Corporate Governance of Taiwan: Substantial Director Focused

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Abstract. The substantial director system under the Company Act of Taiwan is prepared to prevent de facto and shadow directors damaging the rights and interests of companies and their shareholders. However, the issue concerning the identification and applicability of relevant provisions remains to be defined. By describing its preconditions and applicable scope, the paper is expected to facilitate the improvement of the Taiwanese corporate governance system.

Introduction
To eliminate long-standing abuses and boost the effective corporate governance, following the current international trend of corporate governance, by reference to the legal systems of Britain, in 2012, the Company Act of Taiwan made a new provision for substantial directors in Section 8.3. By describing its preconditions and applicable scope, the paper is expected to facilitate the improvement of the Taiwanese corporate governance system.

Corporate Governance of Taiwan
Generally, corporate governance is a directive and administrative system that aims to perform operators’ duties, and through improvement of corporate performance, guarantee shareholders’ rights and interests without damaging other stakeholders’ interests. However, no unified standard has been made for the significance and scope of corporate governance. From legal point of view, it is considered that corporate governance is committed to effectively supervising the activities of companies and preventing disadvantages in operation through legal control under the organizational system that separates ownership and the right of operation.

Taiwan initiated corporate governance in 1998, and constructed a legal framework of corporate governance according to the Company Act, Securities Exchange Act and the listing review standards of securities exchanges. Subject to the Company Act, limited liability companies establish the internal governance mechanism that includes the board of shareholders, board of directors and supervisor, as if it was a system of separation of three powers to achieve mutual restriction and corporate governance. However, a large number of malpractices arose from the defects of related systems, making it inevitable to promote the reform of many legal systems including the substantial director system in Paragraph 3, Article 8 of the Company Act of Taiwan.

Amendment to the Company Act of Taiwan
Previously, directors were identified using formalism. Except to de jure directors, no responsibilities were granted to substantial directors (including de facto and shadow directors) under the Company Act, causing adverse effects and thus contributing to the amendment to the Company Act in 2012.

Reference to the Company Act of Britain
According to the amendment to the Company Act of Taiwan, the substantial director system was prepared by reference to British laws. Although no provision has been made for the definition of director, Britain has been identifying a director in essence instead of in form, that is, this is not only subject to the title as a director. As set forth in Section 250 of the Company Act of Britain, a director
refers to any person occupying the position of a director, by whatever name called. Therefore, the
directors of British companies include: (1) de jure directors, who are validly appointed according to
the Company Act and related articles of association; (2) de facto directors, who have not been
formally appointed but participate in corporate decision making and carry out business activities in
the capacity of a director; (3) shadow directors, in accordance with whose directions or instructions
the directors of a company are accustomed to act.

In general, a de facto director is a person who has not been elected and appointed in accordance
with legal procedures but actually performs the functions of a director by declaring it to be a director
and intervenes in and has direct influence on company affairs. A shadow director is a person in
accordance with whose directions or instructions the directors of a company elected and appointed
according to law act and has no direct influence on company business; however, a shadow director
who has not only exerted indirect influence on the company might be considered as a de facto
director. According to British courts, one of the two was alternative to and incompatible with another
in most cases; but there was at least a common between the two, that is, both of the two were those
other than de jure directors but imposed substantial influence on corporate governance (excluding
professional advisers), which might be concealed and/or made available to the public.

Substantial Director System

As provided in Paragraph 3, Article 8 of the Company Act of Taiwan prepared in 2012, “For a
company whose shares have been issued in public, a non-director who de facto conducts business of a
director or de facto controls over the management of the personnel, financial or business operation of
the company and de facto instructs a director to conduct business shall be liable for the civil, criminal
and administrative liabilities as a director in this Act, provided, however, that such liabilities shall not
apply to an instruction of the government to the director appointed by the government for the purposes
of economic development, promotion of social stability, or other circumstances which can promote
public interests.”

The clause gives a definition to substantial director, i.e. the person who is not a director but
substantially performs the functions of a director (hereinafter referred to as “de facto director”) or the
person who is not a director but substantially controls the personnel, financial or business affairs of a
company and commands directors to perform business (hereinafter referred to as “shadow director”).
Substantial directors undertake civil, criminal and administrative liabilities together with directors.

Evaluation on the Substantial Director System of Taiwan

Necessity

In the principle of separation of ownership and the right of operation under the Company Act, the
board of directors plays an important role in a company. However, prior to revision of the Company
Act of Taiwan in 2012, director liabilities were only granted to de jure directors, so the person who did
not act as a director was not subject to the director liabilities under the Company Act. In such case, it
is impossible to achieve corporate governance, making it necessary to prepare a substantial director
system. There is such disadvantage as a person having no the title as a director but owning the right of
operation in practical operation. Additionally, the actual responsible persons of most Taiwanese
companies operated business using the de jure directors who were accustomed to act in accordance
with the directions and instructions of shadow directors. For instance, Rebar Group was involved in
the historically greatest economic crime of Taiwan that heavily hit the financial market in 2007, in
which the actual responsible person committed economic crimes like transfer of internal funds and
loan fraud by establishing and operating subsidiaries under the nominal control of its relatives,
crones, friends and employees, by means of which NT$ 50 billion was gained; however, once a
company was involved in such similar crimes, its actual responsible person may be exempt from
related liabilities, which greatly endangered social economy and the rights and interests of the public. This was indeed a legal flaw in terms of corporate governance.

**Indefinite Conditions of Applicability**

Without definite provisions in Paragraph 3, Article 8 of the Company Act, there might be doubts concerning the applicability, which are hereby described as follows:

**De facto director.** There are two questions for the first part of Paragraph 3, including: (1) how to explain “substantially perform the functions of a director” (2) According to Paragraph 2, Article 8 of the Company Act of Taiwan, except in the event the manager of a company fulfills duties, the related provisions do not apply. However, according to the operation practice of Taiwanese companies, a manager usually performs the duties of a director on behalf of the director, in which case the issue concerning whether the manager should comply with the director-related provisions under the Company Act as a person who is not a director but substantially performs the business of a director remains to be defined.

First, the standard of identifying whether a person substantially performs the functions of director should be determined by the court according to facts and gives consideration to (but not limited to): A. whether it declares that it is a director or uses the title as a director; B. before making decisions in relation to the company, whether it has obtained sufficient background information as a basis or not; C. whether it performs the duties which are related to the company and may be performed only by directors; a manager below the level of director who may perform duties is not considered as a de facto director; consideration should also be given to whether it has participated in or is provided with an opportunity to participate in group decision making other than the fact that it provides suggestions or participates in this on behalf of others.

Second, if it is found to exercise its power and perform the functions of a director after the above factors are considered, it will be deemed to be a de facto director, and should undertake its liabilities together with de jure directors. The above standard may be used to determine whether a manager of a company is a de facto director. This is because it is not declared to be a director and has not performed duties with the title as a director, and it will not be considered as a director even though it substantially performs the functions of a director.

**Shadow director.** With respect to the second part of Paragraph 3, there are following doubts concerning its applicability:

(1) In relation to the concept of shadow director, it may be subject to the following: (i) a shadow director should have a certain influence on corporate affairs to an extent that enables it to perform the duties of a director, but it is not necessary to influence all activities of the company. (ii) a person who substantially commands directors to perform business should be identified in strict accordance with the compliance by directors with instructions on a long-term and regular basis instead of on a single or occasional basis. (iii) there is a causal relationship between its instructions and performance by directors, so as to prove that it has an influence on the company. (iv) there must be a majority of directors who act in accordance with instructions, based on which it is deemed to a shadow director who effectively controls the activities of the company.

(2) Consideration should be given to whether the person who provides directors with suggestions in the capacity of a professional constitutes a shadow director. In commercial practice, the suggestions given by a professional advisor to the board of directors of a company have a significant role in business operation and are generally adopted by the operator, leaving it seem to be qualified as a shadow director. However, a professional adviser does not necessarily constitute a shadow director, for the reasons hereby described as follows: (i) a shadow director proactively exercises its substantial control over directors, but a professional adviser passively accepts the consultations from directors and passively imposes a certain control. (ii) directors are accustomed to accept the instructions of a shadow director which they have an option to accept or reject; no directors are accustomed to accept the suggestions given by a professional adviser, which are usually accepted subject to the evaluation
on the risks arising from failure to do so. (iii) Particularly, if any third person who gives information, suggestions or instructions to a company, regardless of its identity and title, substantially controls the personnel, financial or business affairs and commands directors to perform business, it should be considered as a shadow director, thus preventing a shadow director being exempt from its liabilities by deliberately acting as a professional advisor.

**Limited Applicable Scope**

The substantial director system under the Company Act of Taiwan only applies to the companies that issue stocks in public. However, to achieve corporate governance and protect stakeholders, measures should be taken to enable the system to apply to those that issue stocks in private as well. Taiwan has a large number of small and medium enterprises most of whom are family firms, the governance of which involves inconsistency, making it necessary to apply the system; second, no proper legal basis is available for determination of the applicability of the system subject to the manner in which stocks are issued.

**Conclusion**

Although the substantial director system has been included in the Company Act of Taiwan, whether in terms of its preconditions or applicable scope, specific clarification is further required. By initially introducing its applicability, the paper is expected to form indicative views concerning the issue in judicial practice and facilitate the improvement to the Taiwanese corporate governance system.

**References**

[1] Smith and others v Hinchliffe and others [2010] EWHC 396 (Ch) at [272].