>Directors</th>
<th>Affiliated Firms*</th>
</tr>
</thead>
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<td>Firms affiliated</td>
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<tr>
<td>with the</td>
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<td>Controlling</td>
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<td>13</td>
<td>22</td>
</tr>
<tr>
<td>Firm</td>
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<tr>
<td>Individual</td>
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<td>Directors</td>
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<tr>
<td>Firms affiliated</td>
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<td>with the</td>
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</tr>
<tr>
<td>Controlling</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm</td>
<td>No. of</td>
<td>Firms</td>
<td>Firms</td>
</tr>
<tr>
<td>Control by the</td>
<td>13</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td>Chairman</td>
<td>No. of</td>
<td>Firms</td>
<td>Firms</td>
</tr>
<tr>
<td>Relatives of the</td>
<td>6</td>
<td>11</td>
<td>2</td>
</tr>
<tr>
<td>Chairman</td>
<td>No. of</td>
<td>Firms</td>
<td>Firms</td>
</tr>
<tr>
<td>Directors</td>
<td>4</td>
<td>1</td>
<td>6</td>
</tr>
</tbody>
</table>

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

Table 5 Related Party Transactions – By Transaction Type

<table>
<thead>
<tr>
<th>No. of Firms</th>
<th>Asset acquisitions</th>
<th>Asset sales</th>
<th>Equity acquisitions</th>
<th>Equity sales</th>
<th>Sale of goods and services</th>
<th>Purchase of goods and services</th>
<th>Loans and guarantees</th>
<th>Rent Expenses</th>
<th>Cash receipts</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5</td>
<td>5</td>
<td>2</td>
<td>3</td>
<td>29</td>
<td>24</td>
<td>8</td>
<td>11</td>
<td>7</td>
<td>14</td>
</tr>
</tbody>
</table>
relationship 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.\(^\text{79}\) Using the same technique, Cheung et al. (2009) examine
the valuation effect of 290 sample RPTs of Chinese listed companies during 2001 and
2002. Similar to the results of Cheung et al. (2006), the Chinese study finds that asset
acquisitions, asset swaps, trading relationships, and cash payments are value-
destroying and cash receipts are value-enhancing.\(^\text{80}\)

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.\(^\text{81}\)
However, Cheung et al. (2006) find limited evidence that supports the anticipation
argument, suggesting that investors cannot anticipate expropriation prior to the
announcement of RPTs and the value change is likely due to the announcement of
RPTs.\(^\text{82}\)

Table 5 provides a classification of the RPTs of the sample firms by transaction
types. 29 firms (70 percent) engage in sales of goods and services transactions with
related parties; 24 (59 percent) engage in purchases transactions; 11 (27 percent) firms
rent offices or warehouses from related parties; 8 (20 percent) provide loans and
guarantees (similar to cash payments in Cheung et al. (2006)); 5 (12 percent) engage
in asset transfer transactions; 22 (54 percent) engage in transactions with subsidiaries.

To assess whether the sample RPTs involve conflicts of interest, we also need to
know the party of the transaction. I further classify sample RPTs by both counterparty
and transaction type in Table 6 and 7. The most common RPTs with controlling firms
are trading relationships, rent and asset acquisitions. 23 firms (56 percent) sell goods
to and 13 firms (32 percent) purchase goods from controlling firms; 9 firms (22
percent) rent offices or warehouses from controlling firms; and 7 firms (17 percent)
acquire assets from controlling firms. Since controlling firms have control power over

\(^{79}\) Id., at 366-371.
\(^{80}\) Cheung et al., China, supra note 73, at 385-387.
\(^{81}\) RONALD GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 216-217
(2d ed. 1995).
\(^{82}\) Cheung et al., Hong Kong, supra note 67, at 375-379.
sample firms, it is likely that the above transactions involve tunneling. Cheung et al. (2006) and Cheung et al. (2009) also presented confirming evidence.

Trading and renting relationships are also common among the RPTs with chairpersons. However, there are loans and guarantees as well as cash-receipt relationships with chairpersons. This suggests that a chairperson and his/her controlled firms not only benefits from financing by the sample firms, he or she also helps finance the sample firms by providing loans or guarantees if needed. The financing chairperson and the firms that chairperson controls occur in two sample firms that are relatively small in size and controlled by individuals. In one of these firms, the chairperson also provides personal loans to the company with no interests. Hence, there are also propping transactions among sample firms.

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

Again, trading relationships are also common among the RPTs with company directors. This also reflects investments among firms that have business relationships. RPTs with subsidiaries or affiliates are mostly trading relationships. While 7 firms provide loans and guarantees to their affiliates, no sample firms receive cash or guarantees from affiliates. 6 firms sell assets or equity to their subsidiaries or affiliated firms, which mirrors the results in asset acquisitions where 7 firms purchase assets from controlling firms. Hence, in related-party asset transfer transactions, there is a tendency that firms lower in the ownership chain tend to purchase assets from firms that are upstream. It is likely that the upstream firm (sometimes the controlling shareholder) will exert its influence over the terms and force the downstream firm (the subsidiaries or affiliates) to pay higher prices for the assets. Hence, from the evidence presented to us, we can reasonably infer that the asset or equity sales transactions with affiliated firms are most likely propping transactions for sample firms.\footnote{Cheung et al., Asset Transfer, supra note 34.}
Overall, there are considerable asset acquisitions, trading transactions, as well as cash payment transactions between sample firms and their controlling shareholders, chairmen, and directors. Cheung et al. (2006) and Cheung et al. (2009) report that those transactions result in significant negative abnormal returns for listed firms in Hong Kong and China, suggesting that controlling shareholders might tunnel through those transactions. Although there is not a systematic study of RPTs in Taiwan testing the valuation effects of each type of transactions, we can still reasonably infer from logical reasoning and limited evidence from Hong Kong and China that sample Taiwanese firms may engage in tunneling activities through RPTs with controlling firms, chairmen and directors. Even if those transactions do not in fact involve tunneling, the conflicts of interest between related parties and sample listed firms also warrant the participation of independent directors in the decision-making process.
Table 6 Related Party Transactions – Cross Table 1

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

<table>
<thead>
<tr>
<th></th>
<th>Controlling Firm</th>
<th>Chairman</th>
<th>Directors</th>
<th>Affiliated Firms (not wholly-owned subsidiary) of Subject Firm</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Acquisitions</td>
<td>7</td>
<td>1</td>
<td>2</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Asset Sales</td>
<td>1</td>
<td>3</td>
<td>4</td>
<td></td>
<td>8</td>
</tr>
<tr>
<td>Equity Acquisitions</td>
<td></td>
<td></td>
<td>3</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Equity Sales</td>
<td></td>
<td>1</td>
<td>2</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Sale of Goods and Services</td>
<td>23</td>
<td>10</td>
<td>8</td>
<td>12</td>
<td>53</td>
</tr>
<tr>
<td>Purchase of Goods and Services</td>
<td>13</td>
<td>9</td>
<td>7</td>
<td>9</td>
<td>38</td>
</tr>
<tr>
<td>Loans and Guarantees</td>
<td></td>
<td>1</td>
<td>-</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>Rent Expenses</td>
<td></td>
<td>9</td>
<td>5</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>Cash Receipts</td>
<td>2</td>
<td>6</td>
<td>2</td>
<td></td>
<td>13</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
<td>5</td>
<td>2</td>
<td>6</td>
<td>23</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>67</strong></td>
<td><strong>43</strong></td>
<td><strong>23</strong></td>
<td><strong>42</strong></td>
<td></td>
</tr>
</tbody>
</table>
### Table 7 Related Party Transactions – Cross Table 2 (Detailed Breakdown)

<table>
<thead>
<tr>
<th></th>
<th>Controlling Firms</th>
<th>Chairman</th>
<th>Individual Directors</th>
<th>Company Directors</th>
<th>Affiliated Firms (not wholly-owned subsidiary)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Controlling Firm</td>
<td>Firms affiliated with Controlling Firm</td>
<td>Firms Controlled by the Chairman</td>
<td>Firms Controlled by the Relatives of the Chairman</td>
<td>Firms affiliated with Individual Directors</td>
<td>Firms affiliated with Company Directors</td>
</tr>
<tr>
<td><strong>Asset acquisitions</strong></td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td><strong>Asset sales</strong></td>
<td>1</td>
<td>3</td>
<td></td>
<td></td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td><strong>Equity acquisitions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3</td>
</tr>
<tr>
<td><strong>Equity sales</strong></td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td><strong>Sale of goods and services</strong></td>
<td>11</td>
<td>12</td>
<td>8</td>
<td>2</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td><strong>Purchase of goods and services</strong></td>
<td>4</td>
<td>9</td>
<td>7</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Loans and guarantees</strong></td>
<td>1</td>
<td>1</td>
<td>2</td>
<td></td>
<td></td>
<td>7</td>
</tr>
<tr>
<td><strong>Rent Expenses</strong></td>
<td>8</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td><strong>Cash Receipts</strong></td>
<td>2</td>
<td>1</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>6</td>
<td>4</td>
<td>1</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>35</td>
<td>32</td>
<td>8</td>
<td>27</td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>
C. Corporate Board Reform

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

The corporate-board structure of Taiwan generally follows the Japanese-style governance structure, which is a modified version of the German governance structure. The governance structure in Taiwan and in Japan differs from the typical German governance structure in that the statutory-supervisor position in Japan and Taiwan is weaker than its German counterpart, the supervisory board. In Germany, the supervisory board has the right to appoint or remove directors; however, in Japan and Taiwan, supervisors are nominated by the board and elected by the shareholders.\(^84\) In addition, the statutory supervisors in Taiwan do not act collectively as a board as does their German or Japanese counterpart; rather, they act individually.\(^85\) According to the Corporation Law of Taiwan, a supervisor is an independent supervisory institution responsible for auditing the business conditions of companies and for evaluating the performance of companies’ boards of directors and managers.\(^86\) 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.”

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\(^85\) 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.

In the aftermath of Enron and other high-profile corporate-fraud cases, the U.S. Congress, in enacting the Sarbanes-Oxley Act of 2002 (SOX), placed great reliance on outside/independent directors and audit committees as a means of monitoring both firms’ internal control system and the integrity of firms’ financial-reporting systems. Following the passage of SOX, many Asian countries, such as China, Japan, South Korea, and Taiwan, initiated corporate-board reforms to be in alignment with the U.S.-style governance structure. In response to local corporate-fraud scandals, Taiwan’s financial authority has considered introducing the institution of independent directors to enhance corporate-monitoring functions. Finally, in 2006, the Congress revised the Securities and Exchange Act to give public companies the option to choose whether or not they have independent directors.\(^87\) 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.\(^88\) The amendment basically resembles the 2002 Japanese board reform, which also grants corporations the option to choose between a U.S.-style board structure and traditional board structure.\(^89\)

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, the FSC has mandated that all public financial firms and those non-financial listed firms with equity value over NT$50 billion (US$1.6 billion) should have at least two independent directors on their board and that the total number of independent directors should be no less than one-fifth the number of board members.\(^90\) As of October 2009, 38.2% of the TSE-listed companies have at least one independent director on their board.\(^91\)

Under current regulation, there are three types of board structure in Taiwanese public companies: (1) with independent directors and an audit committee (no statutory supervisor), (2) with independent directors and statutory supervisors (no audit committee), (3) with only statutory supervisors. In general, large companies (with equity value over NT$50 billion (US$1.6

\(^{88}\) ZHENG QUAN JIAO Yi Fa art. 14-4.
\(^{89}\) Gilson & Milhaupt, supra note 84, at 352-54.
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. 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. The finding may reflect the lack of reform-related consensus, which itself reflects some of the impetus behind the enabling approach. Gilson and Milhaupt’s initial examination of the Japanese board reform suggests that formal convergence may trigger an initial reduction in overall system productivity because the new form was perhaps not complementary with other existing institutions. This study reminds us of the importance of local forces in the success of corporate-governance reform.

Clarke (2006) is generally pessimistic about the effectiveness of independent directors’ ability to police Chinese public companies. In 2001, the China Securities Regulatory Commission issued its “Guidance Opinion on the Establishment of an Independent Director

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92 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.
93 Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 AM. J. COMP. L. 329, 339 (2001).
94 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.
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.⁹⁶

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IV. DO INDEPENDENT DIRECTORS PREVENT TUNNELING?

A. Who are Independent Directors?

From where exactly do these independent directors come? This study classifies the occupation into 10 categories and compiles data from MOPS where descriptions of each independent director’s current full-time job are available. The top three occupations for independent directors are Corporate Directors (29.03%), Professors (24.91%) and Managers (12.36%) (Table 8). In the U.S., most independent directors are directors or CEOs of other public companies. In Taiwan, Corporate Directors and CEOs account for 41.2 percent of all independent directors, which is still a significant number. Together with Managers, people from the corporate world take up over half (53.56%) of this population.

Table 8 Occupations of Independent Directors

<table>
<thead>
<tr>
<th>Occupations</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Directors</td>
<td>155</td>
<td>29.03</td>
</tr>
<tr>
<td>Professors</td>
<td>133</td>
<td>24.91</td>
</tr>
<tr>
<td>Managers</td>
<td>66</td>
<td>12.36</td>
</tr>
<tr>
<td>CEO</td>
<td>65</td>
<td>12.17</td>
</tr>
<tr>
<td>Accountants</td>
<td>39</td>
<td>7.30</td>
</tr>
<tr>
<td>Others</td>
<td>30</td>
<td>5.62</td>
</tr>
<tr>
<td>Lawyers</td>
<td>24</td>
<td>4.49</td>
</tr>
<tr>
<td>Government Officials</td>
<td>10</td>
<td>1.87</td>
</tr>
<tr>
<td>Politicians</td>
<td>10</td>
<td>1.87</td>
</tr>
<tr>
<td>Physicians</td>
<td>2</td>
<td>0.37</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>534</strong></td>
<td><strong>-</strong></td>
</tr>
</tbody>
</table>

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...

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“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.\(^98\)

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

They [the professors] can only do the so-called “oversight” from the documents given by the firm. In fact, they are incapable of doing any substantive oversight because they do not have the business knowledge. Therefore, I think professors being independent directors is a disaster for our society because they know so little about what they are doing.\(^99\)

Such statements further point out the limitation of professors being independent directors. To be sure, most professors are not familiar with business operations and if he/she is not a professor of finance or accounting, he/she may not have enough knowledge to even understand financial statements, let alone discover fraudulent accounting practices.\(^100\) An interviewee, who is a professor of engineering, admitted that:

[r]eviewing financial reports is not my expertise…..I am able to contribute more towards devising the company’s strategy and its future direction. To be honest, I don’t understand financial reports very well. I do not have a complete understanding of the impact or the meaning of some of the specific numbers (on the reports). Other directors might be more knowledgeable about that. During

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\(^{98}\) Interview No. 3 (Sept. 30, 2008), at 9.
\(^{99}\) Interview No. 31 (Nov. 5, 2009), at 3.
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.\textsuperscript{101}

One might reasonably infer, and the reality might well be, that different independent directors serve different functions. A professor of engineering might contribute to the firm more on technical consultation than on internal auditing improvement. In practice, firms will choose directors who can contribute in some way to the firm. For example, evidence shows that Japanese firms that tend to appoint retired government bureaucrats as outside directors are those in the construction industry and have significant business with government agencies.\textsuperscript{102}

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.\textsuperscript{103} However, independent directors do not have veto rights to these decisions. They can only ask the board to keep their dissenting opinion on file. The board can still decide by majority votes even if independent directors have dissenting opinions.

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

\textsuperscript{101} Interview No. 22 (Feb. 25, 2009), at 5.
\textsuperscript{103} ZHENG QUAN JIAO YI FA art. 14-3.
appointment after reviewing the dissenting opinion. In the end, the firm withdrew the appointment.  

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

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.  

The above quote fairly reflects the reality of independent director participation in Taiwan. The standard tasks of independent directors are to attend board meetings, review meeting materials before the meeting, and review internal audit reports every month. In general, board meetings of firms in the financial industry are held once a month, while those in other industries are usually held every two to three months. Most interviewees admit that they didn’t spend much time reviewing materials before the meeting. However, if attending board meeting is the only major task for independent directors, the effectiveness of board meetings becomes crucial.
Despite the fact that some independent directors are just too busy to preview the materials\textsuperscript{107}, sometimes it is because firms prefer not to provide all the detailed information outside the meeting for confidentiality reasons.\textsuperscript{108} 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.\textsuperscript{109} Although some with accounting backgrounds pay more attention to the internal control systems, most interviewees reveal that such review is usually cursory and superficial. Some directors might not even have a clue how to review an internal audit report.

To be honest, I personally feel that the system of requiring independent directors to review internal audit report does not achieve much of its goal. For example, one company provides me with a report that lists every item as “no material irregularity” every month. To be honest, I really don’t know what to question further. On the other hand, the other company provides me with a very detailed report about what the internal auditor found and what he plans to do. My feeling is that on the one hand, I feel much better when I see the more detailed report; on the other, I don’t know what to question because you already handled all the issues\textsuperscript{110}

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. On Dec. 19, 2005, the FSC of Taiwan revised the “Regulations Governing Establishment of Internal Control Systems by Public Companies” art. 15 (2009.3.16), available at http://eng.selaw.com.tw/FLAWDAT0201.asp.

\textsuperscript{107} i.e. Interview No. 29 (Oct. 21, 2009), at 10.
\textsuperscript{108} i.e. Interview No. 30 (Oct. 22, 2009). at 12.
\textsuperscript{110} Interview No. 26 (Oct. 12, 2009), at 7-8.
 Systems by Public Companies” requiring the internal audit departments of all public companies to be directly supervised by the board. The revision formally enhances the status and independence of internal auditors and provides a better structure for internal auditors to ensure the functioning of the internal control system.

However, when facing related-party transactions, most independent director interviewees do not believe that internal auditors are able to be a check-and-balance to controlling shareholders. 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.

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

D. Empirical Evidence on RPT Oversight

From the analysis of RPTs in previous section, 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


\[112\] i.e. Interview No. 26 (Oct. 12, 2009), at 12; Interview No. 31 (Nov. 5, 2009), at 12.

\[113\] i.e. Interview No. 31 (Nov. 5, 2009), at 12.
concentrated ownership) and can use their independent judgment to review these transactions for the best interests of the corporations. Independent directors presumably fit this criterion and have been considered a proper post to review conflict-of-interest transactions impartially on behalf of minority shareholders under U.S. Delaware law.

However, a review of published board decisions of sample Taiwanese firms reports stunningly opposing results (Table 9). In 2007, when excluding decisions on RPTs with wholly-owned subsidiaries, only 9 boards of the sample firms (22 percent) ever reviewed and decided on RPTs. These decisions involved asset swaps, equity acquisitions, equity sales, and loans with related parties. Even among these 9 firms, only very few disclosed RPTs were reviewed by the board. Apparently, trading relationships, renting relationships and cash receipts from related parties were never reviewed by the sample boards. Even for asset transfer and loans, only a few firms submitted these RPTs for board review.

Table 9 Board Decisions on RPTs

<table>
<thead>
<tr>
<th>No. of Firms</th>
<th>Report Decisions on RPTs</th>
<th>Decisions not Available</th>
<th>No decision on RPTs</th>
<th>Report Decisions on RPTs (excluding decisions with regard to wholly-owned subsidiaries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>5</td>
<td>20</td>
<td>9</td>
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Interviews with independent directors further confirm this finding. Only 15 out of 40 interviewees have reviewed RPTs in board meetings. When asked about the types of RPTs they have reviewed, ten recalled loans/guarantees, two mentioned asset transfers, one mentioned equity acquisition, and two mentioned sales and purchases of goods. None mentioned renting and cash receipts relationships. Among the 15 interviewees, 9 of them serve in financial firms where the law requires their boards to review and approve RPTs with controlling shareholders or chairpersons by super-majority vote. 3 of the remaining 6 interviewees who serve in non-financial firms only recalled reviewing loans/guarantees RPTs where the law also requires the


boards’ approval or ratification.\textsuperscript{116} Therefore, independent directors’ participation in monitoring RPTs is largely influenced by the laws and regulations promulgated by the government.

One major area where the law does not require boards’ participation is in RPTs that involve purchases and sales of goods and services (trading RPTs). From previous analysis of sample RPTs, we know that trading transactions are the most common sample RPTs. The majority of trading RPTs are conducted with the controlling firms or the affiliated firms of the sample firms. These intra-group transactions, while often serving legitimate business purposes, might provide opportunities for dominate shareholders to transfer out corporate assets.\textsuperscript{117} 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.\textsuperscript{118}

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

In addition to the complexity of RPTs, fierce market competition is another reason

\textsuperscript{116} Regulations Governing Loaning of Funds and Making of Endorsements/Guarantees by Public Companies (2005) (Taiwan).

\textsuperscript{117} Pierre-Henri Conac et al., Constraining Dominant Shareholders’ Self-Dealing: The Legal Framework in France, Germany, and Italy, 4(4) EUR. COMPANY & FIN. L. REV. 491, at 495-96; Cheung et al., China, supra note 73, at 385-386.

\textsuperscript{118} Interview No. 14 (Nov. 11, 2008), at 8.
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. ¹¹⁹

The idea that market competition can serve as a monitor for trading RPTs may work in a competitive industry where margins are relatively low, for example, the personal computer industry. However, markets change. A good corporate governance measure should not be altered simply based on unstable market conditions. Furthermore, trading relationships with either controlling firms or affiliated firms involve conflicts of interests where independent directors should step in and make decisions for the best interests of the corporation. ¹²⁰ Although independent directors may decide the level of monitoring based on industry conditions, the participation of independent directors in ensuring the fairness of the transaction should not be neglected simply because the risks of deviation from market price is relatively low in certain industries.

¹¹⁹ Interview No. 13 (Oct. 30, 2008), at 6.
¹²⁰ Bebchuk & Hamdani, supra note 114, 37.
V. 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.\(^\text{121}\)

This interviewee basically tells us that when there is intentional fraud, there is nothing an independent director can do because of information asymmetry problem. In this case, one might wonder why independent directors would not dig further to uncover the fraud. Is it true that controlling shareholders could hide everything from the eyes of independent directors? An interviewee, who involves deeply in the corporate board reform in Taiwan, shares the difficulties in “digging further.”

\(^{121}\) Interview No. 20 (Feb. 19, 2009), 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.122

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

122 The interviewee resigned after serving for less than a year as an independent director in a family conglomerate. Interview No. 31 (Nov. 5, 2009), at 4.
the public to avoid scrutiny.\textsuperscript{123} With the complex ownership structure of Asian companies, it is usually hard to even identify “related parties” in the first place.\textsuperscript{124}

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.\textsuperscript{125}

Even for related transactions that are disclosed, it is sometimes hard to decide whether the terms are fair or abusive if there is no market price to compare.\textsuperscript{126} 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.\textsuperscript{127}

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

\begin{itemize}
\item \textsuperscript{123} OECD, THE 2007 ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, SYNTHESIS NOTE 6-7 (June 27-28 2007, Singapore), available at http://www.oecd.org/document/48/0,3343,en_2649_34813_39336752_1_1_1_1,00.html. [hereinafter OECD 2007 ASIAN ROUNDTABLE]
\item \textsuperscript{124} Id., at 7.
\item \textsuperscript{125} Interview No. 26 (Oct. 12, 2009), at 11.
\item \textsuperscript{126} OECD 2007 ASIAN ROUNDTABLE, at 7.
\item \textsuperscript{127} “Taiwan does not have a well-developed appraisal industry. There are some appraisal companies in Taiwan providing real estate appraisal service. Some are ethical, like China Credit Information Services Ltd., while most are not as ethical as long as you pay. That’s very bad. Without the support of a fair appraisal industry, the legal requirement of independent appraisal report for RPTs is useless.” Interview No. 34 (Nov. 27, 2009), at 16.
\end{itemize}
companies established by the controlling shareholders, not those regular related party transactions.\textsuperscript{128}

The 2006 Reba Group debacle exemplifies such collusion. The accountant of the Reba Group, Si-Da Shan, not only did not correct the omission of the disclosure of certain related party transaction but also consciously deleted Ho Hsin Co., one of the company controlled by the controlling shareholder of the Reba Group, from the audit working paper prepared by his assistant at the request of the controlling shareholder of the Reba Group.\textsuperscript{129} Of course, such collusion requires cooperation from internal legal and auditing departments. One interviewee admitted that he once had been aware of a potential tunneling RPT, but since the firm did not specify the counterparty as a related party, he chose to trust the firm and approved the transaction without actively verifying the information.

I myself have approved some related party transactions that are questionable. ….Many family businesses in Taiwan are conducting related party transactions……Sometimes it’s hard to tell if the party is a related party or not. And we, independent directors, would not verify whether the counter party is a related party or not. …..Even the legal department or internal audit department won’t tell you whether it is a related party. If you ask them, they will tell you it is not and then you will approve the transaction. But in fact, the counter party could be an indirect related party. So I guess the internal audit department is also covering up for the controlling shareholder.\textsuperscript{130}

2. Passiveness

\textsuperscript{128} Interview No. 5 (Oct. 9, 2008), at 4.
\textsuperscript{129} Hsio-Ru Ma and Yi-Ting Ho, \textit{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, \textit{Rebar Audit Failure}]
\textsuperscript{130} Interview No. 4 (Oct. 7, 2008), at 9.
In reality, independent directors in Taiwan are helpless in overseeing controlling shareholders, especially 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.\(^{131}\)

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

> To be frank, if the chairman wants to hide something, the independent directors will not know, right? After all, 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.\(^{132}\)

\(^{131}\) Interview No. 18 (Feb. 18, 2009), at 9. See also Interview No.19 (Feb. 19, 2009), at 10. “My personal feeling is that the (accounting) records relating to tunneling or embezzlement are typically created by entry-level employees. Frankly, if you are not an accounting employee or the chief financial officer, I think your chances of discovering fraud in documents which falsify sales transactions, invoices, and certificates is zero. For an outsider of the company like me, I think the chances of me discovering fraud is definitely zero.”

\(^{132}\) Interview No. 5 (Oct. 9, 2008), at 3, 5. See also Interview No. 3 (Sept. 30, 2008), at 6 (“I don’t think all the board members will cover up for wrong doings. Most of the board members are knowledgeable of ethics and want this
Such helplessness and pessimism also shape the way independent directors perceive themselves. Almost all the interviewees regard themselves as corporate monitors and recognize that making sure board decisions comply with the law is their major responsibility. However, what is surprising is that only six of them view themselves as the proper people to monitor RPTs. Others assign such task to other constituencies because they think that they are outsiders and there is 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.133

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

Honestly speaking, if they (the controlling shareholders) want to

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133 Interview No. 9 (Oct. 15, 2008), at 12.
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.134

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 are from, that determines the success of legal transplant and in turn economic development.135 Countries that received 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.”136 Borrowing the legal institution of “independent directors” alone from the U.S. incurs various externalities on corporate governance in Taiwan.

Under traditional Taiwanese corporate law which originates from Japan, the board of directors is a managing board, instead of a monitoring board, and the oversight function is assigned to another internal institution, the statutory supervisor.137 Hence, from the beginning, the board is not meant to play a monitoring role. The institutional design of board of directors and statutory supervisors complement each other. Complementarities could contribute to the path dependence of the corporate structure in a given country.138

In practice, the internal governance function of statutory supervisors in Taiwan is not

134 Interview No. 29 (Oct. 21, 2009), at 3.
136 Id. at 168.
138 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).
efficient. The oversight function of statutory supervisors has long been undermined mainly because the statutory supervisors are also elected by the shareholders meeting, which is controlled by the controlling shareholders. The way supervisors are elected results in the dependence of supervisors to controlling shareholders, leading to the failure of internal governance.¹³⁹

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.¹⁴⁰ 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.¹⁴¹ Japan also experiences such transplant effect when introducing the board committee system.¹⁴²

The friction between independent directors and existing local institutions is most apparent in companies who on the one hand, introduce the new institution, and on the other, preserve the existing institution of statutory supervisors. 37% of TSE-listed companies adopted such strategy.¹⁴³ 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 minority shareholders.¹⁴⁴ On the other hand, the law still requires the pre-existing statutory supervisors to perform their

¹³⁹ 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).
¹⁴⁰ Lin, supra note 11, at 904-12.
¹⁴¹ Gilson, supra note 93, at 339.
¹⁴² Gilson and Milhaupt, supra note 84, at 369-372.
¹⁴³ As of November 2009, 289 TSE-listed companies have at least one independent director and only 26 companies established audit committee and abolished the institution of statutory supervisors. There are a total of 718 TSE-listed companies as of December 2008.
oversight job. The failure of independent directors to oversee controlling shareholders as found by this paper exemplifies the “transplant effect” coined by Berkowitz et al. (2003).

In addition, introducing a new legal device to a local environment without corresponding complementarities could contrarily cloud the true face of corporate governance. In Taiwan, all newly listed companies, public financial firms, and large listed firms are required by the law to have independent directors. However, although all independent directors meet the legal definition of “independence,” the true independence of most independent directors is highly dubious. Furthermore, Taiwanese courts have not established a practice of ex post judicial review of the “independence” of directors in board decisions that involves conflicts of interests. Hence, in some way, the new legal institution serves as a camouflage for bad corporate governance. Even some companies that do not honor corporate governance will strive 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. The investors would not know the true independence of directors merely from their resume. Similar concerns were expressed towards the corporate board reform in Japan. Gilson and Milhaupt (2005) write:

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

146 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, http://shenyun.epochtimes.com/b5/7/5/31/n1727895.htm.
147 Interview No. 31 (Nov. 5, 2009), at 9. (“I think in many ways, it’s worse than when we didn’t have any corporate governance concept. …… In the past, people have better ideas about what this organization is doing. Now you force everyone to put on the uniforms. In this way, people instead cannot see your true face.”)
entrenchment.\textsuperscript{148}

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

\textsuperscript{148} Gilson and Milhaupt, \textit{supra} note 84, at 371.
CONCLUSION

One of the most important challenges to modern corporate governance is to constrain controlling shareholder from tunneling corporate resources at a cost to non-controlling shareholders. This 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 would jeopardize the interests of minority shareholders. That includes a more detailed financial disclosure on RPTs and a call for public companies to revamp their internal procedures to prevent unfair dealings. How to structure the tasks of independent directors and statutory auditors in conflicts of interest matters is also an important issue for companies that have both legal institutions.