Article

Are Independent Directors Effective Monitors in Taiwan?—A Theoretical Analysis

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ABSTRACT

About a decade ago, Taiwan introduced the institution of independent directors, which has long been advocated as a good corporate governance practice in the United States of America ("U.S."). At the time, the concept of independent directors then was a whole new legal idea in Taiwan that fundamentally changed the original intention behind the internal corporate governance system in the Taiwan Company Act in which supervisors were supposed to address oversight and to take action against the board of directors and managers. Traditionally, the U.S. corporate conventional wisdom argues that independent directors benefit companies in some aspects, but it is also believed that they could face some inherent limitations while carrying out their monitoring tasks. The most serious issue is how to ensure an independent director has true independence from management. In addition to the limitations that U.S. independent directors normally face, Taiwanese independent directors also encounter other constraints arising from characteristics of Taiwan's business environment. This article argues that independent directors in Taiwan have few chances to rid themselves of the controlling shareholders' influence. Even in the absence of such powerful shareholders, they would still encounter other difficulties in carrying out the monitoring tasks such as insufficient information. This article concludes that as a result, Taiwanese independent directors will function in a very limited way, and can hardly be effective monitors for Taiwanese companies under the current business and legal environment in Taiwan.

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I. INTRODUCTION

In recent decades, Taiwan's capital market has been tarnished by a number of corporate scandals. Most of these scandals (such as Procomp in 2004 and Rebar in 2007) involved false accounting reports and managerial embezzlements. The scandals occurred more frequently during the late 1990s, and ultimately forced the government of Taiwan to take steps to improve corporate governance. Contemporary Taiwanese corporate scandals have revealed that the internal checks and balances system designed by the Taiwan Company Act ("TCA") was extremely vulnerable and dysfunctional to the extent that company managers enjoyed numerous opportunities to defraud investors. Supervisors as the statutory monitoring device were usually uninformed about managerial misconduct and, in some cases, had even become the accomplices of those who engaged in misconduct.

Many Taiwanese commentators have suggested that Taiwan develop a more effective internal monitoring system. Specifically, many argue that Taiwan should introduce the institution of independent directors which exists in the U.S. because conventional supervisors have been proven to be unsuccessful in performing their monitoring tasks in previously exposed scandals. In 2002, the Taiwan Stock Exchange ("TWSE") introduced the concept of independent directors by promulgating its modified listing rules ("Listing Rules") that mandated all new applicants ("Newly-Listed Companies") appoint at least two independent directors when applying to be listed.[1] The Listing Rules specified that non-compliance with this requirement regarding the appointment of independent directors would automatically result in rejection from listing. The TWSE also recommended that currently listed companies, which were not subject to the Listing Rules, should voluntarily hire independent directors as they saw fit.[2]

Taiwan's introduction of the institution of independent directors evolved rapidly. In addition to the TWSE's Listed Rules with respect to the mandatory appointment of independent directors for Newly-Listed Companies, an amendment to the Taiwan Securities and Exchange Act ("TSEA") in 2006 legally introduced the institution of independent directors

1. According to Article 9 of the TWSE's Listing Rules (Feb. 12, 2002), TWSE "may disagree to its listing if the issuing company has any of the events listed below, except for any of those in Subparagraphs 10 or 12 under which the TWSE shall disagree to its listing, and is deemed by the TWSE to be inappropriate for listing: […] 12. If a company applying for listing has less than five members on its board of directors, or less than two independent directors. […] At least one of them must be a professional in accounting or finance." Taiwan Chêngch'üan Chiaoiso Kufên Youhsien Kung ssu Youchia Chêngch'üan Shangshih Shênch'a Chuntsê [Taiwan Stock Exchange Corporation Rules Governing Review of Securities Listings], art. 9 (2002).

2. TWSE and GreTai Securities Market in 2002 jointly issued "Corporate Governance Best-Practice Principles for TWSE/GTSM Listed Companies (Best Practice Principles)" recommending that a listed company appoint independent directors and set up special committees.

and the institution of audit committees. Additionally, Article 14-2 and Article 14-3 of the TSEA provide legal authority regarding eligibility, election procedures, and the authority of independent directors. Furthermore, companies can set up audit committees to replace conventional supervisors, according to Article 14-4 and Article 14-5 of the TSEA.

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

Traditionally, the original Taiwanese corporate laws imported most of its concepts from Germany and Japan.[3] As Taiwan has been struggling with the failures of supervisors and many reforms in this regard seemed futile, the U.S. laws are gradually becoming more and more important, especially in terms of corporate governance. The U.S. corporate conventional wisdom believes that the institution of independent directors can help companies because independent directors can significantly reduce the agency costs that arise out of the separation of ownership and control in modern companies. Most U.S. listed companies have boards of directors primarily consisting of independent directors, and insiders have lost their dominance on most corporation boards. The appointment of independent directors in U.S. companies is optional and companies have the freedom to choose governance practices at their discretion. However, the examples of Enron and other corporate scandals forced the U.S. Congress to enact the Sarbanes-Oxley Act ("SOX") in 2002. This Act requires listed companies to establish audit committees consisting exclusively of independent directors. Self-regulatory organizations such as the NYSE and NASDAQ have also set up mandatory listing requirements that require the majority of boards of directors to be independent directors.

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

3. For example, Taiwanese scholars comment that "[t]he corporate governance institutions of Taiwan demonstrate a hybrid mix of German, Japanese, and American influences against traditional Confucian traditions of governance." Wallace Wen-Yeu Wang & Carol Yuan-chi Pang, *An Analytical Framework for Controlling Minority Structure and Its Application to Taiwan*, SSRN (2006), http://ssrn.com/abstract=903853, at 4.

recovering damages usually turn out to be fruitless.

However, independent directors have evolved in different ways in the United Stated and Taiwan. In the United States, the concept of independent directors has become statutory in SOX, at a time when most listed companies have long-term experience with independent directors. Most U.S. companies have voluntarily chosen to have independent directors without regulations forcing them to do so. When SOX was initially developed, the presence of independent directors was already pervasive in practice.[4] When the TWSE's Listing Rules of 2002 and the TSEA's amendment of 2006 were made, most listed companies did not have sufficient experience with or knowledge of independent directors, and the presence of independent directors was uncommon in practice.

This article seeks to provide a comprehensive study of the institution of independent directors by using a theoretical and comparative approach, and will discuss the question "what problems will Taiwan's independent directors face?" The U.S. corporate conventional wisdom argues that independent directors will benefit companies in some aspects, but it is believed that they will face some inherent limitations while carrying out the monitoring tasks. The most serious issue is how to ensure an independent director has true independence from management. In addition to the limitations that U.S. independent directors normally face, Taiwanese independent directors also encounter other constraints arising from characteristics of Taiwan's business environment. Under Taiwan's laws and regulations, I argue that independent directors have few chances to rid themselves of the controlling shareholders' influence. Even in absence of shareholders who have dominance in the boardroom and supervisor system, independent directors will still encounter difficulties in carrying out the monitoring tasks while insiders are unwilling to disclose the material information before any board decision is to be made. In conflict-of-interest transactions (or, related-party transactions), which have frequently been utilized as a form of embezzlement, it is likely that independent directors are unable to detect wrongdoings or even illegality. As a result, this article concludes that Taiwanese independent directors will function in a very limited way, and can hardly be effective monitors.

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4. For example, according to the 2004 Korn/Ferry report, targeting 904 boards in publicly-held Fortune 1000 companies, indicated that SOX and relevant regulations had not impacted the board composition of these companies which averagely have 9 outside/independent directors (because the same number had been reported since 1990). Scholars argue that SOX appears to mirror the corporate governance trends and its impact had been fairly minimal. *See* Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U.L. REV. 381, 395 (2005).

II. WHAT PROBLEMS WILL INDEPENDENT DIRECTORS FACE?

Theoretically, whether or not independent directors can serve as effective monitors is an open question.[5] Like independent directors in the U.S., Taiwanese independent directors also face the same limitations. In addition, Taiwanese independent directors are likely to face other problems arising from Taiwan's legal and business environment distinctive from those in the U.S. This part will review the debates in the U.S. In part III there will be an analysis addressing problems that Taiwanese independent directors will face.

A. *The Theory on the Weakness of Independent Directors*

Some U.S. scholars argue that independent directors cannot provide effective monitoring of management based on the following inherent limitations.[6]

1. *Lack of Adequate Time*

Many independent directors are employed part-time by their companies and do not have enough time to do more than review business decisions.[7] They do not have enough time to make business decisions. An independent director may also work as a full-time employee for another company, or may be concurrently hired by several companies.[8] They usually cannot devote most of their time to one company on whose board they serve.[9] To work

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5. Debate about the effectiveness of independent directors started in the 1978 at the time that the ALI recommended the boards of directors shift to monitoring boards and emphasized the importance of the independent directors. John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1363-64 (1992). For arguments for and against the value of independent directors, *see* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers too*, 22 GA. ST. U.L. REV. 251, 299-300 (2005).

6. Some have even argued that "[t]here are risks in over-reliance on the independence of directors." Stephen J. Friedman, *Remarks to American Law Institute at American Bar Association Conference on Investment Company Regulation: How Much Can We Expect from Independent Directors?*, COMM'R, U.S. SEC. & EXCH. COMM'N (Dec. 12, 1980), http://www.sec.gov/news/speech/1980/121280friedman.pdf, at 1. Professor Deakin in his article concluded that "[t]here are limits to the effectiveness of independent directors as monitors that derive from the complexity of modern business organizations and the volatility of the markets in which they operate." Simon Deakin, *What Directors Do (and Fail to Do): Some Comparative Notes on Board Structure and Corporate Governance*, 55 N.Y.L. SCH. L. REV. 525, 541 (2010).

7. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 26 (2002).

8. Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope-Faint Promise?*, 76 MICH. L. REV. 581, 585 (1978).

9. *E.g.*, Professors Lipton and Lorsch argued that "the most widely shared problem directors have is a lack of time to carry out their duties […] In essence, the limited time outside directors have

effectively, independent directors must be willing to devote a substantial amount of time to the company.[10]

In the U.S., the lack of time has been an even more serious problem for the effectiveness of independent directors since the introduction of SOX in 2002. "The time required for audit committee meetings has at least doubled," so "The [independent] directors committee work usually cannot be completed in the allotted time, and their discussions often end up being truncated or spilling over into hastily arranged teleconferences."[11]

2. *Lack of Important Information or Industry-specific Knowledge*

Effective monitoring is theoretically premised on accessibility and availability of the company's information.[12] Independent directors are outsiders who rely on information provided by insiders.[13] If management refuses to provide important information to independent directors, or intentionally hides such information, it is difficult for them to effectively monitor the company. Even though independent directors can actively

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together is not used in a meaningful exchange of ideas among themselves or with management/inside directors." Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 64 (1992); Professor Lin argued that "even if [independent directors] have the expertise, these directors' busy schedules may preclude them from devoting sufficient amounts of time to thoroughly review management's proposals. Laura Lin*, The Effectiveness of Outside Directors as A Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 914-15 (1996). In short, "outside directors presently lack the time to monitor, except during corporate crises, because they are either CEOs themselves or hold equally demanding full-time positions." Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 884 (1991).

Many commentators believe that "carrot and stick" approach should be utilized to provide independent directors with more incentives to stimulate the effectiveness of independent directors (this will be discussed later). Some research literature, however, argues that independent directors can best use their limited time by making business decisions. *See* Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 5 (1981).

10. Symposium, *Director Liability*, 31 DEL. J. CORP. L. 1011, 1040 (2006) (citing Bob Mendelsohn's speech).

11. Jay W. Lorsch & Robert C. Clark, *Leading from the Boardroom*, 86 HARV. BUS. REV. 104, 107 (2008). However, some scholars indicated that directors have been serving on fewer and fewer boards since SOX, and that would help boards maintain a performance advantage. *See* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 Geo. L.J. 1843, 1865 (2007).

12. *E.g.*, Deborah A. DeMott, *Reweaving the Corporate Veil: Management Structure and the Control of Corporate Information*, 41 LAW & CONTEMP. PROBS. 182, 184 (1977). Toda and McCarty suggest that "[o]utside independent directors also need to be provided with necessary, full, timely, and accurate information while employees and managers need access to board members." Makoto Toda & William McCarty, *Corporate Governance Changes in the Two Largest Economies: What's Happening in the U.S. and Japan?*, 32 SYRACUSE J. INT'L L. & COM. 189, 228 (2005). As agreed by independent director advocates, even a board with a majority of directors who are independent can't "perform its monitoring function without objective data on the financial results of the managers' stewardship." Melvin A. Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187, 206 (1983). [hereinafter *Modernization of Corporate Law*]

13. Ribstein, *supra* note 7, at 26.

collect information, unless they have enough time to do so at a company, they usually have insufficient information to make discriminating choices that can benefit shareholders.[14] In addition to the lack of information, the amount and complexity of the data independent directors receive may be another difficulty that most independent directors would encounter.[15]

Today, most directors of the U.S. listed companies are completely "independent." Due to current strict standards of independence, many directors lack industry-specific experience and knowledge.[16] Even if independent directors are provided with comprehensive, well-organized data, they will still be unable to process such data.[17] The current viewpoint of policymakers regarding corporate governance is that independence is superior to working knowledge of the company, and has become the principal criterion for appointing directors.[18]

Finally, public companies are growing bigger and their businesses are more complex than those in past decades.[19] That may require independent directors "to keep up with various facets of their businesses and industries."[20]As a matter of fact, expecting an independent director in an automobile manufacturer to know the details of a new engine technology may be unrealistic.[21]

3. *Structure Bias or Inclination in Favor of Management*

"Structural bias" here can be defined as an inherent prejudice that results from the composition and character of the board of directors.[22] In U.S. companies, candidates for independent director positions are often nominated by CEOs, and the elections of independent directors tend to be greatly influenced by management.[23] For example, a CEO may invite favored outside independent directors onto the board by offering generous

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14. Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 555-56 (1984).

15. Lipton & Lorsch, *supra* note 9, at 65.

16. Deakin, *supra* note 6, at 537 (citing Leo E. Strine, Jr., The Role of Delaware in the American Corporate Governance System, and Some Preliminary Musings on the Meltdown's Implications for Corporate Law at Utrecht Univ. Molengraaff Inst. for Private Law Conference on Governance of the Modern Firm 2008, at 26 (Dec. 13, 2008)).

17. Lipton & Lorsch, *supra* note 9, at 65.

18. Deakin, *supra* note 6, at 541.

19. Lorsch & Clark, *supra* note 11, at 108.

20. *Id.*

21. *Id.*

22. Mark A. Underberg, Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 601 n.14 (1980).

23. *E.g.*, Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 266 (2010); Lipton & Lorsch, *supra* note 9, at 66; Haft, *supra* note 9, at 21.

annual pay, insurance, and retirement benefits.[24] Additionally, independent directors and CEOs are often friends and social acquaintances.[25] Directors' feelings of cordiality and friendliness may develop over the years in companies on whose boards they serve, and bias may develop. CEOs may nominate directors who are unwilling or unable to monitor the managerial team.[26] The bonds of friendship and collegiality among directors are so powerful sometimes those independent directors are unlikely to show the qualities of independence and objectivity in monitoring their colleagues' performance, especially when board culture calls for consistency in the boardrooms.[27] The possible result is that directors may be reluctant to challenge management, in the absence of obvious evidence.[28]

The structural bias can also be explained by an implicit conspiracy theory that argues directors pursue group interests due to an implicit conspiracy among directors.[29] Independent directors may be disinterested in some transactions in which they believe have no direct personal conflicts of interest, but their decisions might favor other interested directors.[30] They may also do so in order to maintain their positions on the board.[31] Independent directors may be reluctant to "reduce board cohesiveness by failing to be perceived as team players, or by reducing trust within the board."[32] Some literature also indicates that independent directors who can deliver dissenting opinions regarding certain suspect transactions may be excessively influenced by the leader of the group. Therefore, removing the CEO as a member of the board means that an independent board is more

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24. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2057 (1990); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project,* 61 GEO. WASH. L. REV. 1034, 1059 (1993). [hereinafter *ALI Governance Project*]

25. Solomon, *supra* note 8, at 584.

26. Allen, *supra* note 24, at 2057.

27. Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 142 (2006). [hereinafter *Promoting Accountability*]

28. Ribstien *supra* note 7, at 26.

29. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 856 (2004).

30. *Id.*

31. *Id*. Research suggests that the market for independent directors functions in the interests of managers, not shareholders. Directors who have ousted a CEO will be hired by fewer companies than those who have not. Furthermore, companies on whose boards they serve tend to be significantly smaller and less reputable. As a result, "independent directors who overtly signal their alignment with shareholders by virtue of their actions on prior boards are penalized in the directorial market." Mary-Hunter McDonnell & Brayden King, *The Market Hates a Monitor: The Adverse Selection of Independent Directors Who Oust a CEO*, SSRN (July 23, 2011), http://ssrn.com/abstract=1893713.

32. Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 247 (2009); some scholars argue that a tradeoff between objectivity and proximity exists, because directors who are in close proximity to management cannot be truly objective. Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 400 (2004).

likely to engage in frank discord in dissent.[33]

With regard to derivative litigation, it is critical that independent directors be able to perceive and represent corporate interests when they determine whether or not a shareholders' demand or shareholders' suit is in the best interests of the company.[34] However, Professors Cox and Munsinger concluded that "several psychological mechanisms can be expected to generate subtle, but powerful, biases which result in the independent directors' reaching a decision insulating colleagues on the board from legal sanctions."[35] There exists skepticism to the effect that independent directors might not be objective in derivative suit contexts. According to *Zapata Corp. v. Maldonado*,[36] decisions made by a special litigation committee consisting of independent directors receive greater scrutiny. A Delaware court has the discretion to apply its own business judgment and second-guess a special litigation committee's decision that has been made by disinterested independent directors.[37]

In reality, as pointed out by Delaware Chancellor Strine, independent directors are usually managers of other corporations, and the social affinities often exist between independent directors and managers.[38] Outside

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33. Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 620 (2011). [hereinafter *Corporate Governance*] The author also points out the proportion that the CEO serves simultaneously as chairman of the board, is decreasing in U.S. public companies. *Id.* at 620-21.

34. A shareholder should make a demand to the board of directors before bringing a derivative suit on behalf of a corporation, unless the shareholder can prove that such a demand is futile. Even in demand futility, a company, however, can set up a special litigation committee solely consisting of independent directors to investigate whether or not a shareholder's suit has merit and is in the best interests of the company. After investigations, the committee can deliver its recommendation to courts which would give considerable deference to the committee's recommendation. In most cases, the committee recommends that the court dismiss a shareholder suit. For special litigation committee, *see* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 IOWA J. CORP. L. 625, 650-51 (2004). [hereinafter *Rethinking Corporate Federalism*].

35. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 85 (1985). Professor Rock also points out that "[t]o the extent that they are economically or psychologically dependent on management, they have significant incentives not to act as the shareholders' champion." Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 505 (1991). However, some scholars disagree with the presumption of structural bias that independent directors are more willing to risk financial and reputational harm than deal with complaints against insider directors. Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 533-35 (1989).

36. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981).

37. Grover C. Brown et al., *Director and Advisor Disinterestedness and Independence under Delaware Law*, 23 DEL. J. CORP. L. 1157, 1190 (1998).

38. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1375 (2002). [hereinafter *Delaware Impact*] More responsibilities being placed on independent directors will also be a concern about true independence, because independent directors may have "to spend so much time on issuer business that because of their increased fees and added work they will no longer be functioning as truly outside, independent directors." Perry E. Wallace, *Accounting, Auditing and Audit Committees after Enron, et al.: Governing Outside the Box without Stepping Off the Edge in the Modern Economy*, 43

independent directors may be tied to management in several ways so that "it is delusion or pretense to expect them to represent shareholder views," especially in conflict-of-interest transactions.[39]

The independent directors may naturally give weight to the perspectives of CEOs who usually have special knowledge and experience related to the operation of the company.[40] In many situations, independent directors may be unable to identify and control their own biases. The idea of "bounded rationality," meaning the inability of people to perceive their own ethical limitations, has demonstrated that people are unaware of their biases and how their biases affect their personal decision-making.[41] Independent directors are human beings who are subject to this inability and are unable to avoid unconscious bias. The impact of unconscious bias may be tremendous to the extent to which the effectiveness of independent directors would be impaired.

In short, independent directors will face "significant personal costs, both financial and psychological, to serving an active, independent role in the boardroom," and "the personal costs of fighting these financial and psychological constraints have been quite high."[42] Therefore, independent directors may "have an incentive to work closely and amicably with management and little incentive to challenge it."[43] With an eye on the true utility of independent directors, it is very essential to minimize these costs for them.[44]

4. *Lack of Incentives*

Independent directors are usually outsiders who have no ownership interest in a company.[45] How well the firm performs normally does not have any financial impact on independent directors. Thus, they "may not have any significant economic incentive to discipline company management."[46] Outside independent directors also typically lack an affirmative incentive to monitor effectively, because they are rewarded with a flat monetary benefit

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WASHBURN L.J. 91, 115 (2003). (citing Roberta S. Karmel, Federalization of the Law Regarding Audit Committees, N.Y. L.J., Feb. 20, 2003, at 3.).

39. Allen, *supra* note 24, at 2056. *See also* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1395-412 (1989).

40. Haft, *supra* note 9, at 3.

41. Page, *supra* note 32, at 239-40.

42. Note, *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2204 (2004). [hereinafter *Corporations and Society*].

43. Solomon, *supra* note 8, at 590.

44. *Id.*

45. Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 499 (2004).

46. Rock, *supra* note 35, at 505.

for their work.[47]

Assuming independent directors have enough incentives to provide active monitoring, these incentives will not always ensure optimal levels of monitoring, because boards must exercise power by collective actions that will likely to raise the free-riding problem.[48] Thus, faithful and active monitoring may be in line with an individual director's interest, and she may assume that other colleagues will do the work very industrially for the whole group, so she does not have to work as hard as others.[49] Therefore, the free-riding problem will likely lower the board's capability to offer the optimal levels of monitoring.[50]

5. *Costs and Benefits*

Adding independent directors to a board may be associated with costs and benefits in certain respects.[51] Searching for, and hiring, desirable independent directors may be costly. Benefits may be created by having independent directors if most of them are business experts or experienced officers who can provide valuable insights into the business strategies that can produce better company performance.[52] However, independent directors may be unable to create efficiency in terms of decision-making made by boards of directors. The board of directors is a collegial body that uses consensus-based decision-making, and consensus works best where team members are given equal access to information and have comparable interests.[53] In comparison with independent directors who are outsiders, inside directors are more likely to have comparable access to information and have similar interests,[54] so scholars argue that independent directors may be undesirable in terms of efficient decision-making by boards of directors.[55]

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47. Lin, *supra* note 9, at 916. For the insurance of independence and low possibilities of conflicting interests that affect the objectivities of independent directors, directors' fees must be the sole compensation for them, but these fees may vary due to responsibilities for each different director. Toda & McCarty, *supra* note 12, at 196.

48. *ALI Governance Project*, *supra* note 24, at 1060-61.

49. *Id.* at 1061.

50. *Id.*

51. But the problem is that there may be no good scientific mechanism for quantifying benefits or costs associated with the appointments of independent directors. *See* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1827 (2007).

52. *E.g.*, Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 33 (1987).

53. Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 383-84 (2002). [hereinafter *NYSE's Director Independence*].

54. *Id.*

55. *Id.* Professors Lipton and Lorsch also argued that "if independent directors are to be more effective monitors, we need to find a means to strengthen the cohesiveness of boards and the process by which directors work together." Lipton & Lorsch, *supra* note 9, at 66.

When boards of directors focus on monitoring, it can negatively impact productivity. There may be trade-offs for board members between the ability to manage the business and the ability to function as an effective monitor.[56] Some argue that independence of independent directors will only function in the conflicts of interest between management and shareholder, so expecting independent directors to make better business decisions and run the company better is "to misconceive the role of the independent director and to fetishize independence."[57]

6. *Other Factors*

Even if independent directors are willing to be actively evolved in monitoring management, few board meetings are held during a year and most of them are short.[58] A survey indicated that large U.S. manufacturing companies have 14 board and committee meetings per year on average, and the average board meeting lasts three hours.[59]

7. *Summary*

Some scholars doubt the functions of independent directors, and argue that their inherent limitations are likely to lead to ineffective monitoring. A comprehensive study suggests outside directors, in fact, are faced with limited time and information, which hinders them from evaluating senior management adequately.[60]

Professors Gilson and Kraakman contend that "good character and financial independence from management may be necessary," but insufficient conditions for effective monitoring due to the inherent limitations of independent directors.[61] The limitations include dependency, ideologies and social obstacles to monitoring.[62] More specifically, a financially independent outside director depends on management in order to maintain tenure as directors.[63] Many outside directors of public companies

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56. Professor Bainbridge contended that "If the board is limited to monitoring management, and especially if it is limited to objective measures of performance, however, the board may be unable to differentiate between acts of god, bad luck, ineptitude, and self-dealing." *NYSE's Director Independence*, *supra* note 53, at 392.

57. Usha Rodrigues, *The Fetishization of Independence*, 33 IOWA J. CORP. L. 447, 495 (2008).

58. *ALI Governance Project*, *supra* note 24, at 1058 n.127.

59. *Id.* (citing The Conference Board, Membership and Organization of Corporate Boards 25 (1990).

60. JAY W. LORSCH & ELIZABETH MACLVER, PAWNSOR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARD 84-89 (1989).

61. Gilson & Kraakman, *supra* note 9, at 874-75.

62. *Id.* at 875.

63. *Id.*

are CEOs of other companies, which makes it unlikely that such directors will monitor in a more energetic manner than they believe they should be monitored by their own boards.[64] Finally, outside independent directors may be financially independent but not socially independent from management.[65]

In conclusion, scholars point out the ineffectiveness of independent directors by pointing at the collapse of Enron, which had a majority of independent directors on its board of directors.[66] Like what happened in Enron, "[n]o director can be expected to catch sophisticated fraud by company insiders. The head of Enron's audit committee, Robert Jaedicke, is a professor of accounting at Stanford University, who could hardly have been more qualified for the job."[67]

B. *The Theory on the Effectiveness of Independent Directors*

1. *Professionalism and Business Experience*

The board of directors has two basic functions: the advisory function and the monitoring function. Boards can produce value for companies in several ways, including providing advice, developing long-term business strategies, and offering expertise as needed by companies.[68] Independent directors are usually business veterans or experts in some professional areas that the company needs.[69] They help management develop business strategies that improve the competitive advantages of companies. Their insights can be valuable.[70]

Compared to the advisory function, scholars suggest that the board's "monitoring or oversight function is paramount."[71] An independent board consisting of a majority of independent directors will be able to prevent self-interested activities that may harm the interests of shareholders by offering a robust review of suspicious transactions. Independent directors

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64. *Id.*; Allen*, supra* note 24, at 2057.

65. Allen*, supra* note 24, at 2057.

66. *E.g.*, Page, *supra* note 32, at 247. However, some scholars argue that "[t]he failings of Enron's directors…, should not suggest that proximate monitors [company's directors] can never be effective, or that reliance on the "objective" outside monitor is more appropriate." Elson, *supra* note 45, at 502.

67. *NYSE's Director Independence*, *supra* note 53, at 391-92 (citing Special Report, Corporate Governance—Designed by Committee, THE ECONOMIST, June 15, 2002, at 69, 71).

68. Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 43 (2004).

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

70. *E.g.*, Pease, *supra* note 52, at 33.

71. *Modernization of Corporate Law*, *supra* note 12, at 205.

equipped with professional abilities can help board monitoring by reducing the possibility of wrongdoing by management. A NYSE report claims that having a majority of independent board of directors increases the quality of board oversight and reduces the possibility of damaging conflicts of interest.[72] For example, an independent director with accounting expertise could better detect irregularities in financial reports prepared by management than could non-expert directors. Furthermore, an independent director's business experience could offer valuable comments regarding how to monitor management.

Independent directors who ask pointed questions can induce management to consider matters which their staff members do not want to make them to consider.[73] Hard issues are often filtered as they make their way up the line towards decision makers.[74] During the information-filtering process, people can slant the facts, and the information may not be completely accurate by the time it reaches decision-makers.[75] Therefore, an independent director must be willing to challenge managerial proposals and ask the critical questions that nobody else is asking.

2. *Functions in Emergency*

Some scholars argue that independent directors can perform useful roles in emergencies, such as replacing ineffective CEOs, assuring an orderly transition in the event of the retirement or death of CEOs, and forming special litigation committees to investigate the merits of shareholder demands or lawsuits.[76]

3. *Conflicts of Interest*

Normally, compared to outsiders, inside directors with firm-specific expertise and adequate information are in better positions to exercise business judgment for the company. In some situations involved with conflicts of interest between insiders (and management) and shareholders, insiders' judgment may be tainted by personal interest. For example, a hostile tender offer creates a conflict of interest between shareholders and

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72. Symposium, *Panel 2: Corporate Governance Issues*, 8 FORDHAM J. CORP. & FIN. L. 49, 61 (2003). [hereinafter *Corporate Governance Issues*].

73. Symposium, *supra* note 10, at 1039.

74. *Id.*

75. *Id.*

76. Pease, *supra* note 52, at 33-34. *See also Promoting Accountability*, *supra* note 27, at 114. Some even argue that "one of the board's most important functions is to evaluate the performance of the CEO, and to replace an underperformer in a timely fashion." *See* Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1494 (1993).

managers, and independent directors can provide oversight to the extent that protects shareholders' interests.[77] Thus, independent directors can help prevent skewed judgment from being made.[78] In the U.S., that is why there will be nearly insurmountable hurdles for shareholders to challenge board actions tainted by conflicts of interest through derivative litigation if independent directors have validated such actions.

Independent directors usually have substantial experience in making tough evaluative judgments, which can affect friends and business colleagues, including decisions such as arranging dividends among partners and dismissing long-time employees.[79] Outside independent directors who have invested years in building their reputations are likely to resign themselves to having to make tough, relationship-straining decisions.[80]For example, the Delaware Court generally tends to give more credit to a board consisting of a majority of independent directors when assessing the reasonableness of a board's defensive reactions to a hostile takeover.[81] Another example is that executive compensation approved by independent directors will be more likely assumed reasonable.

Furthermore, independent directors can evaluate conflict-of-interest transactions within the company rather than in a court in the litigation.[82] With the presence of independent directors, the board of directors will more likely accept an unsolicited takeover offer, because independent directors may not easily decide to reject the offer and a CEO's tenure may already be less secure when the independent directors are present.[83] Management may have to face more threatening discipline from the market.

Chancellor Strine argues that independent directors are subject to the desire to protect their positions. They are, thus, more likely to impartially decide whether or not a bid is in the shareholders' best interests,[84] as opposed to insider managers who usually have more at stake in terms of financial investment and human capital. Therefore, Delaware law encourages boards to delegate the authority to independent directors in responding to

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77. *E.g.*, James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195, 196 (1997) (finding that tender offer targets with independent boards experience higher shareholder gains).

78. *E.g.*, Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1804 (1976).

79. Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1316 (2005).

80. *Id.*

81. Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 677 (2005). [hereinafter *Delaware Way*].

82. Cyril Moscow, Margo Rogers Lesser & Stephen H. Schulman, *Michigan's Independent Director*, 46 BUS. LAW. 57, 65 (1990).

83. Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 897 (2002).

84. *Delaware Way*, *supra* note 81, at 677.

takeover.[85] Delaware Chancellor Allen also observed in the famous RJR Nabisco case, "in which a committee of structurally independent directors has appeared to function quite adversarily" and "the outside directors were seen as energetically exercising informed and independent judgment in the sale of the enterprise."[86]

4. *Protecting Shareholders*

Independent directors are anticipated to function in the interests of shareholders, and may be able to articulate shareholder concerns and push management towards the maximization of shareholder wealth.[87] Robust monitoring of management can help preserve the interests of shareholders, and the management integrity can be maintained.[88] Justice Veasey stressed that independent directors could function as an effective stockholder protection device.[89]

Independent directors can also be securities monitors who protect securities investors.[90] In some cases, the managers may prefer not to disclose bad news to the public, independent directors can provide a check on management who desires to avoid or prolong disclosing bad information and ensure compliance with the disclosure rules.[91] Generally, they can enhance the reliability of public disclosure made by companies, which will make "stock market prices a more reliable signal for capital allocation and for the monitoring of managers at other firms as well as their own."[92]

5. *Summary*

Independent director advocates generally admit the inherent limitations that may impair their effectiveness, but are of the opinion that board

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85. *Id.* Chancellor Alan also states that "use of outside directors to protect minority shareholders was specifically encouraged by the Delaware Supreme Court in its 1983 Weinberger opinion." Allen, *supra* note 24, at 2058.

86. Allen, *supra* note 24, at 2059.

87. *E.g.*, Deakin, *supra* note 6, at 541; Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469 (2007).

88. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 979 (2003). *See, e.g.*, Prentice & Spence, *supra* note 11, at 1908. The authors argue that "audit committees be composed entirely of independent directors pays concrete benefits in terms of accurate financial reporting."

89. E. Norman Veasey, *An Economic Rationale for Judicial Decision Making in Corporate Law*, 53 BUS. LAW. 681, 687 (1998). [hereinafter *Rationale for Corporate Decision*].

90. Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1382 (2006).

91. *Id.*

92. Gordon, *supra* note 87, at 1469.

independence is a worthwhile goal.[93] As Chancellor Allen states,

> "Director independence does not assure that a director will make a better contribution on the board than an insider might make. Independent directors may have less information about the firm and may, in fact, tend to make less brilliant decisions over time than those with a close financial interest in the firm. Nevertheless, independence offers to investors some further assurance that the governance process has integrity. It is a very imperfect signal of integrity, of course. Independent directors can be imperfect in a number of ways, as can we all, but their lack of management bias does offer investors some protection."[94]

Whether the majority of the board of directors should be independent is debatable, but most academia and business researchers agree that independent directors can help the board function effectively,[95] as long as some preconditions can be met.

C. *Preconditions for Effectiveness of Independent Directors*

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

1. *Incentives: Carrot vs. Stick*

Like inside directors, independent directors are also agents for shareholders. They may shirk for their own interests and the agency cost may rise albeit little. In situation that they are granted other expansive powers over auditing, director nomination, and executive compensation, the costs certainly rise.[96] Some scholars argue that independent directors should be compensated for time spent on monitoring in order to give them a monetary incentive that will motivate them to monitor in an effective manner.[97] Independent directors who fail as monitoring watchdogs will

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93. *Rationale for Corporate Decision*, *supra* note 89, at 687-88.

94. *Id.* at 688. (citing William T. Allen, Independence, Integrity and the Governance of Institutions, Speechto the National Association of Corporate Directors Annual Meeting, 7-8 (Oct. 27, 1997).

95. Pease, *supra* note 52, at 31. *See also* Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 455-56 (1984). (arguing the independent directors can play an important, albeit "limited," role in improving corporate accountability).

96. Note, *Beyond "Independent" Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553, 1558-59 (2006).

97. Incentives to board monitoring include: board independence and director compensation. *See*

probably suffer soiled reputations and negative labor market consequences,[98] so they have incentives to carry out their tasks effectively and avoid colluding with managers to exploit shareholders.[99] Some argue that independent directors should partially be compensated by the equity of the company, so they, as the equity owners, have interests aligned with the interests of shareholders.[100] Also, independent directors' incentives to monitor management include a desire to protect their reputation and to maximize the value of their equity holdings in the company.[101]

Independent directors have the same fiduciary duties to the company as other directors. Some scholars agree that imposing legal liabilities on directors can help motivate them to be attentive and careful in order to avoid adverse financial consequences that can result from the failures to measure up to legal standards.[102] Likewise, liability encourages the independent directors to reject non-arms-length transactions and offers a powerful argument for independent directors when insiders propose a dubious transaction.[103] However, the stick approach cannot be overstated because imposing heavy liabilities on directors has certain disadvantages.

For example, independent directors may be so apprehensive about

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Amy J. Hillman & Thomas Dalziel, *Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives*, 28 ACAD. MGMT. REV. 383, 385 (2003).

98. Davis, *supra* note 79, at 146.

99. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983).

100. For example, granting directors stock options or restricted stock may successfully align independent directors with shareholders. A research indicates that there has been more and more corporations which offer incentive-based compensation for their directors and suggests that incentive compensation would influence board's monitoring efforts. *See generally* Tod Perry, *Incentive Compensation for Outside Directors and CEO Turnover*, SSRN (June 2000), http://ssrn.com/abstract=236033. However, some doubt if this method would work. *See* Rodrigues, *supra* note 57, at 460-61; Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677 (2007).

101. Lin, *supra* note 9, at 940.

102. Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1387 (2006). Professor Sale contends that "[Independent directors] are potentially liable if they simply rubber-stamp the statements or information provided to them by the officers." Sale, *supra* note 90, at 1381. *See also* Hamilton, *supra* note 69, at 5. *But see Promoting Accountability*, *supra* note 27, at 117. (noting that cumulative effect of protective devices normally used in practice, such as business judgment rule, demand requirement in derivative suits, exculpation, indemnification, and insurance lead to de facto "no liability" rule for directors. Thus, independent directors will face very infinitesimal risk of paying for damages caused by breach of fiduciary duty out of their own pockets).
However, Professor Stout argues that the deficiencies of directors' external punishments (i.e., legal sanctions and social sanctions) are not seen as threats to directors because the punishment is inadequate, and does not explain why a purely self-interested director would take fiduciary duties seriously. She argues that some non-pecuniary reasons, such as "honor," "integrity," "trustworthiness," and "responsibility," can push directors to make altruistic decisions. *See* Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, What You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 5-10 (2003).

103. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 800 (2001). [hereinafter *Preconditions for Strong Securities Markets*].

shareholder lawsuits that they might back off from innovative decision-making, which would reduce their effectiveness on behalf of the company.[104] Furthermore, they spend time collecting documents that can be utilized as part of the defense in future lawsuits, which would diminish their ability to function.[105] Even independent directors are not in a better position than insiders to understand the relevant facts and make material decisions, such as in mergers or hostile takeovers, in the best interests of the company and its shareholders. The courts do not hold them "to a lesser standard in being informed and in exercising requisite care in their decisions."[106] Thus, protecting independent directors from potential liabilities is an important issue.[107] Imposing heavy liability on them would provide less incentive for experienced or professional experts to be hired as independent directors.[108]

The legal liability risks that independent directors face are higher in the United States than in other parts of the world.[109] For example, independent directors in Taiwan are subject to various legal rules and can be liable for damages that result from breaches of their duties. The legal obligations that independent directors (and non-independent directors) face rarely lead to personal payments, under a recovery system that is impractical for claimants.

2. *True Independence*

The U.S. corporate conventional wisdom argues that independent directors are presumably able to function as an effective monitor because they have no family or financial ties with large shareholders, company officers, and the company. In this sense, there is no question that true independence is critical in order for independent directors to function as expected.[110]

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104. Pease, *supra* note 52, at 96.

105. *E.g.*, *id.*; Cheffins & Black, *supra* note 102, at 1389.

106. Pease, *supra* note 52, at 53.

107. *E.g.*, Haft, *supra* note 9, at 17-19. The author argued that "the law should encourage truly independent directors to serve and act as "monitors," but rather as "deciders." To promote these ends, courts can accord more certain, and probably greater, legal protection to business decisions reached by the truly independent board than does current law." *Id.* at 6. *See also* James M. Tobin, *The Squeeze on Directors—Inside is Out*, 49 BUS. LAW. 1707, 1750-51 (1994); Pease, *supra* note 52, at 49-53.

108. *E.g.*, William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U.L. REV. 449, 455 (2002); *Preconditions for Strong Securities Markets*, *supra* note 103, at 800. (noting "the independent directors shouldn't face too much liability risk, lest skilled directors refuse to serve").

109. Cheffins & Black, *supra* note 102, at 1387. However, as a matter of fact, directors seldom paid the damages out of their own packets. Indemnification and D&O insurance greatly reduce the legal risks that they would face. *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

110. *E.g.*, Tobin, *supra* note 107, at 1723. The author believes that it is "[c]ritical to an outside [independent] director's ability to successfully carry out his or her management oversight function is

Independent directors are specifically assumed to be able to make fairer decisions on behalf of the company than inside directors, particularly in situations where conflicts of interest between inside directors and the company exist.[111] In cases of shareholder lawsuits in which directors allegedly breach their fiduciary duties by engaging in transactions that involve their self-interest, independent directors are deemed to be the best parties to make the final decisions regarding the best interests of the company. If the alleged transactions are reviewed and agreed upon by independent directors, the courts will not second guess the legality of such transactions, which are usually presumed to be in the best interests of the company. Under the business judgment rule, which presumes that board decisions are made on a fair, informed, good-will basis, aboard of directors primarily consisting of independent directors would receive a great deal of deference by courts avoiding trivial lawsuits.

In order for independent directors to maintain true independence, some U.S. scholars suggest that there should be a stricter standard for independence.[112] In fact, the standards have become increasingly stricter.[113]

There are two primary approaches used to determine which director can be an independent director. The traditional approach used in U.S. litigations is a function-specific approach that is used to determine who would qualify as independent directors in litigation. Delaware courts tend to defer to business decisions made by the majority of aboard of directors whose members have no direct and personal interest in the alleged transaction and are independent of the defendant directors. The business decisions made by independent directors are assumed in the best interest of shareholders. In general, the more independent directors on board, "the more likely it is that board action will find a safe harbor from liability in many settings."[114] The

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the ability of that director to exercise his or her business judgment, independent from management." *Id.* at 1748; Professor Millstein also argues that "[t]rue independent oversight is the key to achieving accountability. At the board level this requires true independence of management to enhance the board's credibility with the shareholders" Millstein, *supra* note 76, at 1494; *see also* Leech & Mundheim, *supra* note 78, at 1830 (noting that the benefits of a board dominated by outside directors can be achieved only by ensuring that such outsider is truly independent); Toda & McCarty, *supra* note 12, at 189. (suggesting that independence among directors is vital to effective corporate governance). However, some argue that inducing both faithful and capable agents should be the goal of corporate governance. Even though independence can be a proxy, fetishizing the independence proxy sometimes is misguided and dangerous. *See* Rodrigues, *supra* note 57, at 451.

111. *E.g.*, *Derivative Impact*, *supra* note 38, at 1375; Gilson & Kraakman, *supra* note 9, at 874-75.

112. Fairfax, *supra* note 4, at 383.

113. *Corporate Governance Issues*, *supra* note 72, at 61; Clark, *supra* note 5, at 268.

114. E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices – or Vice Versa?*, 149 U. PA. L. REV. 2179, 2182 (2001). [hereinafter *Good Corporate Governance*] But Delaware Vice Chancellor Chandler has a similar but slightly different opinion, and states that "not rely reflexively only on the status of a director as an inside director or an independent director to inform their determination of whether that director's actions were right or

approach used by Delaware courts to determine independence is situational.[115] Specifically speaking, courts will determine whether a particular director is disinterested or independent on a case-by-case basis, without a bright-line rule.[116] The primary questions that are most often asked by courts regarding independence concern the purpose and independence from whom.[117] A director who is independent in one case may not be independent in another.

Instead of the traditional approach, the SOX and most stock exchanges around the world equates independence with outsider status by using a list of several conflicting relationships that will disqualify directors from being deemed independent.[118] This approach contends that once a director is elected as an independent director, the label of independence automatically comes with that eligible director unless that director later fails to meet the independence standard. This approach, which includes full disclosure of information about directors, can give the public a clear and quick guide to understanding whom and how many independent directors are on board. In contrast, courts determine the independence of directors primarily by evaluating the practical constraints on a particular director's ability to function effectively with respect to a specific issue.[119]

Scholars have criticized the latter approach,[120] because this definition of independence can be over-inclusive or under-inclusive.[121] This approach basically emphasizes the importance of business relationships between directors and the company, which have the potential to impair a director's ability to function in the interest of the company, regardless of how minor such relationships might be. Most current independence standards fail to address the conflict-of-interest situations in which independent directors will help to alleviate the agency problem.[122] For example, in terms of executive compensation, the lack of financial ties to the company and familial ties to the executives may not be sufficient to expect independent directors to solve the agency problem.[123] Instead, whether the financial ties to the executives being compensated exist would be critical. It is unfortunate that current independence rules overlook this obvious element.[124] Additionally, this

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wrong, proper or improper, informed or uninformed." William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1088 (1999).

115. Rodrigues, *supra* note 57, at 447.

116. *Good Governance Practices*, *supra* note 114, at 2182.

117. *Id.*

118. Fisch, *supra* note 68, at 45.

119. *Id.*

120. *Id.*

121. *Id.*

122. Rodrigues, *supra* note 57, at 447.

123. *Id.*

124. *Id.*

approach ignores social ties and friendships that can similarly have an adverse impact on board function.[125] Scholars describe this type of director independence as "cosmetic independence," arguing that current standards for independence are insufficient to remedy the corporate failures of recent years.[126]

Even in the U.S., the related-party transactions involving controlling shareholders are subject to an entire fairness review, which "reflects a distrust of the statutory mechanisms of independent director."[127] The bottom line is that, theoretically speaking, regardless of how precise or strict the independence standard might be directors' actual independence cannot be guaranteed simply by requiring directors to meet independence standards.[128] That is to say, even using a precise definition of independence and rigorous enforcement does not ensure that independent directors will act in a completely independent manner and in the interests of shareholders.[129]

III. PROBLEMS THAT TAIWANESE INDEPENDENT DIRECTORS WILL FACE

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

A. *Dominance by Controlling Shareholders*

Controlling shareholders are pervasive in Taiwanese companies, in the

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125. Fisch, *supra* note 68, at 45; As Professor Brudney notes, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess." Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 613 (1982).

126. Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE UNIV. L. R. 1435, 1437-38 (2011). Professor Sharpe argues that independent directors "frequently lack the time, information, and knowledge to properly monitor the CEO and other top-level management," and current independence standards fail to take these factors into account. As a result, current adopted "definition of independence actually reduces the likelihood that independent directors will be able to act independently of the [CEO]" *Id*. at 1438.

127. Steven M. Haas, Note, *Toward a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2245, 2247 (2004).

128. Sharpe, *supra* note 126, at 1437.

129. OECD, ENFORCEMENTOF CORPORATE GOVERNANCEIN ASIA: THE UNFINISHED AGENDA 50 (2007), http://www.oecd.org/dataoecd/43/15/42365100.pdf. [hereinafter OECD CORPORATE GOVERNANCEIN ASIA] *See also ALI Governance Project*, *supra* note 24, at 1082. Professor Bainbridge argued that "independent directors are not a perfect constraint on management self-dealing. Both actual and structural bias may affect their decision making".

sense that they usually dominate boardrooms. Therefore, in addition to independence from management, independence from large (or even controlling) shareholders is also critical for effective board monitoring, particularly in Taiwanese companies.[130] Ironically, Article 2 of "Regulations Governing Appointment of Independent Directors and Compliance Matters for Public Companies" mandates that companies adopt the "candidate nomination system" in electing independent directors. Under such an election system, only the board of directors and shareholders (who hold more than 1% of a company's outstanding shares) can nominate independent directors. Thus, if the majority of incumbent directors and large shareholders have shared interests, truly independent directors are less likely to be nominated and elected.[131]

One primary reason why Taiwan introduced the institution of independent directors was to prevent the undue dominance of management and board of directors by controlling shareholders. Even in the case of dispersed ownership structures of the U.S. public companies, corporate scholars argue that the key to director independence is not the independence of directors from management but rather their relation to shareholders.[132] Therefore, in Taiwan, director independence from shareholders should be an important issue when it comes to independence of independent directors.

However, the intentions of insiders can determine whether a company will appoint independent directors as part of their team (because the articles of incorporation need to be amended with support from board of directors and major shareholders). Current regulations regarding independence standards stipulate that incumbent directors and major shareholders can still appoint candidates who have close social ties to them, which means that they can nominate only those candidates whom they can ensure will not monitor them in a robust manner.

Hence, given these standards of independence, there is no guarantee that independent directors will turn out to be truly independent of management and controlling shareholders. Managers and controlling shareholders can bypass the independence standards, and the independent directors can be

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130. *E.g.*, *Preconditions for Strong Securities Markets*, *supra* note 103, at 808. The author contended that "nominally independent directors won't be very independent in fact, especially when a company has a controlling shareholder, at whose pleasure the directors serve".

131. John S. Liu & Chyan Yang, *Corporate Governance Reform in Taiwan: Could the Independent Director System Be an Effective Remedy?*, 48 ASIAN SURVEY 816, 836 (2008). The authors contend that without support from the controlling shareholders or the block shareholders, it is nearly impossible for independent directors to garner sufficient votes to be elected.

132. Gilson & Kraakman, *supra* note 9, at 905. However, SOX "does not contain any overarching definition of independent director," and the directors affiliated with large stockholders are qualified to serve as independent directors. Also, NYSE does not prohibit "a major but non-controlling stockholder from being considered an independent director." Chandler & Strine, *supra* note 88, at 991.

appointed or influenced by controlling shareholders and management. The ownership structures of Taiwanese listed companies are relatively concentrated, so powerful shareholders are common in the market and true board independence is less likely to occur in reality.

Unfortunately, Taiwan does not have an effective solution for dealing with the dominance of controlling shareholders. In the U.S., Delaware corporate laws tend to be suspicious of fiduciaries that are interested parties or controlled by controlling shareholders.[133] It appears that independent directors may feel that they owe allegiance to the interests of the controller, rather than the company and its shareholders.[134] Thus, when a controlling shareholder is involved in a deal with the company, the transaction should be reviewed to verify that it is substantively fair even if independent directors negotiated the transaction.[135] An approval by a special committee consisting of independent directors will be necessary.[136]

B. *Weak Enforcement of Corporate Laws*

In relation to the enforcement of corporate regulations, Taiwan is heavily reliant upon the administrative agency in dealing with a company's internal governance issues. In cases that arise from issues concerning the fiduciary duties of directors, shareholders must overcome high legal thresholds if they intend to bring an action on behalf of the company, that is, a derivative suit. Such thresholds include holding a minimum of 3% of the outstanding shares of the company, a holding period of more than 12 months, demand an action against directors to supervisors a waiting period of 30 days, and rendering a security deposit when the court deems it necessary.[137] In addition, the plaintiff shareholder may owe liabilities to the director they sue for damages if that shareholder loses the lawsuit.[138]

The TCA, thus, sets up an almost impracticable dispute resolution mechanism for internal affairs issues. When all of the supervisors have been captured by management or controlling shareholders, or are involved in wrongdoing, the only method that shareholders (particularly minority shareholders) can use is enforcement by a public agency, meaning the Ministry of Economic Affairs ("MOEA") and FSC, which are the competent authorities in Taiwan. However, it is unrealistic to expect too much from the

133. *Delaware Way*, *supra* note 81, at 678.

134. *Id.*

135. *Id.*

136. A Delaware decision demonstrated the ability of independent directors to withstand the fear of a controlling shareholder and the power of independent directors to protect minority interests. *Hollinger International v. Black*, 844 A.2d 1022 (Del. 2004). Haas, *supra* note 127, at 2287.

137. Kung Ssu Fa[Company Act], art. 214 (Taiwan).

138. Kung Ssu Fa[Company Act], art. 215 (Taiwan).

public agencies, because an administrative agency as an outsider has difficulty detecting wrongdoing when it is in progress secretly. Inside and outside governance mechanisms can supplement each other. However, internal Taiwanese governance mechanisms (i.e., supervisors and shareholders) have serious deficiencies and often fail to function effectively. Agencies such as the MOEA, FSC, and criminal prosecutors are subject to many limitations and currently do not aggressively enforce corporate governance regulations.

C. *Majority of Board Members Not Independent*

Few companies in Taiwan have boards on which the majority consists of independent directors. The possible positive effects independent directors might bring to companies would be limited because the majority of board members are not independent. Scholars argue that effectuating a board's monitoring function requires a majority of independent directors on board.[139]

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

Given that independent directors are usually in the minority in boardrooms, independent directors are unlikely to challenge decisions made by their colleagues that form the majority because they cannot determine whether or not decisions might go wrong. As scholars argue, a majority comprised of independent directors in a group is more likely to think and judge independently.[140]

Some scholars suggest that companies should select an independent lead director to chair meetings of independent directors, and the reasons why a company has a lead director, and the role that the lead independent director

139. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278 (1999). [hereinafter *Social Norms*].

140. Liu & Yang, *supra* note 131, at 836-37.

plays in the company should be publicly disclosed by the company.[141] Disclosures are intended to inform investors of the facts about a company's board leadership structure and the degree to which the board can exercise independent judgment.[142]

The introduction of the institution of independent directors in Taiwan is primarily derived from the mistrust of boards that consist of insiders. Adding independent directors as watchdogs into boardrooms may reduce board harmony, and the adversary relationship between inside and outside directors can decrease the efficacy of board monitoring.[143]

During a board meeting in the presence of a majority of inside directors, independent directors may not feel comfortable delivering their opinions, because they may be unwilling to offend or seem to threaten inside directors (and management), or to embarrass themselves due to their relative lack of knowledge.[144] To discharge monitoring responsibilities, U.S. scholars argue that the board of directors will be active, primarily through committees of the board. At least some functional board committees (e.g., audit, nominating, and compensation) should be established and comprised exclusively of such independent directors.[145]

As compared with the U.S. independent directors, the presence of independent directors is uncommon in Taiwan and they rarely comprise the majority of boards of directors. That may indicate that most Taiwanese companies do not recognize the value of independent directors in reconciling conflicts of interest matters.[146]

Finally, if boards are generally independent of management and controlling shareholders, and are actively involved in overseeing managerial behavior, "one might conclude that a board controlled by independent directors is a sufficient constraint on management shirking and self-dealing."[147] It appears that Taiwanese policymakers anticipate that the good theory of independent directors will materialize in Taiwan. However, most Taiwanese companies have boards of directors whose majorities are not independent. Furthermore, there are no supplemental rules or norms that technically assist Taiwanese independent directors facilitate effective

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141. Z. Jill Barclift, *The Battle for Control of Corporate Governance*, 15 CHAP. L. REV. 1, 7 (2011).

142. *Id.*

143. *E.g.*, Leech & Mundheim, *supra* note 78, at 1805. The authors argued that "the creation of a monitoring responsibility may lead outside directors to believe that their role requires them to assume an essentially adversary attitude toward management" .

144. *Corporations and Society*, *supra* note 42, at 2196.

145. *Social Norms*, *supra* note 139, at 1278.

146. Yu-Hsin Lin, *Weak Independent Directors, Strong Controlling Shareholders: Do Independent Directors Constrain Tunneling in Taiwan?*(April, 2010) (unpublished J.S.D. dissertation, Stanford Law School), 172. [hereinafter *Independent Directors*].

147. *ALI Governance Project*, *supra* note 24, at 1035.

monitoring, such as a lead independent director, director oversight of legal compliance systems, and regular meetings of independent directors without the presence of the inside directors and management.[148]

This leads to doubts about the effectiveness of functions that independent directors could have. Not to bring to companies compliance obligations that are too tedious, Taiwanese policymakers compromised to allow public companies to decide whether a majority of independent directors would be appropriate for their companies' circumstances.[149]

D. *No Strong Power Vested with Independent Directors*

According to the TSEA, independent directors generally have no special investigative power without an audit committee. They usually rely on information provided by management to help them make proper decisions. With the presence of an audit committee, committee members can exercise investigative power, as do supervisors.[150] However, weak monitoring power is partially blamed for supervisors' failures. Investing supervisor-type powers in committee members may be inadequate. Furthermore, the board of directors can still veto the decisions of the audit committee with the approval of two-thirds of all of the directors.[151] Because independent directors are not vested with any real investigative power, they are unlikely to operate asan effective monitoring device.

Informational asymmetry is a serious obstacle to the effectiveness of independent directors. Recent research indicates this difficulty exists and reduces the functionality of independent directors.[152] The author of this research interviewed several independent directors of Taiwanese listed companies, and some of the interviewees expressed their concerns about informational asymmetry that exists between independent directors and management.[153]

Such research shows that some interviewees found they were unable to "dig deeper" for information in the presence of controlling shareholders who dominate both management and the boardroom.[154] Independent directors similarly may be unable to detect conflict-of-interest transactions when insiders have an incentive to intentionally hide information about such

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148. Chandler & Strine, *supra* note 88, at 956.

149. This situation also happens in the U.S. Tentative Draft No. 1 of the American Law Institute's Principles of Corporate Governance (ALI Principles) required that independent directors comprise a majority of the board of directors in a large publicly held corporation. However, such requirement was abolished in the final version of ALI Principles.

150. Chêng Ch'üan Chiao I Fa[Securities and Exchange Act], art. 14-4 (Taiwan).

151. Chêng Ch'üan Chiao I Fa[Securities and Exchange Act], art. 14-4 (Taiwan).

152. *Independent Directors*, *supra* note 146, at 137.

153. *Id.*

154. *Id.* at 139.

transactions in order to avoid being scrutinized by the competent authority, or are concerned about attracting too much public attention. Given the complex ownership structure of Taiwanese companies, which involves a variety of methods such as cross-holdings and pyramid structures, it may be difficult to identify whether or not the parties involved are "related parties" in the first place.[155]

In the absence of sufficient information, it may be unrealistic to expect independent directors to be able to determine and valuate suspect transactions in an effective manner. Given the presence of controlling shareholders, independent directors are likely to be kept in the dark when attempting to make decisions. Lin's research concluded that Taiwanese independent directors, who are being deemed to be outsiders by controlling shareholders, in fact are ineffective "in overseeing controlling shareholders, especially in detecting unfair related-party transactions and fraud."[156]

U.S. corporate scholars recommend that companies both appoint majorities of independent directors to their boards and establish some sub-committees consisting solely of independent directors, such as audit, compensation, and nominating committees in order to facilitate the effectiveness of independent directors.[157] According to Lipton and Lorsch, the ideal U.S. board should be a monitoring board with three important committees comprising solely of independent directors.[158] In Taiwan, only audit committee and remuneration committees have been introduced by the TSEA. The company can voluntarily establish other types of committees, as recommended by the Best Practice Principles. At present, few listed companies have established sub-committees (but the remuneration committee is a necessary device for all listed committees in accordance to Article 14-6 of the TSEA).

E. *Concerns Arising from Overlapping Monitoring Devices*

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

Hence, within a company that appoints both independent directors and supervisors, there are two different monitoring devices: independent directors and supervisors. Independent directors are essentially board members that have the same power as a non-independent director.

155. *Id.* at 140.
156. *Id.* at 143.
157. *E.g.*, *Good Governance Practices*, *supra* note 114, at 2190.
158. Lipton & Lorsch, *supra* note 9, at 59.

Independent directors are responsible for monitoring some material business decisions, which are specifically itemized in Article 14-3 of the TSEA, such as reviewing a company's internal control mechanism, fundamental transactions, and financial reports.

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

In comparison with supervisors, independent directors are vested with powers as regular directors except for the delivery of dissenting or qualified opinions. In fact, when there is no audit committee, one effect is that some fundamental decisions can be approved only by the board of directors, and cannot be delegated to subcommittees. The primary function that independent directors have is sounding the alert by delivering dissents or qualified opinions in the minutes of board meetings for public disclosure (*See* Table 1 for details).

Table 1 Independent Directors vs. Supervisors

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

Source: Author

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

One may argue that independent directors have advisory functions, because they have certain types of expertise that companies need. However, independent directors are empowered to object to important items, so the monitoring function should be the focus of Taiwan's recent independent director reforms. Thus, independent directors are expected to function primarily as a monitoring device instead of an advisory role. In order to clarify the scope of responsibility of independent directors, Article 26 of the Best Practice Principles suggests that a listed company stipulate the scope of duties of their independent directors.[159]

F. *Mandatory Nature of Taiwanese Corporate Laws*

Why does Taiwan need to codify the function of independent directors? In the U.S., the development of the institution of independent directors emerged from the marketplace without formal regulations. Companies voluntarily appoint independent directors to suit their governance needs for a variety of reasons, including the benefits of better performance and greater deference from courts.[160]

The Taiwanese government prefers to codify such a role, and has left little room for companies to develop individually desirable governance practices. The mandatory rules stipulate that the term "independent directors" refers exclusively to independent directors appointed under procedural rules proscribed in the TSEA (*See* Table 2). The nomination and election procedures are also mandatory, with no room for modifications.[161]

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159. The Best Practice Principles are not mandatory and only for purposes of recommendation.

160. Chandler & Strine, *supra* note 88, at 977-78.

161. One Taiwanese corporate commentator suggests companies may opt to appoint either supervisors or independent directors, but once they choose independent directors, they are mandatorily subject to the all set of the independent director rules prescribed by the laws. *See* Wallace Wen-Yeu Wang, *Shêli TuliTungchienshih Tui Kungssu Chihli Tê Yinghsiang* [*The Impact of Appointments of Independent Directors and Supervisors on Corporate Governance*], 56(1) FALING YÜEH K'AN[THE LAW MONTHLY], 45.

Hence, Taiwanese companies have little room to build their own governance systems freely.

Table 2 Legal Procedure for Appointing Independent Directors

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

Source: Author

The TSEA stipulates that prior to the appointment of independent directors a company must add a clause concerning independent directors into the articles of incorporation. Such an amendment needs a resolution during a shareholder meeting, which needs a quorum of at least two-thirds of the voting shares and approval by at least 50 percent of such a quorum. Given the concentrated ownership structures, and the fact that many individual investors are not interested in attending shareholder meetings, such an amendment usually fails without the support of stock block-holders. Independent directors are expected to provide effective monitoring function of management, without undue influence from other groups or individuals, particularly in situations where controlling shareholders exert control over the board of directors and supervisors. It is difficult to expect large shareholders to support an amendment adopting independent directors.

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

Companies that want to appoint independent directors or an audit committee should comply with the procedures established by law and regulations. In addition to a clause concerning independent directors,

independent directors should be elected through the candidate nomination system, a procedure in which only board of directors and shareholders (those with more than 1% of all outstanding shares) have the right to submit a slate of independent directors. After the elections, the only power that independent directors have would be the right to file objections regarding important items that have been specified in Article 14-3 of the TSEA.[162] However, independent directors' objections cannot invalidate items that have been approved by the majority of the board of directors, and the only effect is that such objections are recorded in the minutes of the board meeting. In comparison with non-independent directors, the right to object to particular items appears to be the only privilege vested in independent directors. In fact, a non-independent director can also express their opinions about a particular item. Therefore, whether or not the objection should be recorded in the minutes is the only different privilege that distinguishes independent directors from non-independent directors.

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

Professors Lipton and Lorsch argue "changes in board practices [shall] be implemented by individual boards, with no changes in laws, stock exchange rules, SEC regulations, or new court decisions. Trying to change regulations or laws will be politically difficult and at best very time consuming."[163] Taiwanese policymakers may need to think about this statement seriously.

G. *Un-examinable Independence*

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

162. Chêng Ch'üan Chiao I Fa[Securities and Exchange Act], art. 14-3 (Taiwan).
163. Lipton & Lorsch, *supra* note 9, at 63.

other illegal activities.[164]

In Taiwan, the controlling shareholders can usually elect the majority of the board of directors, or even the entire board, which means that "the real objectivity and independence, and therefore the real value, of nominally independent directors can be undermined."[165] Taiwan has adopted legislation that assumes that independent directors avoid being unduly influenced by management and make objective decisions that are in the interest of shareholders. However, determining what constitutes true independence remains an open question.[166]

As explained previously, derivative suits tend to not be exercised by shareholders in Taiwan.[167] Thus, there are few or no opportunities to review the true independence of independent directors in litigations. In the absence of effective judicial reviews, shareholders and investors can hardly challenge the credibility of independent directors. In other words, ex post judicial review of director independence determining true independence of directors is almost unavailable in the Taiwan's legal system.[168] Taiwanese independent directors are currently only subject to formality checks that will be performed by companies' self-compliance, the stock exchange, and the competent authority.[169]

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

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

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164. Dooley & Veasey, *supra* note 35, at 503.

165. OECD, WHITE PAPER ON CORPORATE GOVERNANCEIN ASIA 57 (2003).

166. As Taiwanese scholars argue, "[m]any newly appointed independent directors and supervisors seem to be closely associated with the controlling shareholders." Liu & Yang, *supra* note 131, at 836.

167. There are very high legal barriers that militate against bringing a derivative suit against director(s), which is designed for the purpose of avoiding potential abuses by shareholders. These include the minimum number of shares held by plaintiff shareholder or shareholders (more than 3 % of outstanding shares), the minimum holding period (in excess of one year), the written demand made to supervisor(s) requesting an action and a 30-day waiting period, litigation securities upon defendant's request, and the potential liabilities after losing cases. In addition, attorney's fees are not allowed even when the plaintiff wins or settles with defendants. Therefore, there is little incentive offered, and the derivative suits have been rarely come about in practice. *See also* OECD CORPORATE GOVERNANCEIN ASIA, *supra* note 129, at 22-23.

168. *Independent Directors*, *supra* note 146, at 110.

169. *Id.*

independent directors from undue influence by management.[170] To help ensure the true independence and objectivities of directors, a nominating committee consisting entirely of independent directors should be responsible for nomination of directors.[171]

In Taiwan, there is no similar legal notion regarding the nomination committee, and most Taiwanese companies do not have such committees. In contrast, the "candidate nomination system" allows management and major shareholders to manipulate their favorite candidates into being elected as independent directors. The result is that the independence of Taiwanese independent directors remains in doubt.[172]

Corporate literature indicates that the dominant leader of the group may heavily influence independent directors who can deliver dissenting opinions on certain suspect transactions.[173] In most Taiwanese companies, the CEO (or general manager) and board chairman are often the same person (or several individuals supported by the same controlling shareholders), so independent directors are less likely to engage in frank discord against management.

As proposed in the initial draft of TSEA that requires mandatory appointment of independent directors, such a requirement can be a way to promote independent director review of self-dealing transactions.[174] However, such a requirement cannot do much to make the directors truly independent.[175] The bottom line is that even if independent directors are truly independent, restoring investor confidence in the integrity of the Taiwanese system of corporate governance, given recent scandals, requires objectivity and judicial intervention.[176]

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170. Rock, *supra* note 35, at 505.

171. The nomination committee can provide "an independent locus of responsibility for the composition of the board" and "screen out candidates who lack objectivity toward the senior executives by virtue of elements that cannot be adequately captured by an objective test." *Modernization of Corporate Law*, *supra* note 12, at 205.

172. In the U.S., both NYSE and NASDAQ require that director-nomination decisions must be made (or at least recommended to the board) by independent directors only. "The NYSE mandates that such decisions(or recommendations) must be made by standing independent committees, while NASDAQ gives companies the option of using either independent committees or a majority vote of all independent directors." *Corporations and Society*, *supra* note 42, at 2192.

173. *E.g.*, *Corporate Governance*, *supra* note 33, at 620.

174. *Preconditions for Strong Securities Markets*, *supra* note 103, at 826.

175. *Id.*

176. Delaware Court also notes that "even when the transaction is negotiated by a special committee of independent directors, no court could be certain whether the transaction fully approximated what truly independent parties would have achieved." Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

H. *Passive Institutional Investors and Apathetic Taiwanese Shareholders*

One reason for the rise of independent directors in U.S. companies is the advocacy by institutional investors.[177] Along with addition of independent directors to the board, institutional shareholders will continue to monitor directors and their performance.[178]

Unlike the U.S. institutional investors who hold majority of equity in the listed companies,[179] institutional investors in Taiwan tend to be passive regarding governance issues, so companies feel little pressure to adopt better governance practices. Share prices are the primary concern of institutional investors. Individual investors contribute most of the capital in Taiwan, and the governance issues may not interest them. Taiwanese shareholders may have little interest in whether or not directors are independent, but they do rate managerial performance by voting using the "Wall Street Rule" if the management fails to meet their standards of performance.[180]

The U.S. institutional shareholders have long been advocating for boards to have a majority consisting of independent directors.[181] Also, institutional investors may help companies to identify qualified candidates to be independent directors who have "specific charge of being independent of management and accountable for advancing shareholder interests."[182]

I. *Summary*

In addition to the U.S. debate associated with the effectiveness of independent directors, some Taiwanese commentators also show their concerns in this regard. Firstly, independence matters but it is very difficult to ensure in Taiwan's society. Most leaders of Taiwanese companies generally prefer to hire independent directors with whom they are familiar. A controlling shareholder, of course, will look for good candidates according to their personal preference. They will judge the candidates primarily based on their prior "Guan Xi (relationship)" with candidates. The Guan Xi generally provides reliable information as primary resource allowing people to network with others in Chinese (and Taiwanese) society.[183] The best strategy

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177. "[T]he primary pressure is on outside [independent] directors and comes from advocacy by institutional investors." Tobin, *supra* note 107, at 1707.

178. *Id.* at 1729.

179 "[T]he equity ownership by all types of public and private institutions is between 50% and 60% of the total value of stock-exchange-listed companies." Lipton & Lorsch, *supra* note 9, at 60.

180. Walter Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1643-44 (1981).

181. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 840 (1992).

182. Gilson & Kraakman, *supra* note 9, at 905.

183. *Independent Directors*, *supra* note 146, at 150.

for a controlling shareholder is to invite someone who has the Guan Xi with her if possible. As mentioned, the presence of controlling shareholders is common and they can normally decide who will be elected as independent directors. It is less likely that the favorable candidates will monitor and advise against their supporters.

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

There is no doubt that substance is more important than form when speaking of independent directors. Directors who are labeled as independent directors may have significant importance in corporate governance but they must be utilized responsibly.[184] However, due to any reasons, when independent directors are not truly independent, the label will be meaningless. It may raise a problem for investors of Taiwanese companies who have given these prima facie labels weight in making investing decisions. Similarly, courts will confront the same problem when the transaction in question has been passed by independent directors. Delaware courts have distinguished the concept of an "interested" director from that of an "independent" director[185] and have realized labeling could have an unfair effect without appropriate sensitivity.[186] By the same token, Taiwanese courts may have to develop a legal standard to determine the legality of behaviors involved with monitoring by independent directors.

A research on Taiwanese independent directors of listed companies conducts a survey in order to explore a question as to what independent directors consider to be the most important key to effective function. The survey contains pre-specified choices: "the lack of sufficient time," "the difficulties in accessing information," "the colleague relationships," "insufficient pecuniary incentives," "the lack of certain types of professionalisms for effective monitoring," "expectations for re-nomination," and "no difficulties to effectively execute powers." "Insufficient time" and "the difficulties in accessing information" are ranked as the first (28%) and second (18%) most important factors in the effective functioning of independent directors.[187] That survey indicates that even in

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184. Chandler & Strine, *supra* note 88, at 997.

185. *Id.*

186. *Id.* at 998.

187. In that survey, there are effective 585 questionnaires with 276 returns (returns-ratio of 47%). *See* Len-Yu Liu, *Hsienhsing Shangshih Shangkui Kungssu Tuli Tungshih Chihtu Chih Chient'ao Chi*

situations where independent directors have true independence from management and controlling shareholders, they may have insufficient time and information to make decisions. In addition to the lack of time and information, Taiwanese independent directors face other challenges when trying to be effective monitors. Of the respondents, 57% responded that they did not experience any difficulties when they effectively executed their powers.[188]

However, that survey may not have revealed the complete picture regarding the difficulties that Taiwanese independent directors face. Whether or not they are truly independent remains uncertain (and can remain unchallengeable through derivative suits in Taiwan). Basically speaking, Taiwan's society has emphasized Guan Xi rather than the rule of law, and that characteristic will be a serious detriment to the effectiveness of Taiwanese independent directors.[189] Taiwan's current legal system states that the FSC, MOEA, and Taiwan's stock exchanges are probably the only mechanisms that might ascertain the true independence of independent directors.

IV. CONCLUSION

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

The U.S. corporate conventional wisdom argues that independent directors will benefit companies in some aspects, but it is believed that they will face some inherent limitations while carrying out the monitoring tasks. The most serious issue is how to ensure an independent director has true independence from management. In addition to the limitations that U.S. independent directors normally face, Taiwanese independent directors also

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Kai chin Fangan- Ts'ung Shihchêng Mien Ch'ufa [*A Study of the Regime of Independent Directors of Listed Companies in Taiwan—An Empirical Approach*], 114 CHÊNGTA FAHSIAO P'INGLUN [CHENGCHI L. REV.] 53, 127 (2010).

188. *Id.*

189. Lawrence S. Liu, *Ts'ai Ching Kai KêYü Hsien Fa ChihYüeh I Tu Li Tung Shih Chin Jung Chieh KuanYü Chin Jung Ping Kou Wei Chung* [*Financial Reform and Constitutional Constraints—Focusing on Independent Directors, Taking-over of Financial Institutes, and Merger and Acquisition of Financial Institutes*], Hsienfa Chiehshih ChihLilun Yü Shihwu [CONSTITUTIONAL INTERPRETATION: THEORY& PRACTICE] (Dennis Te-Chung Tang ed., vol. 4, 2005) 115, 125.

encounter other constraints arising from the characteristics of Taiwan's business environment. Under Taiwan's laws and regulations, independent directors have arguably few chances to rid themselves of the controlling shareholders' influence. Even in the absence of shareholders who have dominance in the boardroom and supervisory system, independent directors will still encounter difficulties in carrying out the monitoring tasks while insiders are unwilling to disclose the material information before any board decision is to be made. In conflict-of-interest transactions (or, related-party transactions), which have frequently been utilized as a form of embezzlement, it is likely that independent directors are unable to detect wrongdoings or even illegality. As a result, this article concludes that Taiwanese independent directors will function in a very limited way, and can hardly be effective monitors under the current set-up for the role of independent directors.

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臺灣獨立董事能否為有效監督者之理論分析

周 振 鋒

摘 要

臺灣引進獨立董事制度後，改變了公司法以監察人為監督機關之內部治理設計。美國公司法學界普遍認為獨立董事制度有助公司治理之推展，但該制卻有本質之缺陷，導致無法完全發揮原被期待之監督功能。最根本性的問題是，如何能確定獨立董事是否真為「實質獨立」。在臺灣引進獨立董事後，除該制本質之缺陷外，臺灣獨立董事將面臨更多本土性之挑戰，尤其是在大股東環伺之商業環境下，獨立董事將難以展開拳腳。另一方面，資訊取得困難亦成為臺灣獨立董事有效監督之隱憂。因此，就目前臺灣法制與商業環境而論，本文認為獨立董事難以有效監督公司經營者，而能興利除弊，未來仍需進一步改革，始能竟其全功。

關鍵詞：獨立董事、公司治理、監察人、公司法、控制股東