AN ANALYTICAL FRAMEWORK FOR CONTROLLING MINORITY STRUCTURES AND ITS APPLICATION TO TAIWAN

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I. Introduction

It is now widely accepted that the diffused ownership characterizing many U.S. and U.K. firms is somewhat an anomaly in the rest of the world. Controlling shareholder structures are prevalent in both Europe and East Asia, as has been documented in extensive studies\(^1\) and the phenomenon is especially pronounced in East Asia.

At the same time, it has been increasingly recognized that corporate ownership structure plays an important role in corporate governance issues. Different ownership structures give rise to different corporate governance issues, and the agency costs associated with the controlling shareholder structure is primarily the one between controlling and minority shareholders as opposed to the managerial agency costs under dispersed ownership. Controlling shareholders are insulated from challenges to their control and when this control is attained without sufficient equity investment aligning their interests with the corporation, severe agency problems ensue. Besides the obvious detriment to company value and productivity through mismanagement and expropriation, this agency problem could also have extremely severe ramifications of other dimensions.

A common concern is that such unfettered expropriation could lead to disinclination to

invest and result in poorly developed capital markets. Furthermore, when controlling shareholders amass control over large portions of their countries’ economy without commensurate equity investment, as is the case in East Asia,2 the agency problems at the firm level can aggregate into inefficient allocation of resources, poor investment decisions, weak equity markets, discouragement of innovation and ultimately slower growth of the economy.3

As noted, ownership structure is an important starting point for any discussion of corporate governance, and the situation in East Asia deserves special attention, as studies have shown that its controlling shareholder structures are accompanied by a sharp separation of control and cash-flow rights and significant expropriation. Recent experience brought home the realization that corporate governance and thus its fundamental element of ownership structure are integral elements of sustained economic growth. Most notably, it has been found that the ineffectiveness of the mechanisms preventing the expropriation of minority shareholders played an important role in the Asian financial crisis.4 The lack of

2 Claessens et al., supra note 1, at 108
transparency and information contributed to the free-fall of investors’ confidence in the face of deteriorating financial soundness. In the absence of institutional mechanisms to protect their interests, foreign investors had confined themselves primarily to short-term investments which entailed little costs of flight and were thus vulnerable to external shocks.

The situation above is clearly in need of reform, but the pressing question is how this reform should be carried out. What is the proper framework for understanding and analyzing ownership structures and their disparity? Do controlling shareholder structures equal large expropriation and should thus be dismantled? If not, then ultimately what concrete measures can be taken in the face of current problems? To answer these questions, we must first obtain a clear, concise understanding of corporate ownership structures. Based on this understanding, we can then proceed to select aspects of the current corporate law regime that are in need of improvement.

The actual application of the proposed avenues of reform would necessarily vary according to the characteristics of the available institutional mechanisms in each country.

Nonetheless, a discussion under the Taiwanese corporate legal system would provide some


insights for many East Asian countries. The corporate governance institutions of Taiwan demonstrate a hybrid mix of German, Japanese, and American influences against traditional Confucian traditions of governance. Thus the legal tools and approaches of Taiwanese corporate law toward many issues display parallels with many East Asian countries, especially Korea and Japan. Consequently, an application of our proposed reforms to a case study of Taiwan could provide interesting and useful lessons for countries in the region.

Following the above, Part II of this article will first elaborate on a proper understanding of the controlling shareholder structure and provide the analytical framework for regulation. Part III presents the current situation of Taiwan, a country characterized by controlling-minority shareholder structures and poor shareholder protection. It highlights the novel approach of Taiwanese law in seeking to deal with the issue by mandatory ownership concentration. The basis and appropriateness of such an approach is then examined in light of the analytical framework proposed above. Part IV seeks to discuss the actual application of reform measures derived from our analytical framework. To enhance understanding, it first sets out a general introduction to Taiwanese corporate legal system beforehand. Part V summarizes and concludes. In this process, we hope to provide some thoughts on future research and reform in similarly situated countries.
II. The Controlling Shareholder Structure

A. The Costs and Benefits of the Controlling Shareholder Structure

As mentioned, the widespread existence of controlling shareholder structures entails a shift in the primary agency problem in corporate governance. Managers are no longer unaccountable in face of the lack of owner-oversight prevalent in diffused ownership structures, but are accountable to the controlling shareholder who could exercise more focused monitoring due to incentives and avoidance of collective action problems. This resolves the managerial agency problem but entails the new one between controlling shareholders and minority shareholders. Theoretically, the controlling shareholder could exert its control to expropriate private benefits of control from minority shareholders.

The incentives of the controlling shareholder can vary and put differing levels of pressure on the framework for protection of minority shareholders. The most noted elements in literature are cash-flow ownership and control rights. Theory suggests the incentives to expropriate decrease with cash flow rights and increase with the deviation between cash flow rights and control rights and has been confirmed in empirical research.7 Conditional on maintaining control, the deviation between ownership and control has been

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7 See e.g., Stijn Claessens, Simeon Djankov, Joseph P.H. Fan & Larry H.P. Lang, Disentangling the Incentive and Entrenchment Effects of Large Shareholdings, 57 J. FIN. 2741, 2755-2756 (2002); Rafael La Porta, Florencio Lopez-Di-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Valuation, 57 J. FIN. 1147 (2002); Lemmon & Lins, supra note 4, at 1445-1468.
dubbed the controlling minority structure.8

Controlling shareholder structures mostly take this form, and the means of enhancing control in excess of cash-flow rights include primarily the use of pyramidal structures, cross-holdings and board participation. This structure also poses the most severe challenge to the protection of minority shareholders.

First, the structure of control in the hands of those who hold a small ownership stake, in itself distorts the incentives of the controlling shareholders concerning economic decisions for the company notwithstanding the absence of tunneling or outright theft of company resources.9 Private benefits of control and not the value added to the company (as would be reflected to the controller through returns on its equity holdings) would dominate decisions. Second, the controlling shareholder would most likely control the board, management, and shareholder meetings by the number of votes, insulating it from traditional corporate governance mechanisms such as the market for corporate control. Thus, non-electoral mechanisms for shareholder protection would play a critical role.

However, it is important to note that despite the possible increased extraction of private benefits of control, controlling (minority) shareholder structures could potentially be


9 Id. at 453-458; Morck et al.,*supra* note 3, at 21-22.
beneficial to public shareholders and efficient depending on the tradeoff between the benefits of heightened monitoring of managers and the increased extraction of private benefits of control.\(^{10}\) Additionally, the structure could have other beneficial aspects. For example, controlling shareholders could be well-suited to overcome weak enforcement of property rights in weak legal and institutional environments.\(^{11}\) The reputation of controlling shareholder’s reputation could also facilitate external financing. If the controlling shareholder also controls other firms, this could lead to better firm performance by pooling resources and information as well as by reducing transaction costs.\(^{12}\)

Thus, a controlling shareholder structure could be a preferable alternative to other monitoring techniques, such as the market for corporate control under diffused ownership structures, depending on the potential value gain to the individual company from more focused monitoring of the controlling shareholder and other benefits net of its extraction of


private benefits.13

B. Determinants of Ownership Structure

Many theories have been posited on the causes of the initial formation of controlling shareholder structures. These include the proposal that ownership concentration arose to empower the enforcement of property rights by individual owners in the face of ineffective enforcement by the state.14 Other theories stress the role of political conditions or other non-efficiency factors.15

Another view that focuses on the cause for the eventual prevalence of controlling shareholder structures is based upon the empirical evidence in extensive law and finance literature demonstrating not only the widespread presence of controlling shareholder structures, but also its positive association with poor legal minority shareholder protection.16 This literature argues that ownership concentration is a consequence of poor legal protection of minority shareholders and the consequent high level of private benefits of control.17 The

14 Claessens & Fan, supra note 11, at 74-75.
16 LaPorta et al., supra note 1, at 471.
17 Id. at 511; Rafael LaPorta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert Vishny., Investor
reason is that poor protection of minority shareholders with its corresponding high private benefits of control encourages control and prevents the dissipation of control once acquired due to fear of exploitation and loss of private benefits of control.\(^{18}\)

Additionally, controlling shareholders who amass control over vast resources would in turn have the incentives and ability to lobby politicians more effectively to serve their interests, thus locking in the state of poor protection.\(^{19}\) While capital needs could induce the controlling shareholders to favor stronger shareholder rights to prevent investors’ discounts of share prices, it seems that up to now controlling shareholders have had vested interests in the status quo of poor protection of property rights and minority shareholder protection.

The above theories are not mutually exclusive and all support the higher incidence of controlling shareholder structures in countries with poor minority shareholder protection. In addition, further research has demonstrated however, the existence of controlling shareholder structures in countries with good shareholder protection, most notably Sweden, and dramatically differing levels of private benefits of control among controlling shareholder


\(^{19}\) Morck et al., supra note 3, at 37-47.
Thus, the ultimate empirical finding seems to be that countries with poor minority shareholder protection and corresponding high levels of private benefit extraction are invariably characterized by prevalence of controlling shareholder structures but controlling shareholder structures are not necessarily the result of poor protection. Good shareholder protection, on the other hand, gives rise to both controlling and diffused ownership structures, most notably Sweden and the United States respectively.

The above findings can be more clearly analyzed and understood from the perspective of the balance of the benefits and costs of maintaining a controlling position. When the benefits substantially outweigh the costs, it can be safely assumed, as noted above that controlling shareholder structure will be predominant due to the rationality of investors. The cost to the controlling shareholder is primarily the liquidity costs and lack of diversification costs of such a concentrated investment. The sources of private benefits of control are more varied. For the purposes of discussion, they can be roughly categorized into benefits that come at the expense of the company and minority shareholders, (i.e., expropriation) and benefits that do not. The latter includes benefits such as non-pecuniary benefits of social and political standing and economic synergies from integration of existing businesses. The legal protection of minority shareholders emphasized in most literature

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concerns benefits that come from expropriation. Under bad legal protection, such benefits are extremely large and lead inevitably to the assembling and maintenance of control.

Conversely, under good legal protection of minority shareholders, there is no such overriding factor. The factors influencing the ultimate ownership structure are complicated and could involve factors such as initial conditions, economic efficiency to the company and minority shareholders, other sources of private benefits of control (pecuniary or non-pecuniary), and the tastes and skills of the controlling shareholder.21

We can infer from the above that conditional on good shareholder protection, controlling shareholder structures are not undesirable or economically inefficient in themselves. Correspondingly, empirical research of U.S. firms does not indicate a link between ownership structure (diffused or concentrated) and firm performance.22 The dichotomy is between good and bad shareholder protection, i.e., low and high levels of expropriation.

C. Analytical Framework for Regulation

The above analysis leaves us with the conclusion that while controlling shareholder structures could arise under both countries that provide good protection and bad protection for minority shareholders, there is a crucial distinction: in the former, the ownership structure the most economically efficient (i.e., brings the most value to the company) would to an

21 See Gilson, supra note 10, at 1658, 1650-1660.

22 Demsetz &Lehn, supra note 13, at 1179; Morck et al., supra note 3, at 15.
extent prevail; in the latter, controlling shareholder structures would always prevail, as high private benefits of control would prevent dissipation of control regardless of the impact on the company and the economy.

The goal of corporate governance should be to promote corporate value and protect minority shareholders. Organizational structure as noted is an aspect of company value and productivity, and in order to realize maximum economic benefits, the ultimate ownership structure of each company should be largely determined on the basis of economic efficiency, i.e., whether the tradeoff of benefits net of extraction of private benefits of control is positive. As demonstrated however, the rationality of investors play an important role. More specifically, when the value of control is excessive, that is when the private benefits of control vastly outweigh the costs of maintaining a controlling position, it would foreclose the possibility of an alternative structure as control would be assembled and held on to whenever possible. The scenario is seen in countries with poor protection of minority shareholders.

It thus follows that only when the level of private benefits of control is roughly approximate to the costs to the controlling shareholder in maintaining the controlling position, can market forces operate to choose the most value-producing ownership structure. Otherwise, a dispersed structure would be inherently unstable regardless of its efficiencies. Additionally, as a conceptual issue, it should be noted beforehand that the lowering the value of control to zero should be avoided, as this would prevent the taking a controlling position
regardless of whether such an ownership structure provides a positive tradeoff to the company and minority shareholders.

It has been further developed that when control is valuable, neither would dispersed ownership structures be chosen in the first place, due to the loss to the initial owner compared with setting a controlling shareholder structure to begin with. In the post-IPO stage, due to the same reason, neither would a controlling shareholder disperse a controlling block. Additionally, at this stage, the controlling shareholder’s decision is affected not only by the absolute value of control, but also by the deviation between cash-flow rights and control rights. More specifically, any efficiency gains or losses of shifts of ownership structure are shared proportionally with other shareholders, but the value of control is fully captured by the controlling shareholder. Thus, the impact of the value of control is magnified through this divergence, and thus further constrains efficient ownership structure choices. Accordingly, the deviation between ownership and control is also a factor in determining whether efficiency competition between organizational structures can take place.

From the above our intuition is to limit the value of control. The most straightforward and uncontroversial approach would be to lower the private benefits of control that arise from

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23 See Bebchuk, supra note 18, at 1-23.

24 Id. at 29.

expropriation of minority shareholders and the company through heightened monitoring and enforcement. Not only would this encourage the competition of ownership structures, it would also protect company value and minority shareholders. On the other hand, private benefits of control that arise from other sources, such as political, social standing and synergies with existing businesses should not be regulated. This is primarily because their amount is not likely to be large and will often not prevail against substantial efficiency concerns, making their regulation unnecessary. Moreover, their value is also highly subjective and abstract, making them nearly impossible to coherently regulate.

Another approach is raising the costs of a controlling position, which is a also factor in the calculation of the value of the control premium. Interestingly, such costs also include the ability to leverage cash-flow rights into incommensurate control. Thus, the degree of separation of ownership and control can be regarded as both an element of the costs of a controlling position and as noted earlier, an independent variable distorting ownership choices of the controlling shareholder. Nevertheless, raising the costs of controlling position entails more complications because it actively decreases the desirability of a controlling (minority) shareholder structure and thus implies the judgment that generally its benefits are insufficient to offset its drawbacks. This gives us pause because as noted, while controlling (minority) structures inherently pose serious incentive issues, they can also have economic benefits.
Despite these concerns, we propose that the ability to leverage cash-flow rights into incommensurate control is an aspect that should be limited. This strikes at the constitutive element of controlling minority structures, but our main reason is that this deviation distorts incentives not only for company operations, but also the controlling shareholders’ choice of whether to disperse control and thus ownership structure. We further speculate that in most countries beyond the primary development stage of economic development, the benefits of controlling minority structures are outweighed by its drawbacks. Nevertheless, before more conclusive findings, taking into account the potential for controlling minority structure to have countervailing benefits, we think is appropriate to first focus on aspects of the separation of cash-flow rights and control rights that are problematic from other perspectives. First is the disclosure rule on ownership structures, as we believe the evasion of market scrutiny is unjustifiable. A second example is cross-holdings. Cross-holdings are not only a relatively opaque measure to leverage equity into control when compared to pyramidal structures, but also entail capital inflation and capital maintenance concerns. Put more clearly, the enhanced regulation of cross-holdings can not only be justified by its greater opacity but also by other regulatory purposes. Accordingly, we propose that such measures can be implemented without complicated evaluations of the benefits and costs of such a controlling minority structure. For the time being, we do not comment on the appropriateness of measures that seek to generally discourage separation of ownership and
control, such as prohibiting or imposing additional taxes on pyramids.\textsuperscript{26}

It is evident that the above are more easily said than done, as vested interests with close-knit ties to politicians would lobby to prevent reform. A possible way out of this quagmire is that the need for capital in the face of increased competition from free trade and pressure for industry upgrading would induce controlling shareholders to voluntarily lower their private benefits of control and adjust their ownership and control ratio in the hope of securing long-term external financing. Through the resulting increase of dispersed shareholders with capital tied to the protection of minority shareholders, the lobby for protection for minority shareholders would presumably be strengthened. This would at the same time weaken the lobby for maintaining weak protection, as the controlling shareholders now derive less benefit from their controlling position and would thus not be as willing to expend that much effort in lobbying as before. Legal improvements that follow will further reinforce this beneficial cycle. Throughout this process, the government should maintain an ongoing effort to implement reform whenever possible. An active, knowledgeable and impartial press can accelerate this process and limit the collusion between vested interests and politicians.

\textsuperscript{26} To take another example, we believe that the mandatory bid rule that forces the controlling shareholder to offer to purchase the shares of minority shareholders implies a judgment for the undesirability of a controlling minority structures.
III. The Case of Taiwan

A. Controlling Minority Structure and Poor Protection of Minority Shareholders

Extensive financial research has indicated that the ownership structures of Taiwanese firms are characterized by the widespread presence of controlling shareholders and separation of ownership and control.\(^{27}\) Empirical findings indicate that 70% of 251 Taiwanese listed companies in 1998 had controlling shareholders and 58.2% of the Taiwanese listed companies were controlled by families.\(^{28}\) Deviation of cash-flow rights and control rights is common and especially severe under family control.\(^{29}\) The means of enhancing control are primarily pyramidal structures, cross-holdings and participation in management or board.\(^{30}\) The latter two mechanisms are associated with discounts on corporate value.\(^{31}\)

From the above, we can surmise Taiwanese firms are exemplary of the controlling minority structure. The question that subsequently arises is whether the prevalence of the controlling minority structure noted above are largely formed and chosen by market forces for economic efficiency or by poor protection of minority shareholders with its attendant high

\(^{27}\) See e.g., Claessens et al., supra note 1; Claessens et al., supra note 7; Yin-Hua Yeh, Tsun-Siou Lee & Tracie Woidtke, Family Control and Corporate Governance: Evidence from Taiwan, 2 INT’L REV. FIN. 21 (2001).

\(^{28}\) Yin-Hua Yeh, Do Controlling Shareholders Enhance Corporate Value? 13 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 313,315 (2005), available at EBSCO Host, AN 16370749.

\(^{29}\) Yin-Hua Yeh, Corporate Ownership and Control: New Evidence From Taiwan, 1 CORPORATE OWNERSHIP & CONTROL 87, 92-96 (2003), available at EBSCO Host, AN 12614790.

\(^{30}\) Claessens et al., supra note 1, at 92; Id. at 93, 97; Yeh, supra note 28, at 317.

\(^{31}\) Yeh, supra note 28, at 322.
private benefits of control?

As noted earlier, the absence of effective protection of minority shareholders would actually encourage the assembling of control and formation of such structures in the first place. Upon formation, controlling shareholders would in turn lobby to maintain the status quo and protect their extraction of private benefits of control. These factors suggest that a high prevalence of the controlling minority structure compared to widely-held firms goes hand in hand with bad shareholder protection. Another piece of intriguing evidence is that Taiwanese family-controlled firms that have low levels of excess control have lower relative performance than both family-controlled firms with high levels of excess control and widely held firms. Family firms also exhibit economically significant incentive effects of cash-flow ownership and entrenchment effects of deviation of voting from cash flow rights as indicated through firm valuation. This is consistent with the fact that controlling shareholders can and do significantly expropriate from minority shareholders when it serves their own interests. This signals clearly the existence of poor minority shareholder protection.

From the reasons set out above, the view of this paper is that the ownership structure of Taiwanese firms, more precisely the predominance of controlling minority structures is

32 Yeh et al., supra note 27, at 37, 46.
33 Yeh, supra note 28, at 318-322; Yeh, supra note 29, at 99.
34 LaPorta et al., supra note 7, at 1163.
predominantly the result of bad shareholder protection. We do not rule out the probable
considerations of tax concerns and evasion of regulatory oversights but believe these are
secondary in importance. This conclusion is further supported by the author’s up-close
observations and experience in Taiwanese corporate reality and law. Thus, Taiwanese firms
exhibit the standard characteristics of the controlling minority structure under poor protection
of minority shareholders, and reform in Taiwanese law could therefore serve as a case study
for countries under similar conditions.

B. Current Taiwanese Approach—Mandatory Ownership Concentration

The stance of Taiwan’s legal system on ownership structure and the separation of
ownership and control is at first glance somewhat ambiguous. The 2001 revision of Article
192 and 216 of the Company’s Law cited the trend of the separation of ownership and
management and removed the stockholder requirement for supervisors and directors. Yet at
the same time, Article 197 and 227 mandate automatic discharge in the event of directors or
supervisors of publicly issued companies transferring during term in office more than half of
their stockholdings in the company held at the time of election. Taken together, these
articles send mixed signals on the desirability of the separation of ownership and control.

However, Article 26 of the Securities and Exchange Act is clear in mandating a
minimum degree of integration between ownership and control. It provides that directors

35 Under the Taiwanese Securities and Exchange Law, shareholders with more than ten percent of all issued
shares are subject to regulatory scrutiny, see Article 22, 25, 157, 157-1 of the Taiwanese Company Law.
and supervisors of publicly listed companies must collectively hold a fixed percentage of the company’s shares. Violators are subject to administrative fines. The premise is that the higher the percentage of shares held by those in control, the greater the alignment of interests and amelioration of the agency costs of separation of ownership and control.

The assumption of the Article is that a fixed minimum degree of ownership concentration in the hands of those in control would be beneficial to all companies. The fixed percentage varies with the amount of capitalization, but otherwise seems to lack clear basis. This mandatory minimum level of ownership concentration is novel in that it intervenes directly in the ownership structure of companies. From a theoretical perspective, this approach warrants the considerations set out below.

First, we can examine the empirical evidence on the relationship between shareholdings of those in control and firm performance. There is no clear empirical evidence that firm performance rises with the ownership concentration of those in control. In fact, in a study of U.S. firms, the percentage of board holdings and firm performance displayed an inverse U-shaped relationship. It is hypothesized that this is because once managers hold enough equity to become insulated from challenges to their position;

36 Rules and Review Procedures for Director and Supervisor Share Ownership Ratios at Public Companies, Article 2.

managers become entrenched and pursue private benefits at the expense of outside
investors.38 A study of Taiwanese firms also finds that firm performance increases with
family ownership when it is below a firm’s critical control level, but then decreases with
family ownership when it crosses the critical control level until excess control becomes
high.39 Both these results suggest that once control is established, excess holdings are
necessary to converge the interests of the controller and the firm. From the above two
findings, we can surmise that insulation of those in control without sufficient convergence of
interest with the firm can be detrimental to firm performance. Additionally, adequately high
shareholdings can align the interests and overwhelm the entrenchment effect.

Accordingly, it seems that holdings just below insulation or in high excess of control
would be most effective in limiting expropriation of the controller. It is questionable,
however, whether the Article contributes to this aim. As the critical control level of each
individual firm varies,40 where the mandatory holdings set each firm on the continuum is
uncertain. For one firm, the fixed percentage might just insulate those in control from
outside challenges but provide inadequate alignment with the company’s interests, thus
harming firm performance. In another firm, the fixed percentage might be too low to make

38 Id. at 301; Claessens et al., supra note 7, at 2742.
39 Yeh et al. supra note 27, at 39.
40 See Yeh et al., supra note 27, at 29 (stating that ownership concentration affects the critical level of control
and changes over time).
much difference. These scenarios make the unitary mandatory holding percentage an extremely blunt and possibly ineffective instrument to limit expropriation.

The second angle is from a broader efficiency perspective and concerns the very fundamental issue of the choice between ownership structures. Article 26 explicitly endorses and requires a degree of ownership concentration in the hands of the controller. This sits uneasily with the point made earlier that whether diffused ownership is preferable to the controlling shareholder structure or vice versa, depends primarily on the tradeoff between heightened monitoring and extraction of private benefits of control. This tradeoff would vary with the circumstances of each company and industry. The point is that each ownership structure has its associated costs and benefits, and individual companies could efficiently make different choices. This Article is in effect precluding the option of diffusion beyond its fixed percentage of controller holdings. A specific company, for example, could prefer more diffused ownership when the market for corporate control, product market competition, alignment of incentives…etc., are sufficient to counteract the separation of ownership and control, making increased holdings of those in control and unnecessary or inefficient.

From the above we can conclude that at best, Article 26 is ineffective, and at worst, inefficient and detracts from firm performance. It is also problematic to limit the property rights of citizens without adequate regulatory basis.
As seen, the regulatory approach in mandating a minimum level ownership concentration in the hands of those in control seems to be misguided. However, when we confront the current situation, the motivation and reasoning of the law are understandable and even reasonable.

Taiwan, as mentioned is characterized by a significant degree of control concentration of controlling shareholders and deviation of control and ownership. This, as we have argued above, is primarily due to bad protection of minority shareholders and consequent high private benefits of control. Faced with this situation, the authorities adopted the straightforward way of seeking to lessen the deviation between ownership and control. When protection of minority shareholders is poor, high private benefits of control will lead to a predominance of controlling shareholder structures, regardless of its efficiency. Taking the ensuing controlling shareholder structure as a given, decreasing the deviation of control from ownership will directly lower the incentive to expropriate.

Of course, this could harm companies that have effective corporate governance mechanisms and do not need to incur the additional costs of ownership concentration or a controlling shareholder structure. However, in the face of the disproportionate prevalence of controlling shareholder structures, most which are probably inefficient, the regulatory approach would probably be on the balance beneficial. The more critical issue currently as demonstrated by the recent corporate scandals is probably that the percentages set are too low
to make much of a difference. On the other hand, it is unlikely that a higher percentage can be set in as it would be seriously interfering with ownership structure and infringing on the property rights of citizens without adequate basis.

Thus, it seems the regulatory approach of Article 26 while understandable and probably useful in the transitional period before fundamental corporate governance reform, is also inherently blunt and imprecise in improving corporate governance. It is nearly impossible to fine-tune the situation with the reflexive measure of lowering deviation of ownership and control by mandating holding percentages. The most fundamental and effective method, as noted at the outset, should be to prevent private benefits of control from substantially outweighing the costs of control. Once controlling shareholders do not substantially gain from their controlling position and do not insist on control, this will enable market forces to choose the most efficient ownership structure for each company. It is highly probable that under such conditions, we will see a decrease in the deviation between ownership and control and controlling shareholders structures.

On a side note, Article 26 also gives rise to problems with enforcement. The first issue is that when the total holdings of directors or supervisors fall below the mandated level, all directors or all supervisors, regardless of whether their actions contributed to the decrease in holdings, are under the obligation to make up for the gap. This unreasonable outcome is exacerbated in the event that the amount sold by a director exceeds half of his holdings at the
time of his election, thus triggering his automatic discharge under Article 197. This would effectively exempt him from the above obligation and possible ensuing fines.

Another problem involves the election of representatives of juridical shareholders as directors or supervisors. As will be mentioned in detail later, Article 27 of the Company Law permits juridical shareholders to appoint natural person representatives to be elected in their own capacity. The Rules and Review Procedures for Director and Supervisor Share Ownership Ratios at Public Companies affirmed by the Highest Administrative Court, provide that in this situation, the subject of fines is the electee. However, this is manifestly unfair as the juridical shareholder remains free to replace its representatives, and consequently retains control over the exercise of the directors’ or supervisors’ duties. Therefore, it is the alteration of the holdings of the juridical shareholder that is relevant to the regulatory goal. Neither is the representative responsible for the alteration in holdings. Consequently, the imposition of fines on the electee instead of the juridical shareholder is problematic.

IV. Current Regulation and Prospective Reform in Taiwan

A. Overview of the Corporate Legal System

Under Taiwanese Company Law, companies are defined as juridical persons organized and incorporated in accordance with the Company Law for profit-making purposes. Companies may take one of four forms: unlimited company, unlimited company with limited
liability shareholders, limited company and company limited by shares. The term “unlimited” connotes unlimited liability, and unsurprisingly, the former two forms are rare, numbering in December 2005, 27 and 12 respectively. The latter two are much more common, numbering 446,837 and 161,614 respectively.\textsuperscript{41}

The limited company was created to provide a closely-held corporate form for small and medium enterprises. The liability of shareholders of limited companies is limited to their invested capital, but otherwise company matters are decided by the majority of shareholders and not the number of shares. The company limited by shares is the standard model for large companies with a large number of shareholders. Companies limited by shares are also the only ones that may publicly issue securities. The decision whether to publicly issue securities is decided by the board of directors, and entails enhanced disclosure and monitoring provided for under the securities law. Publicly issuing companies are further divided into listed companies and those trading in the over-the-counter (Gretai) market (OTC companies), numbering respectively 691 (January 2006)\textsuperscript{42} and 508 (March 2006).\textsuperscript{43} Therefore, publicly issued companies limited by shares most intimately concerns

\textsuperscript{41} Department of Statistics, Ministry of Economic Affairs, \url{http://2k3dmz2.moea.gov.tw/gnweb/statistics/statistics03/stat03_01/stat03_01_files/stat111.xls} (last visited March 3, 2006).


\textsuperscript{43} Gretai Securities Markets, \url{http://www.otc.org.tw/c_index.htm} (follow “stock” hyperlink; then follow “current
large amounts of capital and the interests of the investing public. Correspondingly the bulk of the Company Law and securities laws in are devoted to its regulation. The discussion of this article also focuses on this subset of corporations.

The organizational structure of a company limited by shares consists of three organs: the shareholders meeting, the board of directors and the supervisor. The current directors/supervisors system can be categorized as a type of binary system, where supervisors serve to monitor the performance of the board of directors externally on an ex post basis.

Concerning the delineation between the shareholders meeting and the board of directors, the latter is charged with the carrying out of business operations, with management as an auxiliary when not explicitly otherwise provided for in the Company Law or company charter. The law provides that certain important issues must be passed by shareholder meeting resolution, but in practice the shareholder meeting has failed to play an active role. This is in part due to collective action problems and low, inactive institutional ownership. Another important reason was that prior to the 2005 amendment, shareholders could not raise proposals for the shareholder meeting and were thus restricted to voting yes or no to proposals raised by the board of directors.

The dominance of the board is further reinforced by the weak supervisor system.

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market situation” hyperlink), (last visited March 3, 2006).

44 The 2005 addition of shareholder proposal rights raises the issue of the extent of the proposal right, specifically the precise delineation of the power of the board of directors and the shareholder meeting.
Supervisors are elected by the same method as directors, and thus must have the support of the large shareholders who also elect the directors. This coupled with the paucity of eligibility qualifications and clear authority, have unsurprisingly caused the failure of the supervisor as a monitoring mechanism. Thus, up to now, power in the company has been extremely concentrated in the board of the directors.

At the same time, the board is also extremely vulnerable to the influence of large shareholders. This is most likely caused by collective action problems and the fact that prior to the 2005 amendment; only the board could nominate candidates for director or supervisor positions. This enabled a self-perpetuating cycle of incumbents and their supporters monopolizing the positions indefinitely. Moreover, although cumulative voting is provided by default, most companies opt out of the rule in their charters. Another very notable reason is that Article 27 of the Company Law permits juridical shareholders to assume or control a plural number of director and supervisor seats.

We now turn to the board’s actual exercise of power. The board of directors is by law charged with the carrying out of business operations, and there appears to be no legal basis for the delegation of authority to management. In reality however, some delegation of the running of day-to-day operations is unavoidable. The disconnect between the law and practical needs has resulted in considerable confusion over the respective functions and responsibilities of the board of directors and management. At present, the extent of
delegation varies with each company, as either the board, general manager (CEO) or chairman of the board may be the one actually in charge. Moreover, the actual power structure may differ in accordance with the ownership structure. In the case of a controlling shareholder structure, the manager, board chairman, and the controlling shareholder often form a unit. This scenario is prevalent in many Taiwanese companies.

B. Review of Current Regulatory Measures and Future Prospects

Against this general introduction of the Taiwanese corporate system, we now seek to highlight the issues that contribute to the prevalence of controlling shareholder structures. The prevalence of large shareholdings coupled with the fact that a cumulative voting system is not mandatory, results in boards nearly always controlled by large shareholders. However, by the abolishment of mandatory cumulative voting, the legislator has clearly made the policy choice that such a situation is preferable to hold-ups by minority shareholders and abuse by directors should be prevented by other mechanisms. Therefore, consistent with our analytical framework, here we will focus on two dimensions: mechanisms preventing the expropriation of private benefits of control and the costs associated with leveraging equity into incommensurate control.

Concerning the costs related to the magnification of control in excess of cash-flow rights, we will discuss current rules of ownership structure disclosure and cross-holdings. These concern more intimately the opacity of the ownership structure and the absence of
market scrutiny and thus should be given priority.

Concerning the expropriation of minority shareholders, we will discuss the incorporation of the concept of control, related-party transactions and the independent director system.

Lastly, we will examine Article 27, a feature of Taiwanese law that permits juridical shareholders or their authorized representatives to be elected directors or supervisors. This Article gives rise to varied problems of corporate governance and touches upon both of the two dimensions highlighted above.

1. Disclosure Rules and the Concept of Beneficial Ownership

As noted above, the ownership structure of a company plays a large role in deciding the incentives and ability to extract private benefits of control. Thus, the structure should be of interest to investors, and the capital market can potentially play a significant role in monitoring the ownership structure of a company. For example, companies with a large deviation of ownership and control place more pressure on non-electoral corporate governance mechanisms and are more likely to be disfavored by investors. A company with need of outside financing could respond by altering its ownership structure, or in the case when a controlling shareholder with some accompanying extraction of private benefits of control is more economically efficient, or when the controlling shareholder derives substantial non-pecuniary benefits, strengthen its internal control mechanisms as an
alternative. Market pressure would raise the capital costs of controlling shareholder structures without adequate internal control mechanisms, and this would correspondingly factor in the equation of benefits and drawbacks of maintaining a controlling position.

An important precondition for the capital market to monitor the ownership structure of a company is the disclosure of the shareholdings of those in control and ultimate shareholders, and that such information be readily accessible to the investing public. The actual change in their shareholdings should also be disclosed. For example, the selling of shares by those in control could entail a shift in ownership structure and implies the decrease of alignment between the controllers’ interests and company prospects and sends a warning signal to investors.

Under Article 25 of the Securities and Exchange Law, directors, supervisors, officers and large shareholders in possession of more than ten percent of all shares of a publicly issued company must report and disclose their holdings. They must also report any change of their shares. The calculation of shares held by shareholders includes those shares held under the names of their spouses, minor children, and those held under the name of other parties.45 In the event that the juridical shareholder or its authorized representatives are directors or supervisors under Article 27, shares of them both are calculated.

To further facilitate the identification of the ultimate shareholders, publicly issuing

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companies must list their ten largest shareholders and also shareholders with over five percent of total shares in the prospectus. Furthermore, in the case that directors or supervisors are juridical shareholders or their representatives, the juridical shareholder in question must disclose its ownership structure. The disclosure to the public stops at the first level, regardless of whether the primary shareholders are also juridical persons. In practice, companies also voluntarily disclose the ownership structure of all juridical shareholders.

There are two problematic issues in the above framework. First, the level of disclosure of ultimate controlling shareholders is incomplete and may halt at the level of a juridical person, which could impart little information on the ultimate controller. Second, the criteria for calculating shares possessed are too inflexible and narrow. Taiwan has not adopted the comprehensive and broad definition of the concept of beneficial ownership under American law. The criteria not only impact the above identification of large shareholders with more than ten percent of all shares but the calculation of shares of all persons in relevant articles.

To take an example, the shares owned by the holding company would not be attributed to its controlling shareholder in calculating the possession of the shares by the controlling

46 Criteria Governing Information to be Published in Public Offering and Issuance Prospectuses, Article 11.
47 Id. at Article 10(1) iv.
shareholder for the purposes of disclosure. This case can not be covered by the phrase “nominee”. The defect of this loophole should be readily apparent. A large shareholder could disperse his accounts in this manner and avoid identification as a large shareholder with over ten percent of shares and thus be exempt from disclosing his holdings and their changes. A director could also disperse his holdings in this manner, therefore allowing him to engage in surreptitious selling of his shares.

2. Cross-holdings

a) Overview

Generally speaking, cross-holdings are structures in which firms own blocks of each others’ stocks. This can encompass both holdings between companies belonging to a chain of control and holdings between otherwise unrelated companies. As highlighted, the extent of cross-holdings between companies can be quite opaque and confusing for an investor.

In discussing cross-holdings and their effect on control however, relevant financial literature has been narrower in scope, focusing on cross-holdings in the context of a chain of control. Cross-holdings are defined as when the firm has both an ultimate owner and owns shares in its ultimate owner or in a firm that belongs to her chain of control. This kind of cross-holdings manifestly allows controlling shareholders to magnify control in relation to equity investment, which can result in large deviations between ownership and control,

48 La Porta et al., supra note 1; Yeh, supra note 29, at 92-93.
entailing high agency and entrenchment costs. Empirical studies indicate that controlling shareholders in Taiwan commonly utilize this cross-holdings mechanism to enhance their company control rights.

However, cross-holdings falling outside the narrow scope that is the focus of relevant literature can also enhance control to a certain extent, as insiders in otherwise unrelated corporations tend to vote for the incumbents. Therefore, both the narrower and more general forms of cross-holdings are important to constructing and maintaining a controlling minority ownership structure. Consequently, their positive and negative effects and the relevant regulations bear further examination.

Cross-holdings have various recognized beneficial effects. These include the stabilization of management, facilitation of strategic alliances, and risk dispersal among companies. However, they also bring the risk of formation of self-contained systems that preclude newcomers and result in inefficient allocation of resources, inflation of capital, entrenchment of control, and increased opportunities for insider trading, manipulation of share price and illicit transfer of benefits.

The above negative effects are even more pronounced when subordinate companies

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49 See e.g., Bebchuck et al., supra note 8, at 457.

50 See Yeh, supra note 29, at 93 (finding that 40.1% of companies in the sample utilized the cross-holding mechanism).
hold the shares of the controlling company or other companies along the chain of control. It should be apparent that the ease of control in this case could easily lend itself to abuse. For example, those in control at the controlling company could exercise unfettered control over a subordinate company’s shares and thus vote to preserve themselves indefinitely in power. Moreover, as the subordinate company could be merely a conduit of the controlling company, cross-holdings between them also gives rise to the associated concerns of companies buying back their own shares. For example, a company could tunnel its money to the subordinate company to buy back its own shares giving rise to the additional concern of capital maintenance; Conversely, the benefits of strategic alliances and risk dispersal noted above seem muted in this situation.\(^{51}\)

From the above analysis, the balance of benefits and drawbacks is different between cross-holdings among companies belonging to a chain of control and cross-holdings in general. Thus, the two scenarios should be regulated separately.

\textbf{b) Legislative Development}

Prior to the 2001 enactment of Article 167 III and IV, only Article 369-10 of the Company Law dealt with inter-corporate cross-holdings. It regulates only cases of mutual investment companies, i.e. where a company and another company have invested in each other to the extent that one third or more of the total number of the voting shares or the total

amount of the capital stock of both companies are held or contributed by each other. Its provisions are twofold: notification and disclosure of holdings once they reach the one-third threshold, and the limitation of voting power to one third of all votes when criteria for mutual investment companies are met. This protects creditors from the inflation of capital and alleviates to some extent the entrenchment of control.

However, as noted earlier, the negative effects are more pronounced in the case of cross-holdings between companies along the chain of control, and it is thus arguable that they should be subject to enhanced regulatory scrutiny. The case is even more strengthened by the fact that under Article 167I, subject to limited exceptions, a company is prohibited from buying back its own shares. To be consistent, a company should at the same time to be prohibited from engaging in such conduct through the conduit of its subordinate companies. However, at that time, only Article 369-10 regulated cross-holdings and its ambit was limited to cases of “mutual investment” up to a third of each company’s capital. Cross-holdings between companies along the chain of control would fall outside its scope when the subordinate company does not hold that many shares of its controlling company. Thus, the regulatory framework before 2001 was unbalanced as it neglected to regulate the more problematic aspect of cross-holdings in a chain of control.

The deficiency of the above framework prompted the 2001 enactment of Article 167III and IV, which explicitly prohibit the subordinate company from purchasing or accepting as a
security in pledge, shares of the controlling company and shares of companies along the
chain of control. This prohibition arose from the view that the drawbacks of allowing such
purchases outweighed their benefits in this context and is a policy choice.

This Article was not retroactive and previous purchases by the subordinate company
were still valid. This was a cause for concern because many subordinate companies had
already completed purchases of the controlling company or companies along the chain of
control before the amendment. This was further dealt with by the 2005 amendment of
Article 179, which stripped such shares of their voting rights.

After successive reform, a lingering problematic issue is the fact that the concept of
control/subordinate companies is determined by the formalistic criteria of majority of the
total number of outstanding voting shares or of the total amount of the capital stock. This
makes the regulation extremely easy to evade as substantive control is easily achieved with
holdings below an absolute majority. This also differs from the Chapter of Affiliated
Enterprise which adopts a substantive concept of control.

To summarize, Article 369-10 deals generally with cross-holdings between companies
regardless of their relationship otherwise and Article 167 III, IV, and Article 175 deals with
cross-holdings in the context of a chain of a control. The latter Articles are recent
amendments and are the results of ongoing Taiwanese efforts in corporate governance.
Controllers of a company are now unable to exercise the shares of firms along their chain of
control to magnify their control. The other avenue for magnifying control through the cross-holdings of companies not along the chain of control is also limited to one-third of total shares in the case of mutual investment companies. The disparity between regulatory methods is justified by the economic benefits of general cross-holdings and the higher difficulty of controlling unsubordinated companies’ votes.

An important remaining loophole is that the concept of “control” under Article 167 and Article 179 is still formalistic and allows companies to magnify their control through companies substantively under their control. Nevertheless, these amendments have raised the difficulty of magnifying control through cross-holdings and will rein in the most flagrant abuses. Another concern is whether the one-third threshold for mutual investment companies is set too high as one-third of shares are normally sufficient to exercise control.

3. Incorporating the Concept of Control

a) Present Framework

The concept of substantive control entailing accountability is relatively unfamiliar under Taiwanese law. Article 8 of the Company Law focuses solely on the official positions in defining the responsible persons of a company. Article 27 in providing that representatives of juridical shareholders elected as directors in their personal capacity could be replaced on the whim of the juridical shareholder, further contributed to the disconnect between control and accountability.
Prior to the 1997 enactment of the Chapter on Affiliated Enterprises, according to Article 8, official position within the company was necessary for the establishment of legal liability under Taiwanese corporate law.\textsuperscript{52} While controlling shareholders could theoretically be civilly liable under tort law for injury done intentionally in a manner against the rules of morals, the abstract concepts of tort law were too indefinite and difficult to prove in practice. Therefore, due to formalism, controlling shareholders who assumed no official positions were not accountable for their exercise of power.

A reason for this neglect was perhaps because Article 178 of the Company Law already prohibits the voting of interested shareholders that may impair the company’s interests. This could in theory pose a potential barrier to abuse of control by controlling shareholders, but its application in practice has proved otherwise. The first difficulty is that any shareholder resolution inherently affects the company and its shareholders, and thus the concept of “interested” shareholder needs further clarification. To date, the standard provided has been whether the shareholder in question would gain legal rights or incur legal obligations from the resolution,\textsuperscript{53} but this standard is still somewhat abstract and inadequate to prevent abuse by controlling shareholders. Second, this prohibition would seem to run counter to the normal economic goals of holding shares. A shareholder should arguably be able to exercise his property rights as he sees fit. Third and most relevantly, this Article does not

\textsuperscript{52} Taiwanese Company Law Article 8, 23.

\textsuperscript{53} DaliYuan Tong Zi No. 1766
apply to the election of directors and supervisors. Thus this Article does not prevent the
controlling shareholder from exerting control through the designation of directors and
supervisors and thus cannot avoid the need for accountability for controlling shareholders.
Therefore, this Article has been ineffective in constraining abuse by the controlling
shareholder, and cannot compensate for the aforesaid formalism. The resulting gap in
corporate governance prompted the enactment of the Chapter on Affiliated Enterprises.

This Chapter regulates controlling/subordinate companies and mutual investment
companies. The focus of our discussion here is the former category. The definition of
control in this Chapter is quite comprehensive and covers the concept of substantive
control.\textsuperscript{54} Additionally, this Chapter is limited to the case where both the controller and
subordinate are companies.

Article 369-4 under this Chapter is the only article under Taiwanese law that deals
specifically with the responsibility of controlling shareholders outside official capacity. The
pertinent part reads: “In case a controlling company has caused its subordinate company to
conduct any business which is contrary to normal business practice or not profitable, but fails
to pay an appropriate compensation upon the end of the fiscal year involved, and thus causing
the subordinate company to suffer damages, the controlling company shall be liable for such
damages.” A few observations should be highlighted:

\textsuperscript{54} Taiwanese Company Law Article 369-2, 369-3.
As noted above, the scope is limited to the case where both the controller and subordinate are companies. This is an extremely broad restriction on applicability. The controller would be completely beyond the reach of this Article should he be an individual or other non-corporate entity. While the responsible person of the controlling company may be jointly liable with the controlling company, this is still extremely easy to evade as the ultimate controller would only have to avoid this position in the controlling company. The exclusion of controllers who do not take the corporate form leaves a large loophole in the regulation of the controlling shareholder. The original draft sought to regulate to some extent the control of non-corporate entities (e.g. head coordinating office) but this was deleted from the final version.

The second significant feature of Article 369-4 is that rights toward the controlling company belong to the subordinate company, not the minority shareholders or creditors. The original draft allowed minority shareholders and creditors to sue on their own behalf; simultaneously introducing the concepts of the controlling shareholder’s fiduciary duty to minority shareholders and the piercing of the corporate veil for subordinate company’s debt under American law. The final version, however, adopted the position that minority shareholders or creditors may only bring derivative suits on behalf of the subordinate company, implying that the rights belong to the subordinate company alone. This is a

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55 Taiwanese Company Law Article 369-4 II.
critical shift which protects minority shareholders and creditors exclusively via the subordinate company’s rights.

Third, this Article is significant in that it attempts for the first time to delimit the duty of the controlling shareholder. As seen, the controlling company does owe a duty to the subordinate company. Article 369-4 provides the starting point for discerning the precise contours of the duty.

The determination of the detrimental nature of business or transaction is made by reference to the standard of an independent company. This makes clear that Taiwanese law holds inter-group arrangements to the same standard of business between unrelated companies. The only leeway granted to controlled/subordinate companies is that appropriate compensation at year end may preclude liability. This represents an acknowledgment, by Taiwanese corporate law of the existence and importance of affiliated enterprises as an economic entity, a departure from the traditional viewpoint of individual companies as the regulatory unit. The content of this duty merits the discussion set out below.

First, as noted above, actions that are carried out for the interest of the corporate group would still fall under the term “contrary to normal business practice” and the only leeway allowed is that appropriate compensation can preclude liability. This regime is extremely

hard to implement in practice as demonstrated through the German experience.\textsuperscript{57}

Difficulties such as determining and quantifying detrimental transactions aside, an important difficulty concerns the artificial projection of autonomous interests of the subordinate company in the context of comprehensive corporate group strategy.\textsuperscript{58} This gives rise to the fundamental issue of the content of the duty of controlling shareholders and permeates the entire corporate governance framework. It is worth rethinking under the integrated operation of a corporate group, whether a member company may appropriately pursue not the company’s individual benefit, but the benefit of the corporate group as a whole. This discussion of the exact content of the controlling shareholder’s duty in the context of pursuit of the economic interest of the corporate group is seen under other law regimes.\textsuperscript{59}

Second, the purpose of granting the reprieve of year-end appropriate compensation was to accommodate intra-group arrangements economically beneficial to the corporate group as a whole. Yet this Article on its face permits the utilization of this mechanism for any

\textsuperscript{57} Gerard Hertig and Hideki Kanda, \textit{Related Party Transactions, in THE ANATOMY OF CORPORATE LAW, A COMPARATIVE AND FUNCTIONAL APPROACH}, 102, 124-126 (Reinier H. Kraakman et al.,2004).

\textsuperscript{58} JOSE ENGRACIA ANTUNES, LIABILITY OF CORPORATE GROUPS, AUTONOMY AND CONTROL IN PARENT-SUBSIDIARY RELATIONSHIPS IN US, GERMAN AND EU LAW: AN INTERNATIONAL AND COMPARATIVE PERSPECTIVE 350-358 (1994).

\textsuperscript{59} Hertig & Kanda, \textit{supra} note 57, at 125 (discussing the well-know French \textit{Rozenblum} case which held that a French corporate parent may legitimately divert value from one of its subsidiaries if three conditions are met: the structure of the group is stable, the parent is implementing a coherent group policy, and there is an equitable intra-group distribution of costs and revenues overall.)
arrangements regardless of their purpose. It remains a question under Taiwanese law whether a transaction improperly arranged for the personal benefit of the controller of the controlling company is covered by this Article and could avail itself of the reprieve of year-end appropriate compensation. If so, it would run counter to the objective of facilitating economically beneficial intra-corporate groups arrangements and accord too much discretion to controlling shareholders.\textsuperscript{60} Moreover, in that case, the Article could paradoxically lower the duty of the controlling company under tort law.\textsuperscript{61} The Article adds failing to pay appropriate compensation at the year end as a prerequisite of liability, which is not required under tort law. Actions that would otherwise establish tort liability could escape liability through the mechanism of year-end compensation.

From the above, it seems that this Article should be correctly interpreted as only applying to arrangements carried out for the economic benefit of the corporate group as a whole. However this conclusion would mean that the sole Article dealing with the liability of controlling shareholder does not impose any further responsibility, but only seeks to accommodate the economic reality of corporate groups.\textsuperscript{62} Its ultimate result is only to clarify the ambiguity concerning whether actions carried out for the benefit of the corporate group as a whole are legitimate. It does not regulate the egregious violations such as the

\textsuperscript{60} Faung, \textit{supra} note 56, at 295.

\textsuperscript{61} \textit{Id.}

\textsuperscript{62} \textit{Id.}
tunneling of resources for the controlling shareholder’s personal benefit that is currently the more pressing issue of corporate governance.

On a related note, even if we consider that the Article covers the improper appropriation of personal benefits, it would not materially strengthen the original framework under tort law. The problem of recourse to tort law was the issue of enforcement, namely the burden of proof, which is borne by the plaintiff. This Article does not alleviate this situation as minority shareholders or creditors still bear the burden of proving general and abstract terms. Controlled/subordinate companies’ business may be highly interconnected and may carry out innumerable transactions amongst themselves, and to pinpoint the disadvantage of specific transactions is extremely difficult. Coupled with the high enforcement costs and litigation risks of the derivative suit, the enforcement mechanism under Article 369-4 is extremely weak, and this right does not pose an improvement to recourse under tort law. Thus, regardless of the standpoint on the scope of its applicability, Article 369-4 does not pose much improvement to the non-accountability of controlling shareholders.

To summarize, the duty of controlling shareholders remains extremely limited. Article 369-4 in reality only accommodates economic reality in clearly providing leeway for corporate arrangements for the benefit of the corporate group as a whole, albeit to a limited

63 Id.
extent. Tunneling, for personal benefit, arguably the more pressing issue is still left to tort law.

Third, the wording of Article 369-4 is ambiguous on the whether the company would be liable for negligence toward the subordinate company.64 As both controlling companies and directors exert control and should be held accountable, it is arguable that their duty toward the subordinate company should be the same as directors and include, inter alia, the duty of care.

b) Future Reform

We can surmise that notwithstanding the addition of Article 369-4, the framework for controlling shareholder responsibility is still weak and incomplete. When seeking to remedy the situation, the guiding principle should be the overlap of control and accountability. Many countries such as the United Kingdom and Korea have sought to resolve the issue of control and accountability by introducing the concept of “shadow director” or “de facto director”. The advantage of this approach is that it imposes responsibility on substantive controllers and forgoes the formalistic insistence that only officials of the company are controllers. The extent of the application of the concept of shadow or de facto director can vary. For example, under the Korean version, the shadow or de factor director does not

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64 MING-JYE HUANG, Reflections Upon the Shareholder Limited Liability Regime, in LEGAL FRAMEWORK FOR PUBLICLY ISSUING COMPANIES AND CORPORATE GOVERNANCE, supra note 51, at 69, 111-118.
assume the duty of directors for the purposes of applying the provisions on self-dealing.65

Nevertheless, the underlying principle of control entailing accountability remains unchanged.

Article 369-4 takes another approach by providing a separate regulation of conflicted shareholder transactions. However, most aspects of a controlling shareholder’s duty remain governed solely by tort law. A more simple and comprehensive approach would be perhaps to adopt the concept of shadow director or de facto director and provide that those who directly or indirectly exert control over a company’s personnel, financial or operational matters assume the same duties as the company’s directors. This would encompass the ultimate controller regardless of its form and automatically extend the duty of care of directors to controlling shareholders. It could also at the same time regulate controlling shareholders in the context of interested transactions, effectively incorporating them into the framework of self-dealing by directors, enabling the utilization of the disclosure and screening requirements under the framework.66 Considering the fact that the controlling shareholders’ position is not substantively different from directors in exerting control, this approach would perhaps be preferable to designing a separate system for controlling shareholders.


Nevertheless, the rights accrue to the subordinate company under this approach. Therefore, the problems of high enforcement costs remain. Creditors and minority shareholders are not in a good position to pinpoint problematic transactions amidst the complex interrelated relationship of the controlled and subordinate companies and the mechanism of the derivative suit exacerbates the reluctance to raise suit. A possible resolution would be to confer direct rights on creditors and minority shareholders toward the controlling shareholder and an inversion of the burden of proof to the defendant.67 Another issue is the precise content of the controller’s or director’s duty in the context of the pursuit of benefit to the corporate group as a whole. This exists regardless of the regulatory approach taken. The position of Article 369-4 was that causing any action of the subordinate company contrary to the normal business practice of unrelated companies should be illegal in the absence of appropriate compensation. As noted earlier, this position bears some rethinking. Specifically, the crux is whether some actions that pursue the benefit of the corporate group as a whole rather than that of an individual company, in recognition of the economic reality and utility of controlled/subordinate companies, should be considered legitimate and in line with a controller’s or director’s fiduciary duty.

4. Related-party Transactions:

“Related-party transactions” refers generally to transactions between the company and

67 WALLACE WEN-YEU WANG, Transactions Between the Company and Directors, in NEW CORPORATE AND ENTERPRISE LAW, supra note 66, at 97, 136.
persons in whom those with control or influence in the company have personal interest.\textsuperscript{68}

An important way to extract private benefits of control is to transfer company resources through such transactions. To prevent such expropriation of resources, related-party transactions should be appropriately identified and monitored. Currently however, both the substantive and procedural legal regulations concerning related-party transactions are weak and incomplete.

\textbf{a) Present Legal Framework}

The departure point of the Company Law is the generally applicable rule Article 206, which applying mutatis mutandis the provisions of Article 178 on interested shareholders, prohibits interested directors from voting or voting on behalf of other directors on the matter in question if the company’s interests may be impaired. This provision seems on its face quite restrictive as the concept of “interested” seems broad, and the transaction in theory must be approved by disinterested directors. In practice, it has proved a very weak constraint, the reasons which will be explored in detail below. Nonetheless, the framers of the Company Law presumably considered this mechanism adequate in most conflict of interest situations. Consequently, they only provided for further protection under Article 223 in very limited circumstances.

Article 223 of the Company’s Law deals specifically with self-dealing by directors and

\textsuperscript{68} Id. at 107.
provides that in the case that a director of a company conducts any legal act with the company on his own account or for any other person, the supervisor (not the directors as is usual) should act as the representative of the company. To further combat the prevalence of related-party transactions, Article 171 of the Securities and Exchange Act was amended in 2004. It imposes criminal liability on directors, supervisors, managers and employees of publicly issued companies who directly or indirectly cause the company to undertake disadvantageous and abnormal transactions, to the significant detriment to the company, and directors, supervisors, and managers who, with intent to procure a benefit for himself/herself or for a third person, acts contrary to his/her duties or misappropriates company assets.

The above law on related-party transactions all hinge on the official position of the actor. Another potential avenue is responsibility of the controlling shareholder regardless of his lack of official position. Recourse to this avenue is restricted to Article 369-4 under Taiwanese law and as noted earlier, is subject to limitations such as the expropriation is undertaken via a controlling company and the vagueness of its terms.

There are also additional securities rules concerning related-party transactions of publicly issued companies. In keeping with its goal of protecting the investing public, the measures primarily consist of ex post disclosure and sanction of the company (e.g. prohibition of public listing and mandatory allocation of special reserve). These measures

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69 Regulations Governing the Acquisition or Disposition of Assets by Public Companies, Article 17; Taiwan Stock Exchange Corporation Criteria for Review of Securities Listings, Article 9.
enlist the capital market in monitoring such transactions but would be of little benefit to creditors or shareholders already injured. Other avenues of disclosure include financial reports and the required annual report on intra-group transactions for publicly issued companies under Article 369-12 of the Company Law.

b) Analysis of Present Legal Framework

Article 223 is the only article that deals specifically with self-dealing by directors, but its ambit is extremely limited: only when a director is the other party to the transaction or its representative does this Article apply. This is extremely easy to circumvent as the director has only to avoid personal intervention. Therefore, this Article would be inapplicable to most conflict of interest transactions concerning directors, and even when applicable, it is extremely doubtful whether the supervisor could fulfill this limited monitoring function in light of its institutional weaknesses.

Thus, it seems that the regulation of most related-party transactions would be dependent on how the board reaches its decisions. Article 206 regulates this matter but has proved ineffective. The reasons include the lack of rules mandating disclosure of interest and the time and ability constraints of most directors. Also, most directors would be reluctant to give offense to their colleagues in absence of flagrant conflict of interest. Another critical reason is that the interpretation of the concept of “interested” is unclear. If the above-mentioned interpretation of Article 178 is followed, it seems that the ambit of
Article 206 would be too limited. For example, in a case where the director is elected in the capacity as a representative of a juridical shareholder and the transaction involves the ultimate controlling shareholder of the juridical person shareholder, no legal rights are gained nor legal obligations incurred for the director. Moreover, despite the fact such a juridical shareholder of a publicly issued company would normally disclose its ownership structure, the level of disclosure can stop at first layer of holdings. This contributes to the opaqueness and difficulty of determining conflict of interest. Consequently, the company or the other directors would have no way of knowing, absent voluntary disclosure by the representative director, the director’s conflict of interest with the other party to the transaction (e.g., the controlling shareholder of the juridical shareholder).

As seen above, the primary procedural protections against related-party transactions are flawed and ineffective in practice. The situation is further exacerbated by the fact that compliance with Article 223 and 206 exempts the transaction from judicial review of their validity under the context of conflict of interest. The only recourse remaining is a damages remedy for defective approval. On the other hand, when the procedures are not followed, absent an innocent third party, the validity of the transaction is uncertain and depends on the ratification of the company. Thus under Taiwanese corporate law, similar to other continental law jurisdictions, approval mechanisms for conflict of interest transactions is

70 Hertig & Kanda., supra note 57, at 106.
mandatory. Additionally, civil damages for shareholders and the company are limited to the
general provisions of fiduciary duty and civil law torts. The vague terms are ill-suited to
the complexities of related-party transactions and the situation is further exacerbated by the
placing of the burden of proof on the plaintiff. Thus, the provisions have proved hard to
utilize in practice.

Article 171 of the Securities and Exchange Act seeks to address the issue through the
imposition of criminal liabilities, but as provisions of criminal liability are strictly interpreted
to ensure foreseeability, its indefinite terms are hard to establish in practice. Moreover,
criminal liability should be the option of last resort and should only be utilized when other
measures cannot achieve the goal in question. Related-party transactions concern monetary
damages and the imposition of civil liability should arguably be the preferable way to
compensate the company. In reality however, related-party transactions are mostly
resolved through criminal procedure, due to the aforesaid weakness of the civil liability
framework.

The most fundamental and effective way to regulate related-party transactions is to
establish effective procedural mechanisms that enable independent and impartial parties to

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72 *Id.*

73 *Id.*
review the transaction. As noted above, it is doubtful that supervisors under Article 223 and “disinterested” directors under Article 206 are able to discharge this duty. The most pressing issue currently is perhaps to establish a truly impartial organ within the corporate governance structure, which could take the form of either independent directors or improved supervisors. The current primary mechanism relies on a concept of “disinterested” directors that is too elastic and risks neglecting the nuanced social and business ties between directors.74 Related-party transactions should be clearly and more broadly defined to include all instances where the director has a personal interest in the transaction or party to the transaction, and the interested directors should be obligated to disclose their conflict of interest. As noted earlier, controlling shareholders may also be thus regulated under the concept of de facto director.

Moreover, regardless of whether the procedural safeguards are followed, it should remain possible for the company to claim damages from the directors in question and prove that the transaction was manifestly unfair to the corporation to enable the courts to revoke the transaction.75 Concerning transactions that have not followed the prescribed procedures, it would probably be best to maintain the original approach of making the approval mechanism mandatory. Absent procedural compliance, the legal effect of the transaction would depend on the company’s (independent directors or supervisor) ratification. This would perhaps

74 Wang, supra note 66, at 80.
75 Wang, supra note 67, at 136.
pose more of a deterrent to possible circumvention of the procedural safeguards. Another worthy reform would be to place the burden of proof on the alleged interested directors engaging in related-party transaction who have better access to relevant information and evidence. This would encourage the company or shareholders on its behalf to bring suit.

5. Independent Directors

The introduction of independent directors has been an important recurring theme of corporate governance reform. This is especially so as findings have indicated that boards of Taiwanese corporations are populated with insiders. Studies have shown that the largest shareholder in listed companies provide less than 20% of the capital but hold more than half of board seats. Moreover, board affiliation with controlling shareholders is higher when controlling shareholder voting rights substantially exceed cash flow rights of the firms. As controlling owners' cash-flow rights increases, however, the likelihood of family members on boards decreases, suggesting that the insider dominant board structure is attributable to agency problems from separation between control and cash flow rights. Studies have also shown that in the presence of family control, a positive valuation effect exists when controlling families hold less than 50% of board seats.

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76 Yin-Hua Yeh, The Disappearing Stock King 252 (2005).

77 See Claessens & Fan, supra note 11, at 82; Yin-Hua Yeh & Tracie Woidtke, Commitment or Entrenchment? Controlling Shareholders and Board Composition, 29 Journal of Banking & Finance 1858 (2005); Yeh, supra note 29, at 87, 99.

78 Yeh et al., supra note 27, at 21, 40-42.
The above suggest that boards are used to establish the control of a controlling minority shareholder, and that in the face of a seriously deficient supervisor system, board composition does play an important role in corporate governance in Taiwan. The fundamental resolution would be to establish a viable and effective monitoring mechanism. Currently, differences exist over whether reform of the supervisor or its replacement by independent directors would be preferable.

a) Current Legal Framework

The concurrent regulation of independent directors and independent supervisors applies at the stage of application for public issuance. They require the presence of at least two independent directors, three supervisors and among them, a minimum of one independent supervisor. Independent directors and supervisors must meet certain affirmative and passive qualifications. However, these rules only apply to companies applying initially for listing or trading on the over-the-counter market and take the form of contract entered into by the Stock Exchange or the GreTai (in the case of over-the-counter market) with the issuing

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80 These include professional skills, the absence of concurrently serving as independent directors or supervisors in over five companies and the absence of special relations with the company in which they serve. Another indirect constraint is the general requirement that a proportion of directors and supervisors do not share among themselves and with each other, the special relationships enumerated by the rules.
company. As a result, the Stock Exchange and the GreTai have had trouble with companies that do not reelect independent directors after successfully publicly issuances. Besides this, the only other avenue open to the regulatory authorities is administrative guidance. Neither is the minimum seats reserved for independent directors likely to be sufficient in large boards. Furthermore, as the sanctions arguably infringe constitutional rights, their dependence on rules issued by the securities authorities on their own initiative give rise to concerns of constitutionality.

Another important issue is the fact that the regulations stipulated the simultaneous existence of independent supervisors and independent directors. Notwithstanding the fact that the concept of “supervisor” connotes independence in itself, and thus the concept of “independent supervisors” is somewhat odd, this layering of monitoring mechanisms could negatively impact delineation of powers and accountability. This is further exacerbated by the fact that independent directors have no clear authority or powers by law.

Despite the above shortcomings, up to now over 200 publicly issued companies have elected independent directors. However, their impact or authority has been limited due to the lack of clear legal guidance and operational framework.

b) Reform

The amendment articles of the Securities Exchange Law set to be promulgated in January 2007 provide that absent an order by the competent authority, publicly issued
companies may freely choose whether to establish independent directors. Companies who choose to do so further choose between an auditing committee and supervisor system. The concept of independent supervisors has been dropped.

Thus the amendment provides companies with three possible frameworks: The first is a company that does not elect independent supervisors and relies solely on the supervisor system. The second is a company that elects independent directors but does not establish an auditing committee. In that case, independent directors and supervisors would exist simultaneously, but the former’s function would be limited to reviewing specific resolutions of the board of directors and a record of its opposition. The third scenario is where a company both elects independent directors and establishes an auditing committee in the place of the supervisor.

The auditing committee must be composed by all independent directors, and laws concerning supervisors are to be applied mutatis mutandis. Except for resolutions concerning financial reports, the board can still pass the same resolution by special majority but the opposition of the auditing committee must be recorded. When a company opts for the binary structure of the board of directors and supervisors, however, the mechanism is that opposition or reservations of independent directors to board resolutions concerning certain important issues must be recorded.

The amendments are a step forward but seem inadequate to provide for effective
monitoring due to the following considerations: First, the amendment leaves open the possibility of structures with only supervisors or both independent directors and supervisors. The former is problematic as the supervisor system in Taiwan is still extremely weak. The latter confers too little authority on independent directors and could also bring potential overlapping and unclear power delineation between independent directors and supervisors.

For example, the Japanese model provides only for two choices for companies, a unitary system of independent directors and its various committees or the original binary structure of directors and supervisors. This not only provides free choice for companies but also prevents the overlapping between directors and supervisors. Second, there still remains the fundamental issue of the blurred delineation of power between the board, executive board and management. It would be extremely difficult clearly outline the duties and responsibility of independent directors, and this ambiguity could hamper effective monitoring on their part.

In theory, under the precondition of well-conceived design, both supervisors and independent directors should be able to monitor effectively. While compared to supervisors, independent directors have the advantage of actively contributing and participating in board decisions and policing on a more real-time basis, the assertion of these benefits could

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81 Cf. April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. & ECON. 275 (1998) (finding a positive impact for inside directors on finance and investment committees probably due to informational advantages; we consider that independent directors also have such advantages compared to supervisors and thus contribute to firm performance).
arguably be left to an individual company’s choice. Furthermore, as Taiwanese companies have already become accustomed to the binary system, the supervisor organ should not be abruptly abolished without overriding policy concerns. Thus, consistent with the above amendment, there is no need for mandatory imposition of independent directors.

Following this train of thought, it seems that there is no need to provide companies with the three choices as set out in the above amendment. A preferable regulating framework would follow the Japanese example and allow for a choice between a binary system of directors and supervisors and a unitary system with the establishment of nomination, auditing and remuneration committees composed primarily of independent directors under the board of directors. Companies which provide explanations should be free to choose to maintain the binary system of supervisors. It should be emphasized that these two alternatives should be separate, comprehensive and avoid intermingling. Independent directors and supervisors should not coexist to avoid confusion over supervisory functions and powers. The unitary system additionally necessitates the adjustment of the division of power between the board and management. The board should be recast as an organ in charge of monitoring the management and set broad policy, rather than carrying out business activities as it is currently positioned. Moreover, the committees are crucial for independent directors to monitor effectively and should be an integral part of the independent director system. Under the binary system, the main issue would instead be the reform of the
supervisor system.

This framework would avoid the inevitable confusion following from the co-existence of both supervisors and independent directors. Moreover, the structural flexibility would prompt a beneficial competition between organizational structures. This would lessen the inevitable opposition to mandatory imposition due the prevalence of controlling shareholders among Taiwanese companies. It follows that a company’s choice of whether to adopt an independent directors system would ultimately be subject to capital market inspection and provide an additional avenue for competition among companies. The operation of market mechanisms would ultimately decide for each company its organizational structure. This could facilitate on a deeper level the competition between ownership structures. Controlling shareholders unwilling to accord some power to independent directors will probably be at a disadvantage in the capital market compared with companies with diffuse ownership that are willing to do so. This healthy competition of ownership structures would somewhat ameliorate the current problem of deviation of ownership and control.

Rules on numerous details concerning the operation of the independent directors system still await issuance by the securities authorities. The prerequisites of effective monitoring include a nomination and election process insulated to an extent from those that control directors, strict qualifications for monitors, sufficient compensation, and sufficient authority in their hands. How these aspects are dealt with is imperative to the success of the
amendment.

6. Juridical Shareholders and Their Representatives as Directors

Article 27 permits juridical shareholders or their authorized representatives to be elected directors or supervisors. The authorized representatives are elected as individuals, but are under the complete control of the juridical shareholder. The juridical shareholder may replace its authorized representative at will, unilaterally displacing the original wishes of other shareholder. Additionally, a plural number of authorized representatives of the same juridical shareholder may be elected and it is permitted for the same juridical shareholder to have representatives respectively elected for directors and supervisors.

The corporate governance problems that Article 27 gives rise to are many. First, juridical shareholders and their stand-ins may occupy more than one position as opposed to one for natural person shareholders. This is manifestly against shareholder equality. Second, the juridical shareholder maintains complete control over its authorized representative through the unilateral power of discharge. It is thus unlikely that such directors and supervisors would have the incentive or ability to carry out their duties effectively. Not only are they deprived of term protection, they also owe possibly conflicting duties to both the company and the juridical shareholder. Third, the fact that authorized representatives of the same juridical shareholders may simultaneously be elected directors and supervisors undermines the basic corporate governance mechanism that
supervisors monitor the board. On this last point however, reform is already underway as the amendment of the Securities and Exchange Law set to be promulgated in January 2007 has prohibited juridical shareholders of publicly issued companies or their representatives to be simultaneously elected as directors and supervisors.

The above all increase the ease of expropriation. From another perspective, Article 27 also enhances the control of controlling shareholders and its opacity. By law, controlling shareholders are able to maintain absolute control over their plural representatives and thus numerous directors and supervisors positions. Furthermore, the assumption of these posts by juridical shareholders or their representatives increases the difficulty of discerning the identity of the natural person or corporate group ultimately in control of the company and impedes disclosure.

Bearing the above in mind, we suggest that a fundamental resolution should be to abolish Article 27 and allow only natural persons to assume the positions of directors or supervisors. This would strengthen the institutional mechanisms as natural persons are better suited to carry out monitoring, discussion and bear the responsibility that such positions entail.

V. Conclusion

As has been noted, ownership structure is a fundamental element of any discussion on corporate governance, and thus is extremely important for sustained economic growth.
Bearing this in mind, this Article first sets out to clearly and concisely present the contemporary discussion on controlling shareholders and controlling minority shareholders. From the extensive literature on this subject, we seek to distill the most fundamental concepts necessary for a comprehensive understanding of the structure and its ramifications. As noted, ownership structure can be assessed from an efficiency perspective and which structure would be most efficient differs from company to company. To pursue economic efficiency and company productivity, efficiency concerns should play a role in deciding the ultimate ownership structure of each company. Yet when the value of control is excessively large, controlling shareholder structures would inevitably persist, regardless of economic efficiency, as rational investors in pursuit of profit would assemble or refuse to let go of control.

The above analysis provides some revelations for regulation measures. The value of control can be expressed as private benefits of control net of the costs of a controlling position. Private benefits of control from expropriation must be capped. On the aspect of raising the costs of maintaining a controlling position, however, we refer back to the fact that each ownership structure has its own benefits and costs, companies may vary in their optimum choices, and thus any attempt to interfere with the free choice of ownership structures should proceed cautiously. Thus, in the absence of empirical evidence on the overall tradeoff for controlling (minority) structures, we propose more a more cautious
approach, with a focus on methods of leveraging equity into incommensurate control that are also problematic from other perspectives. Examples include rules on disclosure and cross-holdings.

The next part of the Article seeks to apply this framework to the case of Taiwan. Taiwan is characterized by controlling minority structures and poor shareholder protection. Taiwanese law has been subject to American, German and Japanese influences against a background of Confucian traditions, and thus the deficiencies of its regulations and the process of reform implementation could be representative of similarly influenced countries in the East Asian region. This Article then proceeds to explore in depth the reforms enacted and future prospects.

Controlling shareholder structures entail a fundamental shift of the agency problem in corporate governance, but up to now, little discussion of this issue is seen in Taiwanese legal literature. This article not only seeks to remedy this situation, but its discussion of actual application of reforms under the Taiwanese corporate legal system would be valuable for similarly situated countries also on the path to reform.