Do Social Ties Matter in Corporate Governance: The Missing Factor In Chinese Corporate Governance Reform

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ARTICLES

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THE MISSING FACTOR IN CHINESE CORPORATE GOVERNANCE REFORM
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Yu-Hsin Lin*

I. INTRODUCTION

Since the Asian financial crisis in the late 1990s, “model” corporate-governance practices from the United States have been promoted and implemented in various countries in Asia. The “law and finance” literature has demonstrated that laws governing investor protection play an important role in the development of financial markets. Asian countries have adopted these “best practices” in the hope that strengthening investor-protection laws would boost lagging investment and capital markets. One of the most important best practices adopted involves enhancing board independence and requiring independent directors on boards. In the past decade, many Asian countries have adopted new laws to require independent directors on the boards of public companies. The widespread adoption of independent directors in Asia has drawn scholarly attention on how these reformed boards fit into the local legal systems. Table 1 shows the progress of adoption of independent directors in Asian countries in the past decade.

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* Assistant Professor, College of Law, National Chengchi University (Taiwan). J.S.D., Stanford Law School. A shorter version of this paper was presented at Symposium of Corporate Governance in the Post, Post-World: The Public/Private Debate held at the University of Auckland Business School, Auckland, New Zealand and the 9th Asian Law Institute (ASLI) Annual Conference held at the National University of Singapore, Singapore. This paper was presented at The 30th Annual Conference of the European Association of Law and Economics held at University of Warsaw, Warsaw, Poland. Thanks to participants at those conferences and editors of this journal for helpful comments. Any errors remain mine.


2 See generally Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 DEL. J. CORP. L. 125 (2006) (arguing that “[t]he proponents of the institution of independent directors misconceive the nature of corporate governance problem in China…” and analyzing the reasons why this new institution does not function as hoped); Yu-Hsin Lin, Overseeing Controlling Shareholders: Do Independent Directors Constrain Tunneling in Taiwan?, 12 SAN DIEGO INT’L. L.J. 363 (2011) (evaluating the effectiveness of the transplanted institution, independent director, in Taiwan by empirically assessing the extent to which independent directors constrain tunneling by controlling shareholders); Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, 6 HASTINGS BUS. L.J. 281 (2010) (examining the transplantation of independent directors in India and evaluating the effectiveness of such institution); Chao Xi, In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China,
### Table 1 The Adoption of Independent Directors in Asian Countries

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Year</th>
<th>Requirements Regarding Independent Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>2001</td>
<td>Boards should have at least two independent directors, and independent directors should not constitute less than one-third of the members of any board.</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>2012</td>
<td>At least one-third of an issuer’s board should be independent non-executive directors (INEDs)</td>
</tr>
<tr>
<td>India</td>
<td>1999</td>
<td>At least one-third of board directors should be independent if the chairman is a non-executive director. If he or she is an executive chairman, or a non-executive chairman linked to the promoter (i.e., a controlling shareholder), then one-half of the directors should be independent.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2004</td>
<td>The board of commissioners of a newly listed company must have at least thirty percent independent commissioners. The board of directors must have at least one “unaffiliated” director. The number of independent commissioners must be in proportion to the number of shares owned by non-controlling shareholders, but at least thirty percent.</td>
</tr>
<tr>
<td>Japan</td>
<td>2009</td>
<td>Listed companies are required to secure at least one independent director or one statutory auditor.</td>
</tr>
<tr>
<td>Korea</td>
<td>1998</td>
<td>At least one-fourth of the board must be “outside” directors. Certain companies (determined by Presidential Decree) must have three or more outside directors (and more than one-half their board).</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2000</td>
<td>A listed issuer must ensure that at least two directors or one-third of the board of directors of a listed issuer, whichever is the higher, are independent directors. If the number of directors of the listed issuer is not three or a multiple of three, then the number nearest one-third must be used.</td>
</tr>
<tr>
<td>Philippines</td>
<td>2000</td>
<td>Boards should have at least two independent directors or at least one-fifth of the board’s directors should be independent, whichever is lesser—but not less than two.</td>
</tr>
<tr>
<td>Singapore</td>
<td>2005</td>
<td>The issuer’s board must have at least two non-executive directors who are independent and free of any material business or financial connection with the issuer.</td>
</tr>
</tbody>
</table>

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22 CONNECTICUT J. INT’L L. 2 (2006) (exploring the “forces that have shaped the evolution of Chinese legal rules on board governance”).

Since 2002, newly listed firms must have at least two independent directors and one independent supervisor. In 2011, the regulator mandated that all public financial firms and those non-financial listed firms with equity value over NT $10 billion (US $345 million) should have at least two independent directors on their board (and not less than twenty percent of the board should be independent directors).

Thailand 2006 Independent directors should constitute at least one-third of the board and should number no fewer than three.

Although the institution of independent-directors has been a popular regulatory measure in Asia, scholars in the United States have cast doubt on the over-reliance on independent directors to address corporate governance issues. This popular structural reform has given rise to a well-recognized puzzle in the United States, where scholarly studies have found no statistically significant relationship between board independence and overall firm value. Furthermore, empirical studies have found no evidence that audit committees consisting of only independent directors exhibit enhanced firm value. This puzzle suggests that independent directors do not improve overall firm performance. If this is so, have all the efforts of these Asian countries been in vain? If not, then what would explain the puzzle?

If our intuitive faith in independent directors is correct, one explanation to the puzzle would be that current independent directors are not independent enough. Current worldwide ex ante regulations regarding definitions of

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7 But see Benjamin Hermelin & Michael Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96–97 (1998) (noting another explanation would be that board structures are usually voluntarily chosen and are endogenous to other firm characteristics); accord Renee Adams, Benjamin Hermelin & Michael Weisbach, *The
‘independence’, including those adopted by the NYSE and NASDAQ, are concerned largely with employment, financial, and business relations. However, the seemingly tightened definitions cannot ensure the impartiality of directors. In the case of Enron, a report from the United States Senate reveals that several of the independent directors had close personal relationships with Chairman and CEO Kenneth Lay. Although United States federal laws do not address the issue of social or personal relationships, state courts exercise ex post judicial review over the true independence of independent directors in shareholder-derivative suits or suits concerning conflict of interest transactions. In Asia, most countries did not have such ex post judicial review in place when they transplanted the new institutional form because shareholder suits are not common in these countries. Furthermore, such judicial review is unlikely to develop in the near future unless these countries adopt major reforms that would stimulate shareholder suits. Therefore, there is no legal safeguard governing the social ties between independent directors and corporate insiders in Asia.

Empirical studies provide solid evidence of the effects that social ties among board directors have on corporate governance. Studies also show that the effectiveness of independent directors depends on the information environment of the firm. Yet social ties sometimes provide independent directors access to inside information, which may strengthen the effectiveness of their decision-making efforts. All of these findings suggest that independent directors are working in a corporate environment that is far more

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9 United States Senate, The Role of the Board of Directors in Enron’s Collapse 8 (July 8, 2002) [hereinafter Report on Enron]. The Senate opined: Enron Board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay.


11 Id. at 110 n. 144.


complicated than we expected and that we may need to refine our expectations about independent directors’ capacities.\(^{15}\)

Most East Asian countries have been influenced by traditional Chinese culture. *Guanxi* (personal connections or interpersonal relationships) has been an important pillar of Chinese culture and has profoundly affected the operations of corporate society. China and Taiwan are the only two Asian countries where Chinese is the official language and the roots of Chinese culture run deep. Although many East Asian countries have transplanted the institution of independent directors from the United States, it is particularly interesting to observe how social ties function in Chinese and Taiwanese corporate boards and whether such functioning contributes to a “transplant effect”, a term referring to the ineffectiveness of legal transplantation due to different preconditions between the origin country and the transplanting country.\(^{16}\)

To lay the foundation for this article’s discussion of the effects that board members’ mutual social ties have on corporate governance, Part II evaluates the functions and the effectiveness of the boards by drawing on theoretical and empirical studies. Part III reviews recent empirical studies on these effects and discusses the legal control exercised by Delaware corporate law over social ties among board members.\(^{17}\) Part IV empirically assesses the effects of board members’ mutual social ties on the functioning of independent directors in Taiwan and China, two societies deeply influenced by traditional Chinese culture. Part V concludes that social ties do matter in corporate governance.

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\(^{15}\) Id. at 1190.


and urges Chinese policy-makers to implement legal reforms that would address social ties between independent directors and corporate insiders.

II. RETHINKING BOARD FUNCTIONS AND EFFECTIVENESS

THE ADVISORY AND MONITORING ROLES OF BOARDS

Corporate boards of directors are at the apex of corporate internal control systems and are responsible for final corporate decisions. The boards not only advise management on corporate strategy, but also monitor management. The advisory and monitoring roles of boards sometimes overlap. Boards seeking to give effective advice to management rely on management to first provide them with accurate information. On the one hand, boards will advise management more effectively if management provides it with more sound information. But on the other hand, providing more information to boards exposes management to more effective monitoring.

In theory, shareholders want CEOs to share sufficiently sound information with boards so that boards can give sound recommendations to management and effectively monitor management. In practice, however, CEOs face a trade-off in sharing reliable information with their respective boards. Assuming a moral hazard problem presents itself and that CEOs’ preferred projects are different from shareholders’, CEOs would be hesitant to share firm-specific information with their own boards if those boards are independent and intensely monitoring their own CEOs. As a result, the advisory and monitoring roles of boards may conflict with each other. Economic theories suggest that it may be optimal for shareholders to choose a friendly board that does not monitor too intensely and with whom the CEO is willing to share information.

In his 2011 article, Faleye provides empirical evidence showing that advisory and monitoring roles do conflict. The study classified board

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20 See generally Renee Adams et al., supra note 7.
committees as either monitoring committees or advising committees and categorized audit, compensation, and nomination committees as monitoring committees. The study defined directors as monitoring-intensive if they served on at least two of the three principal monitoring committees and defined boards as monitoring-intensive if a majority of their members were monitoring-intensive directors. In addressing the quality of board-advising functions, the study used acquisition performance and corporate investments in innovation as proxies of innovation. A major finding was that firms with monitoring-intensive boards exhibited worse acquisition performance and less innovation than did firms with weakly monitoring boards, implying that intense monitoring could compromise board-advisory functions.

The question is whether boards with intense monitoring and weak advising functions would be most likely to strengthen or to weaken firm value. Faleye found that monitoring-intensive boards are associated with a statistically significant reduction of 12.1 percentage points in Tobin’s $q$, a proxy for firm value. There are many possible explanations for the loss in firm value. Because of time constraints, increases in directors’ time spent monitoring management could reduce the time available to the directors for advising management. In addition, monitoring-intensive directors would perceive themselves as corporate monitors rather than advisors and thus are reluctant to provide strategic advice. On the other hand, CEOs tend to share less information with monitoring-intensive boards, and this could result in poorer board advice.

Empirical research supports the theoretical hypothesis that the advisory and monitoring roles of boards are sometimes in conflict with each other. In general, research suggests that the net effect of increased monitoring is negative, especially in larger firms where the firms’ needs on board advising is greater than smaller firms because their operations are more complex, or when firms are in need of their own board’s advice on specific value-creating activities, such as corporate acquisitions and investments in research and development.

24 Id., at 164.
25 Id.
26 Id., at 170–73.
27 Id., at 170.
28 James D. Westphal, Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management, 43 ADMIN. SCI. Q. 511, 512–13 (1998); Benjamin Hermalin & Michael Weisbach, supra note 7, at 96–97.
29 Faleye, supra note 23, at 175 (“Tobin’s $q$ is defined as total assets minus the book value of equity plus the market value of equity, divided by the book value of assets”).
30 Id. at 175.
31 Id. at 175–78.
Boards tend to rely on management to provide them with sound information with which they can make effective decisions. This pattern is also true for outside directors. Some observers are skeptical about the effectiveness of outside directors because they are thought to possess information inferior to that of insiders on boards. Theoretical research shows that the effectiveness of outsiders in both advisory and monitoring functions depends on the information environment of the firm. Therefore, it would be reasonable to suspect that prior research could not find statistically significant relations between board independence and firm performance partly because the research had omitted a very important variable: information cost.

In their 2010 article, Duchin, Matsusaka, and Ozbas conducted an empirical study testing the impact of information cost on the effectiveness of outside directors. They constructed firm-specific proxies for the cost of outsiders’ becoming informed. Those proxies included the number of analysts posting firm-related forecasts in a given year, the dispersion of analyst forecasts, and the analyst-forecast error. These variables rested on the availability, homogeneity, and accuracy of analysts’ quarterly earnings forecasts.

First, Duchin, Matsusaka, and Ozbas estimated the relation between board independence and firm performance in general. Consistent with prior research studies, they found no significant relation between the two. Nevertheless, they noted a significant improvement in performance of the firms in the lowest information cost quartile as the percentage of outsiders on a board increases. For firms in the highest information cost quartile, their performance deteriorated when the percentage of outsiders on the board increased. The research suggests that the effectiveness of outside directors depends on information costs. In addition, the researchers found that firms

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32 See Adams & Ferreira, supra note 21.
33 Ran Duchin et al., supra note 13, at 197–211.
34 Id. at 201–02:
   [t]he dispersion of analyst forecasts is measured as the standard deviation of earnings forecasts across analysts prior to a quarterly earnings announcement, normalized by the firm’s total book assets and averaged across four quarters in a given year. The analyst forecast error is measured as the absolute difference between the mean analyst earnings forecast prior to a quarterly earnings announcement and the actual earnings, normalized by the firm’s total book assets and averaged across four quarters in a given year.
35 Id.
36 Id.
37 Id.
38 Id. at 204.
39 Id.
40 Id. at 204–06.
do take information costs into consideration when composing their boards. In line with theoretical research, Duchin, Matsusaka, and Ozbas uncovered empirical evidence that it may be optimal for insiders to control some boards, and that recent regulations mandating outsider control of boards could harm firm value of certain firms.

**SOCIAL TIES AS SOURCES OF INFORMATION**

Theoretical and empirical research has shown that information is essential to the effectiveness of outside directors in both the monitoring and advising functions. Hence, sources of information are an important factor. Most outside directors obtain inside information from the CEO. Theory suggests that if the interests of a CEO differ from those of the firm’s shareholders, the CEO faces a trade-off in sharing information with the board. If outside directors are independent and monitor intensely, the CEO will likely be unwilling to share information. In that situation, outside directors lose an important source of inside information and their performance declines. It is therefore optimal to have a friendly board. Westphal examined whether social ties between outside directors and their CEO would increase board involvement and firm performance. To identify social ties, Westphal relied on surveys of corporate directors and CEOs that asked the respondents whether they were friends with each other or mere acquaintances. The research study shows that social ties can contribute to board effectiveness and firm performance by fostering collaboration between CEOs and directors in the strategy-making process without reducing board control.

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41 Id. at 211.
42 Id. at 212.
43 Id.
45 Id.
46 See generally Adams & Ferreira, supra note 21, at 80 (“[W]hen it is likely that directors possess valuable information about an acquisition, the returns of the acquirer are higher on announcement of the acquisition for bidders with more friendly boards”).
48 Westphal, supra note 47, at 13–14; Westphal et al., supra note 47, at 433 (it is common in social network research to ask the respondent to identify their perceived level of friendship with others).
49 Westphal, supra note 47, at 20; Westphal et al., supra note 47, at 442–43.
III. DO SOCIAL TIES MATTER IN CORPORATE GOVERNANCE?

EMPIRICAL FINDINGS

Although social ties can help facilitate information exchange between CEOs and outside directors, they can cast doubt on the independence of outside directors and the effectiveness of their monitoring activities.\(^\text{50}\) Studies have examined the effects that social ties can have on outside directors’ monitoring function.\(^\text{51}\) In testing the monitoring effectiveness of outside directors with social ties, studies have used different proxies including CEO-compensation level, earnings management, and financial-reporting quality.\(^\text{52}\)

Recent theoretical work has presented economic models that probe into the relations between social networks and corporate governance.\(^\text{53}\) Theory suggests that social connections between board members tend to impede governance effectiveness because boards, desirous of preserving their social capital, are reluctant to undertake an intense monitoring of CEOs.\(^\text{54}\) In addition, social networks can reduce the precision of information collected and used by board members in deciding resource allocation.\(^\text{55}\) While precise information may improve resource allocation, it could also raise the probability of detecting CEO’s siphoning of corporate assets.\(^\text{56}\) Therefore, board members with social ties to CEOs tend not to collect precise information in order to preserve social capital.\(^\text{57}\)

Subrahmanyam presented empirical evidence on social networks and corporate governance.\(^\text{58}\) The study uses age differences, occupation, ethnicity, gender, and familial relationships between CEOs and board members as proxies for social networks.\(^\text{59}\) Subrahmanyam’s empirical tests present compelling evidence that when boards consist of both fewer members who are CEOs and greater non-Caucasian representation, the corresponding firms are better governed and executive compensation is lower than would otherwise be the case.\(^\text{60}\)

Given that the majority of board members of United States

\(^{50}\) See James D. Westphal & Poonam Khanna, Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite, 48 ADMIN. SCI. Q. 361, 363, 385–91 (2003) (studies have shown that social ties among board members and CEOs would have adverse effects on governance).
\(^{51}\) Id. at 362–63.
\(^{52}\) Id. at 377–78.
\(^{53}\) Avanidhar Subrahmanyam, Social Networks and Corporate Governance, 14 EUR. FIN. MGMT. 633, 636–45 (2008).
\(^{54}\) Id.
\(^{55}\) Id.
\(^{56}\) Id.
\(^{57}\) Id.
\(^{58}\) Id.
\(^{59}\) Id. at 649.
\(^{60}\) Id. at 649 (the quality of governance was measured by the governance index obtained from Andrew Metrick’s website).
companies are Caucasian, research results suggest that firms’ governance can improve when social networks between board members and CEOs are minimal or absent. In sum, Subrahmanyam’s work suggests that social ties can reduce board’s monitoring capabilities and increase CEO compensation, which lead to lower shareholder value.

Hwang and Kim examined the social ties between board directors and CEOs within individual Fortune 100 firms and the association between these ties and executive compensation. The researchers identified social ties by noting board directors and CEOs’ shared backgrounds, including mutual alma mater, military service, regional origin, academic major, and industry, and found that the percentage of independent boards dropped from eighty-seven percent to sixty-two percent when screenings indicated that there were shared backgrounds. Using CEO compensation as a proxy for directors’ monitoring level, the researchers tested the association of social ties among board members on CEO compensation. They found that the CEOs of companies with socially independent boards received significantly lower compensation than CEOs of companies with non-independent boards, suggesting that social ties do impair the impartiality of outside directors and diminish their monitoring function.

Following up on their prior research, Hwang and Kim further examined the effects of social ties between CEOs and audit committee members on audit committees’ oversight capabilities and, in particular, on the firms’ financial reporting process. The researchers found that social ties, defined by shared backgrounds, between audit committee members and CEOs are more prevalent than conventional ties, as captured by the law since Sarbanes-Oxley Act of 2002 (“SOX”). The samples of this study include Fortune 100 firms as declared in 1996 and 2005. The researchers built a social index which represents the average number of ties each audit committee member has with the CEO. In twenty-five percent of the sample firms, the average social ties of each audit committee member to the CEO is greater than 1.0; in 2.4% of the samples firms, the average number is greater than 2.0, suggesting a strong presence of social ties in Fortune 100 firms. Each audit committee member, on average, has 0.6 social ties and 0.1 conventional ties to the CEO. Since the samples span the period from 1996 to 2005, it is expected that

61 Id. at 647–53.  
62 Id. at 647–53.  
63 See Hwang & Kim 2009, supra note 12, at 139–44.  
64 Id.  
65 Id. at 145–48.  
66 Id. at 145–48.  
67 Id. at 10.  
68 Id.  
69 Id.  
70 Id.  
71 Id.
conventional ties will not be prevalent because all audit committee members are supposed to meet the independence requirements set by 2002 SOX and later-published rules of NYSE and NASDAQ.\textsuperscript{72}

Hwang and Kim further examined the association between audit committee members’ social ties and the firms’ earnings-management practices.\textsuperscript{73} The major responsibility of an audit committee is to oversee the integrity of a firm’s financial reporting system.\textsuperscript{74} Earnings management refers to attempts by the management to influence or manipulate reported earnings.\textsuperscript{75} Earnings management practices are usually associated with fraud and threaten the integrity of a firm’s financial reporting system.\textsuperscript{76} Hwang and Kim used abnormal (i.e. discretionary) accruals as proxies for earnings-management activities and examined the association between social ties of audit committee members and abnormal accruals.\textsuperscript{77} They found that the association between abnormal accruals and the extent of audit-committee members’ social ties to the CEO is substantially stronger than the association between abnormal accruals and audit-committee members’ conventional ties to the CEO.\textsuperscript{78} This finding suggests that mutual qualities foster relationship building and that social ties can impair the oversight ability of audit committees, as evidenced by facilitation of earnings-management practices.\textsuperscript{79}

Empirical research shows that social ties between independent directors and CEOs do compromise the monitoring ability of independent directors. However, because social ties could foster information exchange – which is essential for independent directors’ execution of their responsibilities – social ties between independent directors and CEOs could foster board collaboration and improve boards’ advisory function. Finally, whether social ties increase or decrease firm value will depend on each firm’s specific current status, such as a firm’s development stage and a firm’s complexity. The optimal composition of boards may vary among different firms and at different stages of development.

\textsuperscript{72} Id. at 19–20.
\textsuperscript{73} Id. at 7.
\textsuperscript{74} Id. at 1.
\textsuperscript{75} Id. at 7.
\textsuperscript{76} Id. at 15.
\textsuperscript{77} Id. at 7–8.
\textsuperscript{78} Id. at 10–12.
\textsuperscript{79} Id. at 10–12.
United States scholars have long been aware of the social and psychological causes of bias that could impair independent directors’ impartiality. Directors may be biased by group loyalty, friendship, and other non-pecuniary self-interests that are not captured by current regulations of independence. This theory of structural bias suggests that even if an independent director does not have financial or employment ties with a firm, he may still be biased in making decisions because of the social pressures generated from his personal relationship with other board members or management. Drawing on structural bias theory, scholars have called for more stringency in the controls over social ties that could affect the independence of independent directors.

In the United States, internal governance of corporations has long been the domain of state corporate law. Although federal law has intruded into corporate governance following serious financial shenanigans, the regulatory power of American states over the internal affairs of a corporation are largely intact. Since federal laws and rules promulgated by listing agents regarding independent directors do not take into account social ties of independent directors, it is particularly important to analyze how state laws respond to this issue. Delaware law is said to be the “mother of all corporate law” because of the large number of public companies incorporated in Delaware. This section will briefly introduce current definition of independence under federal regulations.

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82 See Victor Brudney, supra note 80, at 611–12.
84 See Edgar v. MITE Corp., 457 U.S. 624, 645 (1982) (Under the internal affair doctrine, the internal affairs, e.g. conflicts between shareholders and directors, will be governed by the state law where the corporation is incorporated. Therefore, by choosing the state of incorporation, companies choose the state corporate law that will govern its internal affairs).
85 See Roe Delaware’s Competition, supra note 17, at 596–97.
87 See also Rodrigues, supra note 86, at 464.
law and Delaware law, and how Delaware courts address the issue of social ties in the absence of black-letter laws.

A. Federal Law: The Case of Enron, SOX and Listing Agents’ Rules

At the time Enron collapsed in December 2001, Enron’s board of directors had seventeen board members, two of whom were senior officers of the company. The other fifteen members were outside directors, and several had more than twenty years of experience on Enron’s board. All of the board members had sophisticated business and investment experience and considerable expertise in accounting and derivatives. Nevertheless, they breached their fiduciary duties by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation.

After Enron’s dramatic collapse, the United States Senate conducted an investigation into Enron’s board. The report shows that most of Enron’s board members had considerable financial relationships with the company. These financial ties included additional consulting fees paid to individual directors, donations by Enron to organizations where board members served as presidents, substantial business relationships between Enron and firms where board members served in high ranking positions, etc. The report concluded that the independence of the Enron board members was compromised by these financial ties.

In response to Enron’s debacle, the federal government enacted SOX to redefine the meaning of independence for directors. SOX requires all audit committee members be independent and defines independence from the perspective of compensation and employment. To qualify as independent, a director may not, “other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.” SOX further requires the Securities Exchange Commission (“SEC”) to direct national

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90. Id., at 11–14.
93. Id. at 51–52.
94. Id. at 51.
96. Sarbanes-Oxley Act of 2002 §301 (m)(3)(A), (B).
97. Id. at § 301 (m)(3)(B).
securities exchanges, including NYSE and NASDAQ, and national securities associations to adopt rules in compliance with the new act. NYSE and NASDAQ have since adopted rules to require each member of the audit committee to be independent. The listing agents went further to require (1) majority of the board be composed of independent directors, (2) both nominating committee and compensation committee be composed entirely of independent directors, and (3) the definition of independence be extended from employment relationship to financial and business relationship.

98 Id. at § 301 (m)(1)(A).


100 NYSE LISTED COMPANY MANUAL, supra note 99, at § 303A.01; NASDAQ, MARKETPLACE RULES supra note 99, at r.5605(b)(1).

101 NYSE LISTED COMPANY MANUAL supra note 99, at §§ 303A.04(a), 303A.05(a); NASDAQ, MARKETPLACE RULES supra note 99, at r.5605(A)(6)-(7).

102 For definition of “independence,” see NYSE LISTED COMPANY MANUAL supra note 99, at § 303A.02:

(a)(i) No director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

(iii) (A) The director is a current partner or employee of a firm that is the listed company’s internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company’s audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company’s present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services
However, the seemingly tightened definition of director independence still cannot ensure the impartiality of directors. In the case of Enron, the report from the United States Senate reveals that many of the independent directors had served on the board for more than twenty years and had close personal relationships with Chairman and CEO, Kenneth Lay. Nevertheless, the definition of independence under SOX and listing agents’ rules do not exclude personal relationships or social ties. So could such close social ties among board members have contributed to Enron’s debacle?

Enron Board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay.

From the Senate’s report, it seems that close social ties do correlate with harmonious board relations, unanimous board decisions and good working relationships with the management. This harmonious atmosphere may have created a structural bias of the independent directors, leading them to approve a series of conflict of interest transactions proposed by management, and ultimately leading to the collapse of the Enron Empire. Nevertheless, federal law is silent on this important issue.

B. State Law: The Law of Delaware

Delaware does not require “independent directors” on corporate boards; hence, Delaware General Corporation Law does not set an explicit standard for director independence. Instead, Delaware General Corporation Law leaves the corporations to decide the number and qualifications of their board members as well as the structure of the board. Nevertheless, Delaware courts have created a regulatory framework where decisions made by

in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company’s consolidated gross revenues.

NASDAQ provides similar definition, see NASDAQ, MARKETPLACE RULES supra note 99, at r.5605(a)(2).


104 Id.

105 See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation, 69 U. CHI. L. REV. 1233, 1241–42 (2002) (“[i]t turns out that the independence of virtually every board member [of Enron], including Audit Committee members, was undermined by side payments of one kind or another. Independence also was compromised by the bonds of long service and familiarity”). See also O’Connor, supra note 81.

106 Fairfax Inside Director, supra note 4, at 146–47.

107 Clarke, supra note 10, at 102.

108 DEL. CODE ANN. tit. 8, § 141 (b), (2010).
disinterested and independent boards will not be substantively reviewed by the court (the “business judgment rule”), and thus, the directors will be shielded from potential liabilities.\(^{109}\) To enjoy the benefit of business judgment rule and avoid potential liabilities, Delaware corporations voluntarily retained outside directors who are disinterested in specific transactions and/or are independent even before the enactment of SOX. Delaware courts grant directors protection from liability if the decision was made solely by disinterested and/or independent directors in three types of suits: dismissing shareholder derivative suits against directors, approving conflict of interest transactions where directors or officers’ interests are involved, and taking defensive measures against hostile takeovers.\(^{110}\)

In determining the independence of directors, the courts of Delaware apply a case-by-case approach and review the factual allegations to determine the independence of an independent director.\(^{111}\) Delaware courts look to whether the decision under review “is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”\(^{112}\) Delaware courts hold the view that a plaintiff must show a “domination and control” relationship among directors.\(^{113}\) Substantial shareholding or even majority ownership of a company alone would not rebut the presumption of independence.\(^{114}\) Plaintiffs must show that “the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is ‘sterilized’.”\(^{115}\) For example, in *Rales v. Blasband*, Supreme Court of Delaware held that two directors were not independent based on their employment relationships because one of them was the President and CEO of

\(^{109}\) Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (whether “(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment”).


\(^{111}\) Aronson, 473 A.2d at 814 (“[a]s to the former inquiry, directorial independence and disinterestedness, the court reviews the factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board”); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) (“Independence is a fact-specific determination made in the context of a particular case.”); see also Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. Rev. 1, 29 (2007); Rodrigues, supra note 86, at 465, 483–84.

\(^{112}\) Aronson, 473 A.2d at 816 (“[i]ndependence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences”).

\(^{113}\) Aronson, 473 A.2d at 815–16.

\(^{114}\) Aronson, 473 A.2d at 815; see also Rales v. Blasband, 634 A.2d 927 (Del. 1993) (holding that factual allegations must give reasonable doubt as to directors’ independent and disinterested business judgment); Levine v. Smith, 591 A.2d 194, 205 (Del. 1991) (holding that shareholder must plead particularized facts creating reasonable doubt to soundness of challenged transaction).

\(^{115}\) Levine, 591 A.2d at 205.
the defendant company and the other is the President of a company where defendant directors are directors and major shareholders. 116

In addition, Delaware courts also take allegations of social or personal relationships seriously. Delaware courts generally hold that mere friendships are not at a level where they create bias in decision making. 117 A mere allegation that the controlling shareholder and the independent director are very close friends is not enough to prove that the independent director lacks sufficient independence. 118 Underpinning the claims against social or personal relationships is the concept of structural bias. In general, the Delaware courts express skepticism about structural bias, 119 and rule in line with economists’ “reputation argument”, according to which directors try hard to avoid bias in order to preserve their reputation in the independent-director market. 120 Hence, unless substantial evidence arises supporting the claim that an independent director “would be more willing to risk his or her reputation than risk the relationship with the interested director,” the court holds the view that even if structural bias exists, structural bias can be avoided by independent directors. 121

However, there are cases in which Delaware courts rebutted assertions pointing to the independence of directors if substantial evidence revealed close social or professional relationships among directors. In particular, in cases

116 Blasband, 634 A.2d at 936–37.
117 Stewart, 845 A.2d at 1050.
118 See Aronson, 473 A.2d at 816–17 (“The director’s approval, alone, does not establish control, even in the face of Fink’s 47% stock ownership.... Therefore, we cannot conclude that the complaint factually particularizes any circumstances of control and domination to overcome the presumption of board independence, and thus render the demand futile.”); Stewart, 845 A.2d, at 1051–52 (“Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes.”).
119 Aronson, 473 A.2d at 815 n.8; Stewart, 845 A.2d, at 1052-53.
120 Eugene Fama & Michael Jensen, Separation of Ownership and Control, 26 J. L. & ECON. 301, 315 (1983); see also Stewart, 845 A.2d at 1052.
121 Stewart, 845 A.2d at 1052 n. 32; Page, supra note 81, at 258–86; (contemporary psychological research studies recognize another prototype of bias—“unintentional bias,” which results from unconscious cognitive processes. Because such bias is “involuntary” and “unconscious,” it can occur even when the decision maker intentionally seeks to avoid biases. Commentators argue that because decision makers are unaware of such bias, the reputation argument supported by economists thus is unsustainable).
involving special litigation committees (SLC), the corporation and the SLC lost the protection of presumption of independence once it established the SLC to consider whether to pursue litigation against its directors. In this situation, the corporation bears the burden of proving the independence of its SLC members.\footnote{Zapata v. Maldonado, 430 A.2d 779, 788 (Del. 1981).} In Biondi v. Scrushy, the Delaware Court of Chancery questioned the independence of two members of the SLC because of their long-standing personal ties with the defendant director.\footnote{Biondi v. Scrushy, 820 A.2d 1148, 1166 (Del. Ch. 2003).} Furthermore, in the case of In re Oracle Derivative Litigation, the Delaware Court of Chancery found that members of the SLC, who were both Stanford University professors, lacked independence because several defendant directors also had substantial financial and professional ties to Stanford University where the SLC members were employed.\footnote{In re Oracle Corp Derivative Litigation, 824 A.2d 917, 947–48 (Del. Ch. 2003); see also Rodrigues, supra note 86, at 474–76.}

In situations where a corporation is considering a merger or acquisition, especially in cases involving management interests, a corporation would establish a special negotiating committee composed of disinterested and independent directors to consider the transaction. In In re Loral Space and Communication, the Court of Chancery of Delaware found the chairman of the special negotiating committee to be a non-independent director because he was a close friend of the controlling shareholder and had a substantial business relationship with the controlling firm. In the context of a special negotiating committee, the courts evaluate not only the relationships among members of the committees and interested parties but also “whether the committee members in fact functioned independently.”\footnote{Kahn v. Tremont Corp., 694 A.2d 422, 429–30 (Del. 1997).} In the same case, the court found another member of the special negotiating committee not independent mainly because he did not demonstrate the knowledge and the inclination to effectively perform his duty.\footnote{In re Loral Space & Commc’ns Inc., 2008 WL 4293781, 22 (Del.Ch. 2008).}

A key factor affecting the outcome of litigation concerning director independence is the burden of proof. Social ties are personal and confidential in nature. It would be hard for everyone to prove another’s personal relationship without going through discovery. Through discovery, both parties are forced to provide confidential information that helps the court to determine the independence of directors. The party that bears the burden of proof usually fails to meet his burden if the case does not go through discovery.

For example, in cases involving a special litigation committee, according to the rules established in Zapata v. Maldonado, the court applies a two-stage test when shareholders challenge the committee’s decision to not pursue the suit.\footnote{Maldonado, 430 A.2d at 779, 788.} “First, the Court should inquiere into the independence and good faith
of the committee and the bases supporting its conclusions.” In this stage, the company bears the burden of proving committee members’ independence and good faith and the reasonableness of the decision. In addition, discovery procedure applies in the first-stage inquiries. This procedural change has significant effects on the outcome of claims. In situations where a company establishes a special litigation committee, the members of the special litigation committee lose the protections associated with presumptions of independence. In Beam v. Stewart, the Delaware Court of Chancery took the view that “[t]he special litigation committee bears the burden of ‘establishing its own independence by a yardstick that must be ‘like Caesar’s wife’—‘above reproach.’”

In addition, with the application of discovery procedures to contexts where significant confidential information about personal relations would not be released otherwise, the burden of proving the independence of special litigation committee members is very high. In Beam v. Stewart, the Delaware Court of Chancery highlighted the profound impact of these procedural differences: “[a]s a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence.” Even if a company passes a first-stage review and establishes the independence of its special litigation committee, Delaware courts still use their own “independent business judgment” to substantively review the decisions of special litigation committees.

In sum, the burden of proof and the applicability of discovery procedure are factors that are key to the outcome of suits challenging director independence from the perspective of personal relationships. Except in cases

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128 Id.
129 Id., at 788 (“Limited discovery may be ordered to facilitate such inquiries. The Corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.”).
130 Stewart, 845 A.2d, at 1055 (quoting Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)).
131 Id.
132 Maldonado, 430 A.2d at 789 (“The Court should determine, applying its own independent business judgment, whether the motion should be granted.”). Conversely, New York State took an opposite position. The New York Court of Appeals ruled that courts shall not second guess the decision of a special litigation committee if the committee’s members pass the first-stage test of independence. See Auerbach v. Bennett, 393 N.E.2d 994, 1001–03 (N.Y. 1979).
133 Maldonado, 430 A.2d. at 789: The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation’s best interests as expressed by an independent investigation committee…. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation’s best interests.
where the defendant company or director bears the burden of proof, such as the ones involving special litigation committees,\(^{134}\) it is very difficult for shareholders to meet the burden and challenge social ties among board members. Some scholars have questioned the presumption of director independence in cases involving structural bias and called for more judicial power in reviewing the substantive merits of independent directors’ decisions.\(^{135}\) More challenges based on personal relationships have been raised in recent years, questioning the independence of directors in the United States.\(^{136}\) Although it is not easy for plaintiffs to successfully rebut the presumption of independence, the courts nevertheless take allegations of personal relationships seriously. In practice, lawyers have also advised their clients to take into account personal relationships when selecting members for special committees.\(^{137}\) This development is worth the notice of countries that have transplanted the institution of independent directors.

\(^{134}\) The burden of proof in pre-suit demand cases is on the plaintiffs. However, where the special litigation committee sought dismissal of lawsuit already filed, the “SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence.” London v. Tyrrell, C.A. No. 3321-CC, at *41 (Del. Ch. 2010).

\(^{135}\) See generally Kenneth B. Davis, Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence, 90 IOWA L. REV. 1305 (2005); Velasco, supra note 81; cf. Rachel A. Fink, Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate “Rubber-Stamping” Boards, 79 S. CAL. L. REV. 455 (2006) (looking to stock exchanges, instead of Delaware courts, to examine the social ties among board members by proposing to require all listed firms to have board-rating agencies score the independence of director nominees).


IV. SOCIAL TIES IN CHINESE CORPORATE BOARDS

Central to Chinese culture is the concept of *guanxi*, which roughly translates into personal connections, or interpersonal relationships. This component of Chinese culture dominates every aspect of social life in Chinese societies, including in the business world. In contemporary Chinese societies, *guanxi* remains so powerful that, if left unregulated, it could endanger the core value of independent directors—**independence**.

Another central feature of Chinese societies is the extraordinary degree to which harmony is prized and conflict is avoided. This cultural respect for harmony can, like *guanxi*, powerfully affect group cohesion, which is an important source of structural bias. This section reviews the process by which Taiwan and China undertook a legal transplantation of independent directors, and analyzes the effects that independent directors’ social ties to controlling shareholders or corporate insiders can have on corporate governance.

TAIWAN

A. Corporate Governance in Taiwan

The most important challenge in corporate governance in Taiwan is to constrain controlling shareholders’ extraction of private benefits from minority shareholders. The corporate ownership of Taiwanese public companies is concentrated, family-owned, and divergent in its control rights and cash-flow rights. Yeh and Woidtke found that seventy-two percent of Taiwanese public firms had a controlling shareholder and that, among them, eighty-three percent were family controlled. The largest shareholders of Taiwan’s non-financial firms controlled 62.69% of the board seats and 49.55% of the statutory-auditor positions. Hence, large shareholders in Taiwan not only own public firms but manage and control them as well.

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140 There is an old Chinese saying, “he weigui,” which means “Harmony is prized.”


Corporate control in East Asian countries is typically enhanced by pyramid structures and cross-holding among firms. 143 Bebchuk, Kraakman, and Triantis (2000) applied the term controlling-minority structure to the pattern of ownership that, through structural devices, separates controllers’ ownership rights (cash-flow rights) from controllers’ control rights (voting rights). 144 In 2005, the average control rights of the largest shareholders in Taiwanese non-financial firms was 29.81%, however, the average cash-flow rights were only 22.13%. 145 The discrepancies between cash-flow rights and voting rights provide controlling shareholders strong incentives to siphon out corporate assets to their own pockets at the expense of minority shareholders. In addition, controlling shareholders’ control over the firms provides further opportunities for such misconduct. 146

The corporate-board structure of Taiwan generally follows the Japanese governance structure, which is a modified version of the German governance structure. In Germany, supervisory boards have the right to appoint or remove directors; however, in Japan and Taiwan, supervisors are nominated by boards and elected by shareholders. 147 In addition, statutory supervisors or statutory auditors in Taiwan act individually, not collectively like their German and Japanese counterparts. 148 According to the Corporation Law of Taiwan, a statutory auditor is an independent supervisory institution responsible for

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143 A pyramid structure refers to an ownership structure where the controlling shareholder holds shares of one company, which in turn holds shares of another company. The controlling shareholder thus controls these two companies. This process can be repeated a number of times and thus creates a pyramid of companies that are controlled by the controlling shareholder. Cross-holding refers to a situation where a subsidiary owns shares of the parent company. See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J. FIN. 471, 473 (1999); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, The Separation of Ownership and Control in East Asian Corporations, 58 J. FIN. ECON. 81, 93 (2000).


145 The cross-shareholding and the pyramidal structure are the most common structures that controlling shareholders use to create deviations in Taiwanese public companies. YIN-HUAYEH & CHEN-EN KO, DE RI MEI HAN GEGUO DULI DONGSHI, SHENJIE WEIYUAN HUI JITA ZHUANMEN WEIYUAN HUI FAZHI GUIFANJI SHIWU YUNZUO QINGKUANG [The Law and Practices of Independent Directors, Audit Committees, and Other Functional Committees in Germany, Japan, the United States, and South Korea], FINANCIAL SUPERVISORY COMMISSION OF TAIWAN 294 (January 2006), available at available at http://www.fsc.gov.tw/ch/home.jsp?id=194&weblink=multiSTUDY_list.jsp&parentpath=0,7,7 2 (last visited Nov. 25, 2013).

146 Bebchuk, Kraakman & Triantis, supra note 144, at 295.


148 Id. at 347–48 (Japan reformed its statutory auditor system in 1993 requiring companies to establish a board of statutory auditors and have at least one member of the auditor board to be an outside auditor. Before this reform, the law in Japan requires statutory auditors to perform their duties individually).
auditing the business conditions of companies and for evaluating the performance of companies’ boards of directors and managers.\(^{149}\) However, a statutory auditor has the right only to attend board meetings, not the right to vote. In addition, the pre-reform law set no qualification for statutory auditors. In the past, many statutory auditors are relatives or friends of the given companies’ founding families, controlling shareholder, directors, or top executives. Therefore, most statutory auditors of Taiwanese public companies are just “rubber stamps”.\(^{150}\)

B. The Reform

To equip a controlled board with checks-and-balances powers, the Taiwanese regulatory authority introduced the institution of the “independent director”. In 2002, the TSE began taking a leading role in requiring all newly listed companies to have at least two independent directors and one independent statutory supervisor.\(^{151}\) In 2006, Taiwan’s Congress revised the Securities and Exchange Law to introduce the institution of independent directors, essentially giving public companies the option to choose whether or not they would have independent directors.\(^{152}\) In the meantime, to speed up the pace of reform, the law authorized the Financial Supervisory Commission to implement the law in stages.\(^{153}\)

In March 2006, Taiwan’s Financial Supervisory Commission (“FSC”) mandated that all public financial firms and those non-financial listed firms with equity valued over NT$50 billion (US$1.6 billion) have at least two independent directors on their boards, and that the total number of independent directors should be no less than one-fifth the number of board members.\(^{154}\) On March 22, 2011, the FSC further expanded the mandate to firms with equity valued over NT$10 billion (US$345 million).\(^{155}\) As of August 2013, there were 425 out of 809 TSE-listed companies whose boards had at least one


\(^{153}\) For a detailed description of corporate-board reform in Taiwan, see Lin, supra note 2, at 395-97; LEN-YU LIU, YI-CHING TU, YU-HSIN LIN & CHRISTOPHER CHEN, THE ELECTION OF INDEPENDENT DIRECTOR AND CORPORATE GOVERNANCE 3-10 (2013).

\(^{154}\) FIN SUPERVISORY COMM’N, Jing-Kuan-Cheng-1-Tzu-0950001616-Hao, Mar. 28, 2006. (abolished on March 22, 2011), available at http://www.selaw.com.tw/Scripts/Query1B.asp?no=3G01000%AA%F7%BA%DE%C3%D2%A4%40++++++++++++++++0950001616++&K1=%BFW%A5%DF%B8%B3%A8%C6&StartDate=20060301&EndDate=20060331 (last visited Dec. 3, 2013).

independent director.\textsuperscript{156} That is, 52.53\% of the TSE-listed companies had at least one independent director on their board. Only 17\% (137 out of 809) of TSE-listed companies adopted the United States-style board structure by establishing audit committees and abolishing statutory supervisors.\textsuperscript{157} Still, 47.47\% of TSE-listed firms did not have any independent directors.

C. Social Ties as Information Exchange

Forty independent directors of Taiwanese public companies were interviewed for this study.\textsuperscript{158} The purpose of the interviews was to identify and characterize the kinds of personal relationships that existed between independent directors and controlling shareholders and whether social ties served as a useful source of information exchange.

Of the forty independent directors interviewed by this study, nineteen used the term “very close friend” to describe their relationship with controlling shareholders, other directors or CEOs within a given firm, and fourteen other independent directors stated that they were personally acquainted with controlling shareholders, other directors or CEOs within a given firm, but were not “very close friends” with these individuals. Only seven of the interviewees had not known the controlling shareholders, other directors or CEOs before being invited to join the board.

The interview results are stunning. Almost half of the independent directors described controlling shareholders, other directors or CEOs of the firms as “very close friends.” While public companies are required to disclose


\textsuperscript{158} This research study adopted semi-standardized and in-depth interviews, where the author/interviewer generally followed a set of predetermined questions but was allowed to make adjustments depending on the situation. Bruce L. Berg & Howard Lune, Qualitative Research Methods for the Social Sciences 112–13 (8th ed. 2012). Semi-structured interviews are appropriate when respondents have information or knowledge that the researcher may not have thought of in advance. Sharlene Nagy Hesse-Biber & Patricia Leavy, The Practice of Qualitative Research 125–26 (2006). Quantitative research studies usually require probability sampling where each unit in the population must have “an equal and independent chance of inclusion” in the sample and the parameters required for creating such samples are quite restrictive. However, social science research studies often examine situations where probability samples are not feasible; hence, researchers tend to rely instead on nonprobability sampling strategies. Nonprobability sampling tends to be the norm in social science qualitative research. Some of the commonly used nonprobability samples are convenience samples, purposive samples, snowball samples, and quota samples. Snowball sampling is similar to convenience sampling and is most popular among studies concerning various classes of deviance, sensitive topics, or difficult-to-reach populations. Since corporate directors in general are difficult to reach, this research study adopted convenience sampling and snowball sampling. Berg & Lune, at 50–53.
the financial, familial, and business relations among independent directors, the companies and corporate insiders, almost no formal sources of information identify their close personal relationships. But such social ties might hinder the monitoring ability of independent directors. Although the interview results are hard to generalize because of the limited number of samples involved, most interviewees agreed that a majority of independent directors in Taiwan had some degree of guanxi with their controlling shareholders or other corporate insiders.\(^{159}\)

Independent directors have long been criticized as outsiders who rely on the firm and corporate insiders to provide information needed for carrying out directors’ duties.\(^{160}\) There is an information asymmetry between independent directors and controlling shareholders, who are usually also managers in Taiwanese firms. It is hard for independent director candidates to decide whether to join a board if they were not first to obtain adequate information about the firm. Interestingly, to screen firms and decide whether to accept the offer, the key criterion used by independent directors in Taiwan is not the corporate governance of a company but the integrity of controlling shareholders or other corporate insiders.

The interview results reveal that the interviewed independent directors were usually assessing the integrity of controlling shareholders on the basis of personal relationships with corporate insiders.

I have my own criteria: a person must be someone whom I can trust and who has a good reputation; otherwise, I wouldn’t dare to join… I think the attitude of the key leader is very important. Basically, close personal relationship constitutes independent directors’ personal trust in the key leader.\(^{161}\)

The survey also shows that more than fifty-five percent of the interviewed independent directors in Taiwan had personally known their own firm’s controlling shareholders, other directors or CEOs for more than ten years. In other words, more than half of the independent directors had personally known their own firm’s major corporate insiders for a long time.

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\(^{159}\) Interview No. 3 (Sept. 30, 2008), at 1; Interview No. 4 (Oct. 7, 2008), at 1; Interview No. 18 (Feb. 18, 2009), at 2; Interview No. 20 (Feb. 19, 2009), at 1; Interview No. 21 (Feb. 25, 2009), at 1.

\(^{160}\) Brudney, supra note 82, at 598 n.3; Adams & Ferreira, supra note 21, at 218–19.

\(^{161}\) Interview No. 14 (Nov. 11, 2008), at 2. See also Interview No. 7 (Oct. 12, 2008), at 1 (“How do I decide whether to take on the position? The first thing is the integrity of the leader. If the leader or the management team always follows the rules, the job of the independent director becomes easier because the cost of monitoring isn’t high.”); Interview No. 3 (Sept. 30, 2008), at 5 (“When I’m considering accepting a position [as an independent director], I will first see who invites me to join the board. He should be a person I can trust because I’ll need to be extra cautious when taking on such a responsibility.”).
before deciding to join the firm. Independent directors’ trust in major corporate insiders appears to have rested on a long-standing acquaintanceship or even friendship between them. It can be inferred from the interview results that independent directors’ strong personal trust in their own firm’s corporate insiders alleviates independent directors’ concerns about transparency and information asymmetry.

If you doubt every report presented to you, the job of an independent director would be endless... I think that independent directors’ trust in the firm should rest on long-term personal familiarity with and trust in the integrity of the major corporate insiders. In addition, the company should perform well. On the basis of these two assumptions, independent directors can monitor [the company] and make reasonable judgments.¹⁶²

The strong social ties between independent directors and controlling shareholders may be an inevitable result of introducing a new outside institution to a closed and dominated board because an independent director eventually needs the support of controlling shareholders in order to be elected. Yet the close personal relationships raise concerns over the impartiality and independence of the independent directors.

Firms also screen potential independent director candidates before nomination. A firm that believes in good corporate governance seeks independent directors who are truly independent and would help them to do their job satisfactorily by providing them with abundant resources. For example, Taiwan Semiconductor Manufacturing Company (“TSMC”) has searched for candidates in law firms and accounting firms, rather than candidates whom the executives know personally. TSMC places considerable value on candidates who are established in their respective fields of practice and have expertise that is helpful to the company. In contrast, a firm that only wants a window-dressing director looks for someone who is willing to be a rubber stamp for board decisions.

Except in a few large companies, most leaders of public companies in Taiwan seek independent directors with whom these leaders have personal relationships. As mentioned, controlling shareholders seek suitable independent directors. There also exists information asymmetry between candidates and controlling shareholders about the qualification and integrity of independent director candidates. Guanxi has been an important source of reliable information in Chinese society. It is no surprise that controlling shareholders seeking to fill a vacant board position would first invite someone with whom they have already established guanxi.

¹⁶² Interview No. 7 (Oct. 12, 2008), at 3.
Nevertheless, *guanxi* might compromise independence. Commentators in several Asian regions, such as China, India, South Korea and Taiwan, have cast doubt on the independence of independent directors. Their close relationship with controlling shareholders is also definitely one of the major concerns:

In many companies, it is the controlling shareholders [, rather than an independent nomination committee,] who invite someone to be nominated as independent director. In addition, many of them maintain good relationships with the major shareholders and executives. They [the independent directors] might politely remind the management [of potential pitfalls] to a certain point. However, I think the role of these [independent] directors is limited.

**CHINA**

A. **Corporate Governance in China**

The two most prominent issues in Chinese corporate governance are single-shareholder dominance (*yigududa*) and insider control (*neiburenkongzhi*). The ownership of Chinese listed companies is highly concentrated and the single most important dominant shareholder of listed companies is the state. Within the share-split mechanism, most state shares are not transferable. In 2008, the largest shareholders of over sixty-three percent of listed companies owned more than fifty percent of their respective companies’ shares, which means that in each of the seventy-three percent of listed companies, the largest shareholder had absolute control over the

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164 ORG. FOR ECON CO-OPERATION & DEV. (“OECD”), Board Member Nomination and Election 58–59 (2012).

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

166 Yuan Tan, Jingjifa Shiyexia de Duli Dongshi Zhidu Wanshan Yanjiu [Research on the Institution of Independent Directors from the Perspective of Economic Law], HUAZHONG SHIFANG DAXUE XUEBAO (RENWEN SHEHUI KEXUEBAN) [JOURNAL OF HUAZHONG NORMAL UNIVERSITY (HUMANITIES AND SOCIAL SCIENCES)], No. 3, at 18 (2012).
corresponding company. Among these largest shareholders, eighty-nine percent were the state.\textsuperscript{167} In a survey of over 1,104 companies listed on the Shanghai and Shenzhen stock exchanges, the largest shareholder of each listed company on average owned 44.86\% of shares and the second largest shareholder owned 8.22\%. The average percentage of total shareholdings held by the first three largest shareholders was close to sixty percent.\textsuperscript{168}

While the presence of a controlling shareholder reduces both the likelihood and the severity of managerial agency problems, it nevertheless suffers from private benefits agency problems, where controlling shareholders extract private benefits at a cost to minority shareholders.\textsuperscript{169} Dominant control wielded by a single shareholder can further exacerbate the problem of “private benefits of control”. Having the state as the largest shareholder further complicates the problem. The prominent issue of insider control is related to the “private benefits of control” problem in China, where Chinese listed companies suffer harshly from the problem under the country’s extremely distorted ownership structure, which allows for inefficient monitoring control by the country’s single largest shareholder, the state.\textsuperscript{170} With dominant control, insiders could easily siphon out corporate assets and resources through related party transactions or other means.\textsuperscript{171}

\textit{B. The Reform}

Introducing the institution of independent directors to the boards of Chinese listed companies is one of the major regulatory measures that the Chinese government has taken to address the issue that most corporate boards are dominated and controlled by single-shareholders and insiders. On August 16, 2001, the CSRC issued its \textit{Guidance Opinion on the Establishment of an Independent Director System in Listed Companies} (the “CSRC Independent Director Opinion”), which is the most comprehensive regulatory measure taken by the Chinese government so far regarding its imposition of independent directors on listed companies. According to the CSRC Independent Director Opinion, all listed companies were required to have at least two independent directors by June 30, 2002 and such directors were to

\begin{footnotes}
\footnotetext{170}{Wen-Chieh Wang, \textit{Corporate Governance of China Listed Companies under Share Splitting: An Examination of Controlling Shareholders}, 122 \textit{CHENGCHI L. REV.} 201, 219–20 (2011).}
\footnotetext{171}{Clarke, \textit{supra} note 2, at 147–48.}
\end{footnotes}
constitute at least one-third of each board by June 30, 2003.\textsuperscript{172} The CSRC further provides detailed regulation of the qualifications, independence, nomination, election, obligations, and responsibilities of independent directors.

Following the CSRC Independent Director Opinion, the CSRC issued several regulatory rules guiding the operation of the independent-director mechanism in Chinese listed companies.\textsuperscript{173} A 2005 amendment to the PRC Company Law formally stipulated that all listed companies should have independent directors on their boards.\textsuperscript{174} Although the 2005 amendment did not identify specific requirements and responsibilities of independent directors, it confirmed the requirement for independent directors in Chinese listed companies.\textsuperscript{175}

C. Renqing Dongshi (Favor Directors)

In the years since 2001, when CSRC published the CSRC Independent Director Opinion, the most notable criticism of independent directors in China has centered on their independence—or, more appropriately, their lack of independence—from controlling shareholders and other corporate insiders.\textsuperscript{176} Since most nominations of independent directors still lie in the hands of boards controlled by dominant shareholders under the current corporate-ownership structure, most independent directors are beholden to dominant shareholders.\textsuperscript{177} In a survey by the Listed Companies Association of Shanghai, fifty-five percent of independent directors were nominated by major shareholders and twenty-seven percent by corporate executives. Since major


\textsuperscript{174} See China Company Law, supra note 172, at art. 123.

\textsuperscript{175} China Company Law, supra note 172, at art. 123 ( stipulating only that listed companies should have independent directors and that the State Council should promulgate relevant rules).

\textsuperscript{176} Xi, supra note 2, at 17–18 (in the prevailing practice, controlling shareholders appoint their social friends to independent-director positions).

\textsuperscript{177} See CSRC Independent Director Opinion, supra note 172, at § 4(1): (“A listed company’s board of directors, supervisory board and shareholders who individually or together hold not less than 1% of the shares in the listed company may nominate candidates for Independent Director. Such directors will be decided through election by the shareholders’ general meeting.”).
shareholders have controlled most corporate executives in recent years, we can calculate that major shareholders have nominated over eighty percent of independent directors during this same timeframe.\(^{178}\) With the largest major shareholder in Chinese capital markets being the state, “China’s corporate governance regime can never wholeheartedly sanction a system in which independent directors can obstruct the wishes of dominant shareholders.”\(^{179}\)

Commentators have coined the term ‘renqing dongshi’ (roughly translated as “favor directors”) in referring to independent directors who join a board simply because of their close personal relationships with corporate insiders, and have coined another term, ‘huaping dongshi’ (roughly translated as “vase directors”) in referring to independent directors whose function is no more than window-dressing.\(^ {180}\) The popularity of these two terms reflects not only the ineffectiveness of Chinese independent directors but also public concerns over social ties among independent directors and corporate insiders.

Culture has also helped reinforce the social ties among independent directors and controlling shareholders or corporate insiders. Guanxi and renqing (favor) are core concepts and practical principles in Chinese social relationships.\(^ {181}\) Guanxi is more close to the concept of social ties or personal relationships.\(^ {182}\) On the other hand, the concept of renqing operates more like the rules of guanxi, such as how you should treat someone you know.\(^ {183}\) The rule of renqing actually operates beyond the rule of reciprocity and it can be manifested in an old Chinese saying, “If you have received a drop of beneficence from other people, you should return to them a fountain of beneficence.”\(^ {184}\) Therefore, if you receive a favor from other people, you should return them not just a favor but much more than that.

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179 Clarke, \textit{supra} note 2, at 215.
180 Xinrong Guan, Duli Dongshi Zhiduyu Gongsi Zhili: Fali he Shijian [Independent Director System and Corporate Governance: Theory and Practice] 321 (2004) (“vase directors” is a term first famously used by Jiahao Chen, the independent director of ZhengbaiwenCorporation, which was accused and penalized by the CSRC for misrepresentation and violation of GAAP rules in 2001. Jiahao Chen characterized himself as a “vase director” to defend himself from possible penalties levied by the CSRC).
181 Park & Luo, \textit{supra} note 139, at 456–57.
182 See Roderick W. Macneil, \textit{Contract in China: Law, Practice, and Dispute Resolution}, 38 STAN. L. REV. 303, 385–86 (1986) The term ‘relations’ has a special meaning in Chinese. It connotes the meaning of ‘relationship’ in the sense of a long-term relationship with a friend or acquaintance, but it also connotes the meaning of ‘connection’, in the sense of being socially or politically well connected. It is not always used in a pejorative sense, but often has an instrumental, if not a sleazy, flavor. The word is often used when someone does something that might be impossible without the help of the person with whom he has “relations.” “Relations” play a crucial part in all aspects of Chinese life, even more important than the part played by “connections” in the West.
184 The old Chinese saying is “Dishui Zhien Dang Yongquan Xiangbao.”
If we understand that a component of traditional and contemporary Chinese culture is the belief that one favor deserves another—and perhaps even better—favor, then we can see that the term ‘renqing dongshi’ (favor directors) refers to those independent directors who join a board because they owe controlling shareholders or corporate insiders a favor and they return those corporate insiders a favor by being nominally independent directors. In this situation, we cannot expect these “favor directors” to act with impartiality in the best interests of the corporation. It was reported in 2011 that China’s top fifty listed companies collectively employed a total of thirty-four independent directors who were retired government officials. By retaining former government officials, these enterprises want not only to take advantage of these government officials’ guanxi in the public sector, but also to use the independent-director position as a kind of gift, presented to these retired officials as a renqing (i.e., a favor); that is, as a way of thanking the retirees for various benefits they might have bestowed on the given enterprise during their time in elected or appointed office.185

Ping Jiang, a well-known law professor and former President of China University of Political Science and Law, once said in a conference that, from his practical experience of serving as an independent director in various posts, independent directors in China are basically window-dressing.186 He also confessed that the corporate insiders who invited him to serve as an independent director had all been his close friends basically asking him to do them a “favor.”

As far as I see it, independent directors in the companies where I participated are no more than a “vase” or “decoration.” The CSRC has made the independent-director system mandatory, and I think boards in general truly don’t want independent directors. Personally, the people who invited me to serve as an independent director were all close friends asking me to do them a favor. We’re close, so I wouldn’t turn my back on them.187

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187 Jiang et al, supra note 186.
It is commonplace for independent directors in China to have close personal relationships with controlling shareholders or corporate insiders.\textsuperscript{188} With boards dominated and controlled by insiders (the so-called “insider-control problem”), the given corporate environment seems to not encourage truly independent directors.\textsuperscript{189} Reported interviews from China have yielded findings similar to those stemming from Taiwan: companies there have tended to hire independent directors who have guanxi with controlling shareholders or corporate insiders and who would not vote against controlling shareholders.

How do boards choose [independent directors]? Corporate insiders want someone who has been working well with them. And board members wouldn’t choose a stranger. He [a candidate for a position of independent director] should come with recommendations, or have some relationship with certain board members, or be highly reputable.\textsuperscript{190}

OTHER INSTITUTIONAL FACTORS

Given the existence of unintentional bias and Delaware courts’ increasing awareness of personal relationships’ effects on director independence, countries that have transplanted the institution of independent directors from the United States should pay more attention to the issue of structural bias. Close relationships between independent directors and controlling shareholders are not constitutive of a phenomenon unique to Taiwan and China; rather it is a common issue faced by most Asian countries.

In Taiwan and China, as in many other Asian countries (e.g., India, Japan and South Korea), a sophisticated system of commercial courts and a complementing legal system do not exist to provide the kind of \textit{ex post} judicial


\textsuperscript{189} Shaoming Liu, Zhongguo Zhengjianhui Shangshibu Zhuren Yang Hua: Ying QianghuaDudong de DulixingZuoyong [Director of the CSRDepartment of Listed-Company Supervision, Hua Yang: We Should Enhance the Independence of Independent Directors], SHANGHAI FINANCIAL NEWS A07 (Dec. 15, 2006).

\textsuperscript{190} XIE, supra note 178, at Appendix 1: Interview Transcripts 01-05, at 32; See also Leeping Lei, Jiaoshoudeng Silei Xiaren Longduan Dudong [Four Types of People Who, Like Professors, Have Plenty of Time, Occupy the Market of Independent Directors], 21 SIJI JINGJI BAODAO [21\textsuperscript{ST} CENTURY ECONOMIC REPORT] 15 (Sept. 1, 2011), available at http://biz.cn.yahoo.com/yopen/20110901/563130.html (last visited Sept. 24, 2012) (where the Director of the Corporate Governance Research Center at Beijing Normal University stated in an interview, “If our [Chinese] independent directors were not recommended by major shareholders, they must have been recommended by managers. This fact basically means that they must serve the interests of major shareholders and managers.”).
Shareholder derivative suits, for example, are almost unheard of in Taiwan and China owing to the various procedural hurdles set in those countries’ respective corporation law. In addition, neither Taiwanese nor Chinese courts have yet to adopt the business judgment rule. Because of these local conditions, ex post judicial review of director independence does not exist in either Taiwan’s or China’s current legal system, and is unlikely to develop there in the near future.

Additionally, Taiwanese and Chinese courts have yet to recognize the role of independent committees in resolving conflicts of interest, a fact that, in turn, limits the function of independent directors and the value they can create. Therefore, corporate insiders generally lack the incentive to hire truly independent directors not only because no one will review the substantive independence of independent directors, but also because corporations would not benefit from having truly independent directors. This is the problem with trying to transplant an isolated legal mechanism into a different legal system without complementary institutions.

V. CONCLUSION

Empirical studies have shown that social ties can compromise independent directors’ monitoring capacity and, thus, do matter in corporate governance. However, current regulations do not address social relations while defining director independence. United States corporations elect independent directors because the United States legal system makes it worthwhile—it protects management from liability in shareholder suits. Delaware courts have recognized the good-faith use of independent directors by management in self-dealing transactions and have provided safe harbors in which managers can undertake transactions that are approved by disinterested directors. Meanwhile, United States courts can review the disinterestedness and independence of directors when transactions are challenged by shareholders.

The problem of transplanting independent directors to other countries lies in the lack of complementary institutions that make such arrangements meaningful in the transplanting countries. These complementary institutions cannot be built in one night but the regulations can. Therefore, the fastest way for policy-makers to institute change is to change the related laws and

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191 Gilson & Milhaupt, supra note 147, at 369–72; Varrotil, supra note 2, at 325–26 (presenting survey and interview data revealing that the general practice of nominating independent directors in Indian listed companies has been for the promoters to identify people known to them or with whom they have significant comfort levels); OECD, supra note 164.


193 Clarke, supra note 2, at 209–10.

194 Id.
regulations. Many Asian countries have changed their laws and regulations, but have undertaken no changes to critical institutional settings related to the transplantation of independent directors. Therefore, it is the case that not only would companies lack an incentive to appoint truly independent directors, but also no institution would check on the true independence of directors. Asian countries are sacrificing the core value of system, independence.

The situation is even worse in Chinese societies, whose shared traditional and contemporary culture prizes harmony and interpersonal relations. In the business world, social ties among board members further enhance collegial board culture, facilitating boards’ advisory function but weakening their monitoring function. The main legislative objective of importing the institution of independent directors from the United States to China and Taiwan has been to decrease insider control over boards and to provide a checks-and-balances system capable of controlling private benefits of control enjoyed by controlling shareholders. However, the current Taiwanese and Chinese regulatory regimes’ failure to address the issue of social ties, whether through ex ante regulation or ex post judicial review, strongly suggests that the legislative objective of the institution of independent directors will remain unachieved and unachievable.

This article urges Chinese policy-makers to rethink the current definition of “independence” and the effect of independent directors’ social ties to controlling shareholders or corporate insiders. Social ties, on the one hand, can serve as an effective source of information for independent directors, who in turn can be more effective in providing advice to the management. But on the other hand, social ties can be detrimental to independent directors’ monitoring capabilities. All countries that transplant independent directors should be aware that the institution of independent directors will most likely lose its core value to the firm if there is no legal control over social ties.