THE INDEPENDENT DIRECTOR SYSTEM IN CHINA:
WEAKNESSES, DILEMMAS, AND POTENTIAL SILVER LININGS

Sang Yop Kang*

Table of Contents

I. INTRODUCTION ................................................................. 152
II. THE INDEPENDENT DIRECTOR SYSTEM IN CHINA ............. 156
   A. Independent Director Institution as a Corporate Governance Tool ...................................................... 156
   B. Independent Directors in China .............................................. 157
III. CRITICISMS OF INDEPENDENT DIRECTORS AND ANALYSES IN THE CHINESE CONTEXT ............................................. 163
   A. “Independence” of Independent Directors and Related Concerns ......................................................... 163
   B. Lack of Information and Expertise ...................................... 165
   C. The Presence of Independent Directors and a Corporation’s Performance ........................................... 166
   D. Independent Directors’ Pecuniary and Non-Pecuniary Benefits ................................................................ 169
   E. Independent Director Institution: Defensive Mechanism? ........................................................................ 173
   F. Controlling Shareholder Ownership ..................................... 176
IV. OTHER CONSIDERATIONS OF THE INDEPENDENT DIRECTOR SYSTEM IN CHINA ......................................................... 180
   A. Reputation-Based Mechanism of the Independent Director System ......................................................... 180
   B. Nonetheless, the Independent Director Institution Works in China to Some Extent ................................... 183
V. CONCLUSION ............................................................................ 184

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Abstract

The independent director system in China has many weaknesses. Independent directors might not be truly independent, and they are not always equipped with the necessary information and expertise. The controlling shareholder ownership aggravates problems of the independent director system. Particularly, it is highly likely that the system based on rubber-stamp directors is used to justify corporate policies and transactions in favor of controlling shareholders. Nonetheless, independent directors in China can bring positive effects to society. Some tainted proposals are screened out before submission by corporate insiders to a formal board meeting since independent directors sometimes raise objections during informal sessions or private conversations (independent directors’ “direct deterrence”). Controlling shareholders, due to the concern of revealing negative information to a capital market and enforcement agencies, would not fully demand independent directors to approve egregious transactions (a controlling shareholder’s “self-censorship”). In addition, regulations on the business role of individuals with government/party or education experience should be carefully reviewed. On the one hand, these regulations can facilitate anti-corruption campaigns that the Chinese government currently pursues. On the other hand, there is no guarantee that alternative groups are more capable, independent, and ethical than the group with government/party or educational experience.

I. INTRODUCTION

Corporate governance scholars, economists, policy-makers, and courts generally consider the independent director institution as a main solution to corporate governance problems. After the Enron

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debacle, the role of independent directors was reinforced in the United States. In the late 1990s, Korea adopted the outside director system (which is functionally similar to the independent director system) as a corporate governance reform in response to the Asian financial crisis. China also joined this trend: in 2001, the China Securities Regulatory Commission (CSRC) issued the “Guidance Opinion on Establishing the Independent Director System” (hereinafter Guidance Opinion), which required the independent director system in listed companies.

The independent director system, however, has many weaknesses. Most of all, there is no clear definition of or objective standard for the adjective “independent”: the title “independent director” does not guarantee the independence of directors. In addition, independent directors, who work on a part-time basis, often do not receive enough information from the corporation they direct. Also, critics maintain that independent directors—even if they are truly independent—often lack expertise, and face time constraints in understanding significant corporate business policies. Moreover, empirical studies do not show a significant correlation between the presence of independent directors and a corporation’s performance. Even worse, it is possible that corporate insiders—either management or controlling shareholders—abuse the independent director system by using it as a defense mechanism for transactions and policies that they pursue: to the outside world (including markets in general, the enforcement agencies, and the court), a corporation’s transactions and policies appear to be “justified” by the advice and monitoring process of independent directors, even when they are not truly independent. Furthermore, independent directors have an incentive not to lose additional compensation opportunities, which might be significant. Accordingly, independent directors are likely to follow corporate insiders, who are influential when recommending, nominating, and electing directors.

Based on the overview of the weaknesses of the independent director system, this article develops in-depth analyses of these
issues in the context of Chinese corporate governance practice. For instance, it is probable that the controlling shareholder ownership, which most corporations in China are based on, could aggravate the problems associated with the independent director system. This is because a controlling shareholder—unlike a CEO in a widely-held corporation—exercises direct control backed by her/his majority of voting rights and influence on virtually all corporate policies including recommendation, nomination, election, and renewal of independent directors.

Based on the reputational mechanism, in theory, incentive/efficiency problems of independent directors can be cured. In jurisdictions with controlling shareholder ownership (including China), however, it is highly likely that the main audience in the reputation market that independent directors consider is not public investors in a capital market, but controlling shareholders. Thus, the mechanism of invisible hands via word-of-mouth would not work well. Since social networks in China are cumulatively connected in a complicated matrix through regional, educational and other backgrounds, the “bad” reputation of an independent director—i.e., the reputation that the independent director is truly independent—will easily spread in the business community. Accordingly, controlling shareholders, who in practice have the power to elect independent directors, screen out truly independent directors from their list. If the trend is strong enough, only compliant independent directors will remain in the market, which will create a situation analogous to “adverse selection.”

According to a recent study, independent directors in Chinese corporations issued only 0.9% of dissent opinions (including abstention as well as overt disagreement) in board meetings. Such a high approval rate (99.1%) strongly indicates that independent directors in China are acting as rubber stamps for controlling shareholders and corporate insiders. It is worth noting, however, that what the study examined was only the opinions of independent directors in official board meetings.

More specifically, the 99.1% approval rate does not reflect two important processes, wherein the institution of independent directors—directly or indirectly—can screen out undesirable

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5 See infra Part IV. A.
6 Originally, “adverse selection” in a market (e.g., a used car market) is explained as follows: “because the potential sellers know more about the quality of what they are selling than the potential buyers, they have an incentive to select the worst things to sell.” PAUL KRUGMAN & ROBIN WELLS, MICROECONOMICS 560 (2nd ed. 2009).
proposals: (1) given the presence of independent directors whom a controlling shareholder may trust less than managers, a controlling shareholder—directly or through an inside director or manager—may voluntarily censor egregious proposals due to fear of leaking sensitive information (what I refer to as a controlling shareholder’s “self-censorship”); and (2) in unofficial, private sessions (before the official board deliberation), independent directors can sometimes persuade corporate insiders to withdraw potentially problematic proposals (what I refer to as independent directors’ “direct deterrence”). In this respect, the independent director institution in China can, to some extent, enhance the quality of corporate governance.

Another dilemma that the independent director system in China presents is the question of which groups are suitable for the position. Many independent directors in China are professors or people with a Communist Party/government background. Perhaps independent directors are beholden (and compliant) to corporate insiders. Nonetheless, compared with inside directors, independent directors—particularly those from universities and the party/government—are not fully obedient to corporate insiders. Due to less hierarchy between independent directors (e.g., professors and people from the party/government) and corporate insiders, corporate insiders find it (relatively) difficult to coerce independent directors to pass unjustified corporate policies and egregious transactions. Particularly for privately owned corporations, even if a hierarchy exists between corporate insiders (without political backgrounds) and independent directors with a political background, the hierarchical relationship could possibly be reversed in favor of the independent directors.

In this respect, regulations on the business role of individuals with government/party backgrounds should be carefully analyzed. On the one hand, this restriction would exert a positive effect by breaking off a questionable tie between business elites and people from the party/government. Indeed, these regulations are understood as a means of the anti-corruption campaign. On the other hand, without an alternative (better) group to fill the vacuum in independent

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8 For a further discussion, see infra Part III. E. 2.
9 See infra Part IV. B.
10 Without such regulations, independent directors with political/governmental backgrounds may abuse their power and harm society, as follows. First, with the collaboration of these independent directors, a controlling shareholder can siphon corporate value at the expense of non-controlling shareholders. Second, it is also possible that independent directors with political backgrounds can abuse their power in favor of a corporation at the sacrifice of society or other corporations. In this case, non-controlling shareholders of the favored corporation benefit from the independent directors’ abuse of power (and thus shareholder wealth could be enhanced).
directorships, this restriction would crowd out the director candidates, who are most capable (and perhaps more independent than other groups from corporations).\textsuperscript{11}

The remainder of this article is structured as follows.\textsuperscript{12} Part II presents an overview of the independent director system in China (with further explanations of the system in the United States). Part III provides classical criticism of the independent director system, and analyzes weaknesses of the system in the context of Chinese corporate governance. Part IV explores other considerations of the Chinese independent director system. Part V summarizes and concludes. In Chinese corporations, supervisory boards (or supervisors) also play an important monitoring role.\textsuperscript{13} However, since the supervisory board system relates to another set of significant and complicated corporate governance issues, this article emphasizes only issues of the independent director system.

II. THE INDEPENDENT DIRECTOR SYSTEM IN CHINA

This Part begins with an overview of the independent director institution. Then, this Part explains the system in China. Subsequently, this Part describes who independent directors are in China (by profession).

A. Independent Director Institution as a Corporate Governance Tool

A primary purpose of corporate governance is to lessen agency problems taking place among different corporate constituencies. In the United States, \textit{inter alia}, the independent director system has been considered a primary solution to various corporate governance problems. In a typical U.S. corporation, shareholding is widely dispersed,\textsuperscript{14} so that public shareholders with fractional share ownership are individually powerless in the corporate decision-making process. Without a controlling shareholder, the vacuum of shareholder power will be occupied by management, which

\textsuperscript{11} Party members and government officials form the most elite group in China. Regarding the corporate corruption issues that have been targeted by regulations, it is also noteworthy that politically powerful individuals—if they are corrupt—can take bribes or illegitimate benefits from corporations, \textit{irrespective} of holding independent directorships. These corrupt individuals might feel that holding a title in a corporation is unnecessary, even inconvenient or risky: with independent directorships, their roles in corporations can be observed more easily by the public and government/party agencies. \textit{See infra} Part IV. B.

\textsuperscript{12} Note that this article does not cover issues of supervisors and a supervisory board in China.

\textsuperscript{13} In terms of monitoring, the roles of a supervisory board and a board of directors may overlap. \textit{See, e.g.}, Sibao Shen & Jing Jia, \textit{Will the Independent Director Institution Work in China?}, 27 \textit{LOY. L.A. INT’L} & COMP. L. REV. 223, 226 (2005).

\textsuperscript{14} For an explanation of dispersed shareholder system, \textit{see generally} ADOLF A. BERLE, JR. & GARDINER C. MEANS, \textit{THE MODERN CORPORATION AND PRIVATE PROPERTY} (1932).
ultimately exercises control over a corporation. This phenomenon of separation of ownership and control\textsuperscript{15} is reinforced by the fact that it is extremely difficult, if not impossible, for dispersed shareholders to act collectively.\textsuperscript{16}

To some extent, the independent director system can rectify this managerial agency problem, since independent directors—another type of shareholder agents who monitor agents (i.e., executives)—can represent the true will of the entire shareholder group. This theoretical support for the independent director system is embedded in the U.S. corporate law regime. In \textit{Unocal Corp. v. Mesa Petroleum Co.}, a milestone corporate law takeover case, directors had to demonstrate that “they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.”\textsuperscript{17} The \textit{Unocal} court continued, “such proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors.”\textsuperscript{18} In other words, the inherent distrust of inside directors—who are seen as colleagues (or sometimes puppets) of high-profile executives—can be substantially assuaged when the strategic decision of a board is effectively made by independent directors.\textsuperscript{19}

Following the U.S. tradition, many countries have accepted the independent director system in order to reform weak corporate governance institutions. In Korea, the outside director system, which is considered generally equivalent to the independent director system, was introduced. It was a response to demands of corporate governance reforms from both the inside (i.e., Korea) and the outside (i.e., the international community that bailed Korea out in the wake of the Asian financial crisis).

\textbf{B. Independent Directors in China}

1. The CSRC Guidance Opinion

Recognizing the importance of the independent director system as a potential solution for corporate governance problems, China

\textsuperscript{15} See id. (explaining the concept of the separation of ownership and control); \textsc{Melvin Aron Eisenberg} \& \textsc{James D. Cox}, \textit{Business Organizations Cases and Materials} 300 (Unabridged 11th ed. 2014) (“Where shareholdership is highly dispersed the corporation will be controlled not by the shareholders, but by management—that is, by the board and the executives.”).

\textsuperscript{16} As to “collective action problem,” see \textsc{Stephen J. Choi} \& \textsc{Jill E. Fisch}, \textit{How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries}, 113 \textsc{Yale L. J.} 269, 271 (2003) (“The explanation for shareholder passivity in large, publicly held corporations is straightforward. The dispersed shareholder body is poorly positioned to engage in effective collective action; the costs of monitoring management or leading a proxy contest typically far outweigh the benefits to an individual shareholder.”).

\textsuperscript{17} \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d. 946, 955 (Del. 1985).

\textsuperscript{18} \textit{Id}.

\textsuperscript{19} \textit{Id}.
adopted the system as well. In 2001, the CSRC issued the Guidance Opinion, and the independent director system was required in listed companies. In addition, the Company Law of the People’s Republic of China requires listed companies to have independent directors.

According to the Guidance Opinion’s definition, “[t]he term ‘independent director of a listed company’ means a director who does not hold any position in the company other than director and who has no relationship with the listed company engaging him or its principal shareholders that could hinder his making independent and objective judgments.” The Guidance Opinion stipulates additional requirements regarding the composition of the board of a listed company, namely (1) (by June 30, 2002) a board should have at least two independent directors, and (2) (by June 30, 2003) a third of directors should be independent directors.

Regarding the notion of “independence,” the Guidance Opinion stipulates conditions for the disqualification of an independent director. For instance, the following individuals may not serve as independent directors: “persons holding a position in the listed company or a subsidiary thereof and their lineal relatives and major social relations (the term ‘lineal relatives’ meaning spouses, parents, children, etc.; and the term ‘major social relations’ meaning siblings, parents-in-law, children-in-law, siblings’ spouses, spouse’s siblings, etc.);” “natural person shareholders who directly or indirectly hold not less than 1% of the issued shares of the listed company or who rank in the top ten shareholders of the listed company, and their lineal relatives;” “persons who hold positions in entities that directly or indirectly hold not less than 5% of the issued shares of the listed company or that rank in the top five shareholders of the listed company, and their lineal relatives.” Also, an independent director may not hold more than five directorships. The rule, however, applies only in principle. Thus, it is possible in practice for an

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20 In Chinese, an independent director is “Duli Dongshi (独立董事).”
21 This movement was distinctive from that of Korea: regarding corporate governance reforms, China voluntarily adopted the independent director system without yielding to the pressure from the international community, since China did not suffer from the Asian financial crisis.
23 Guidance Opinion, art. 1 (1).
24 Id. art. 1 (3).
25 Id.
26 Id. art. 3 (1).
27 Id. art. 3 (2).
28 Id. art. 3 (3). For a further explanation of other disqualification conditions, see id. art. 3 (4)–(7).
29 Id. art. 1 (2).
30 Id.
independent director in a corporation to hold, for example, six directorships.

Regarding the nomination process, the Guidance Opinion stipulates that a board of directors, a board of supervisors, and a shareholder who holds more than 1% of shares in a corporation can nominate independent director candidates,\(^{31}\) and that “[s]uch directors will be decided through election by the shareholders’ general meeting.”\(^{32}\) Also, a listed corporation is required to provide the relevant information of a candidate to the CSRC and the stock exchange in which the company is listed.\(^{33}\) A candidate may not serve as an independent director when the CSRC calls into question her/his independence or qualification.\(^{34}\)

Regarding the Guidance Opinion, many corporate governance issues may arise. For instance, a board where a third of its members are independent directors (as the CSRC requires) might not be independent enough since independent directors do not constitute a majority on a board. Also, many disqualifying conditions for an independent director are centered on the close familial relationship between an independent director candidate and core corporate insiders of a company.\(^{35}\) However, since social connections based on kinship (beyond close familial relationships), region, and educational background are also influential in China, the short list with enumerated “negative standards”\(^{36}\) may not be able to effectively rule out a candidate who is not, in fact, independent.

2. Who Independent Directors Are (by Profession)

Next, consider who are the independent directors in Chinese listed companies. As of December 20, 2011, a survey on independent directors in China was conducted among 7,595 independent directors in 2,285 listed companies in the domestic stock exchanges.\(^{37}\) 38.59% of the surveyed independent directors were scholars or professors; legal experts including lawyers accounted for 10.44%; people with

\(^{31}\) Id. art. 4 (1).
\(^{32}\) Id.
\(^{33}\) Id. art. 4 (3).
\(^{34}\) Id.
\(^{35}\) Id. art. 3.
\(^{36}\) With a short list of enumerated “negative standards,” corporations can get around disqualifying grounds in a relatively easy manner.
\(^{37}\) Ren Jiahe (任家河), *Duodong Xinchou Chaju Da: Gaoxin Ke Guo Baiwan Dixin Zhiyou 1000 Yuan* (独董薪酬差距大：高薪可过百万 低薪只有 1000元) ([The Significant Pay Gap Among Independent Directors: the Highest Wage Exceeds a Million While the Lowest Is Only 1000 RMB], PEOPLE.CN (Dec. 26, 2011, 8:05), http://finance.people.com.cn/stock/GB/222942/16710327.html (explaining independent directors’ backgrounds by profession) (citing 中国经济网) [hereinafter Significant Pay Gap Among Independent Directors]. Note that the total sum of the statistics is not 100%. However, the newspaper article citing the report does not explain further.
government backgrounds accounted for 8.45%; and 6.54% came from audit firms.\footnote{Id. Various surveys in China reported different statistics about the percentage of independent directors with government (public sector) backgrounds. According to another report (which seems to define the scope of government background broadly), “in a survey of 5,760 independent directors at Shenzhen and Shanghai-listed companies conducted [in 2013], fully 45% had government backgrounds.” Te-Ping Chen, \textit{Why Chinese Officials Are Resigning from Company Boards Left and Right}, \textit{WALL ST. J.} (June 11, 2014, 4:06 PM), http://blogs.wsj.com/chinarealtime/2014/06/11/why-chinese-officials-are-resigning-from-company-boards-left-and-right/ (relying on “statistics from the party-controlled China Youth Daily”). It is possible that reports used different samples. In addition, it seems that categorization among different surveys is not standardized. The reliability of the statistics could be another issue.}

To be sure, when analyzing statistics, detailed information on samples, research methodology, and categorization should be carefully reviewed and compared. For example, suppose a law firm lawyer with judicial experience (i.e., former judge) served in the past as the CEO of a corporation over which the government has exercised control. It would be difficult to set a single standard to categorize her/him as a lawyer, former judge, businessperson, person with a public entity background or person with government experience.\footnote{For instance, if the survey defines “public office” narrowly (and thus a post only in the administrative branch is treated as a “public office”), the lawyer could not be categorized as a person with a “public office” background: instead, she/he would be categorized as a person with judicial experience. On the other hand, if the survey defines “public office” more broadly (such that the concept of “public office” includes not only a post in the administrative branch but also judgeship), the lawyer could be categorized as a person with a “public office” background.} If the lawyer is currently teaching in a university as an adjunct professor, the situation is even more complicated.

Nonetheless, at large, there is a pattern in China: those whose background is in education and research in universities (or research institutes) and those who have government (or public) experience account for a large portion of independent directors. Regarding this phenomenon in China which has been influenced by Confucian tradition,\footnote{See, e.g., Robert D. Kaplan, \textit{Asia’s Rise Is Rooted in Confucian Values}, \textit{WALL ST. J.} (Feb. 6, 2015, 3:32 PM), http://www.wsj.com/articles/asias-rise-is-rooted-in-confucian-values-1423254759.} a couple of points are worth noting further. First, since individuals with high education and research experiences are highly respected in society, corporations tend to have many professors as independent directors.\footnote{Teachers in China are highly respected in society as well. See, e.g., Sean Coughlan, \textit{Teachers in China Given Highest Level of Public Respect}, \textit{BBC.COM} (Oct. 14, 2013), http://www.bbc.com/news/education-24381946.} Second, corporations also show their clear preference of independent directors with government backgrounds.

The second point can be explained with a variety of reasons. (1) The most capable college students in China often start their careers as government officials.\footnote{See John P. Burns, \textit{Civil Service Reform in China}, 7 OECD J. \textit{BUDGETING} 10 (2007), http://www.oecd.org/gov/budgeting/44526166.pdf (“The Chinese government has been largely successful in}
active role in the domestic economy, experience in the government is crucial in understanding business even in private companies as well as state-owned enterprises (SOEs). Thus, those who work for the government are appealing independent director candidates for corporations. (2) Also, in general, individuals with civil service experience are most aware of complicated, cumulative government regulations and possible answers to solve regulatory issues (for example, they can find regulatory loopholes in favor of corporations). (3) For the purpose of maintaining influence in companies or providing job opportunities to retired government officials, it is alleged that the government sometimes pressures companies, implicitly or explicitly, to recruit retired government officials. (4) Corporations, through their independent directors with government background, are also interested in opportunities to let the government listen to their opinions. (5) In addition, in Korea, corporations, which have litigations or that are investigated by government agencies, have a good chance of recruiting independent directors with legal or government experience. This observation indicates that corporations may attempt to use some of their independent directors as lobbyists; this phenomenon also provides a meaningful implication to China, when the Chinese independent director system is analyzed.

In China, civil servants and members of the Communist Party are subject to the restrictions of activities in business entities. According to the Civil Servant Law of the People’s Republic of China, without prior approval, incumbent civil servants, not to mention government officials, are not allowed to have a post in a business entity (including an independent directorship). Recently these restrictions on civil servants and party members have been reinforced. In October 2013, for example, Chinese authorities clarified restrictions in the “Opinion on Further Regulations of Holding Positions in

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44 See, e.g., Jong-Hyuck Kim, 관료 출신 사외이사, 한국 30대그룹은 39% . . . 표준 100대 기업은 9.9% [Individuals with Government Backgrounds Account for 39% of Outside Directors in 30 Largest Corporate Groups in Korea . . . Fortune 100 Companies Have 9.9%], CHOSUN ILBO (Aug. 26, 2015, 10:45 PM), http://premium.chosun.com/site/data/html_dir/2015/08/26/2015082601118.html (citing a survey from CEO Score).

Enterprises by Leading Cadres of the Party and the Government.\footnote{Guanyu Jinyibu Guifan Dangzheng Lingdao Ganbu zai Qiye Jianzhi (Renzhii) Wenti de Yijian (关于进一步规范党政领导干部在企业兼职(任职)问题的意见) \[The Opinion on Further Regulations of Holding Positions in Enterprises by Leading Cadres of the Party and the Government] \[announced by Organization Department of the CPC Central Committee, Oct. 19, 2013] \[hereinafter Opinion on Further Regulations].\n}{\n\footnote{For a further explanation of the definition of “leading cadre,” see Yin Shen (尹深) & Tong Zongli (佟宗莉), Zhongjiwei Xiangjie “Dangyuan Lingdao Ganbu” Fanwei (中纪委详解“党员领导干部”范围) \[The Chinese Communist Party Central Commission for Discipline Inspection’s Interpretation on the Scope of “Leading Cadre”] \PEOPLE.CN \[Nov. 26, 2015], http://politics.people.com.cn/n/2015/1126/c1001-27858472.html.]\n}{\n\footnote{See Opinion on Further Regulations, supra note 46.}\n}{\n\footnote{Id. Even if three years have passed since her/his retirement or resignation, in order to have a post in a business entity, a leading cadre needs to report to, and file information with, the organization department of the party or the government that she/he worked for. Id.}\n}{\n\footnote{Id.}\n}{\n\footnote{Jiaoyu Bu Bangong Ting Guanyu Kaizhan Dangzheng Lingdao Ganbu zai Qiye Jianzhi Qingkuang Zhanxiang Jiancha de Tongzhi (教育部办公厅关于开展党政领导干部在企业兼职情况专项检查的通知) \[Notice from General Office of the Ministry of Education: Launching Special Inspection on the Party Leading Cadres’ Holding Positions in Enterprises] \[announced by Ministry of Educ., Nov. 3, 2015] \See also China’s Message to Its Professors: Get Back to the Classroom, BLOOMBERG \[Jan. 4, 2016, 7:00 AM], http://www.bloomberg.com/news/articles/2016-01-03/china-s-message-to-its-professors-get-back-to-the-classroom.]\n}{\nThe definition of "leading cadre" is broad and includes mid-level officials (let alone high-level ones) and officials in SOEs.\footnote{Id.}\n}{\nThus, if the enforcement of these regulations is strict, the impact will be very strong.

Under these regulations, for instance, an incumbent leading cadre is not able to hold a post in a business entity (including an independent directorship).\footnote{Id.}\n}{\nIn addition, if a business entity’s activities were related to, in terms of geography and business fields, her/his job when she/he was in public office, even a retired (or resigned) leading cadre is prevented from holding a post in the business entity for three years.\footnote{Id.}\n}{\nIf a corporation’s business activities are not related to, in terms of geography and business fields, a retired (or resigned) leading cadre’s former job in office, she/he might have a post in the corporation even within three years; however, in that case her/his post in a business entity is subject to the approval of the organization department of the party (or government) branch that she/he worked for.\footnote{Id.}\n}{\nEven in case where a post in a corporation is permitted, leading cadres—including retired and resigned ones—are subject to additional restrictions: they should not receive financial benefits (e.g., salary and equity); they may not be able to have more than one post; they are not able to hold a post in a business entity when over 70 years old.

In addition, Ministry of Education announced that professors with certain positions were also subject to restrictions.\footnote{Jiaoyu Bu Bangong Ting Guanyu Kaizhan Dangzheng Lingdao Ganbu zai Qiye Jianzhi Qingkuang Zhanxiang Jiancha de Tongzhi (教育部办公厅关于开展党政领导干部在企业兼职情况专项检查的通知) \[Notice from General Office of the Ministry of Education: Launching Special Inspection on the Party Leading Cadres’ Holding Positions in Enterprises] \[announced by Ministry of Educ., Nov. 3, 2015] \See also China’s Message to Its Professors: Get Back to the Classroom, BLOOMBERG \[Jan. 4, 2016, 7:00 AM], http://www.bloomberg.com/news/articles/2016-01-03/china-s-message-to-its-professors-get-back-to-the-classroom.]\n}{\n“Until recently, \footnote{Until recently,}}
university professors at state universities had thought themselves exempt from a 2013 ban on high-level government officials and Communist Party members holding corporate jobs, a restriction installed as part of the nation’s anti-corruption drive. This belief was tested “when the education ministry threatened disciplinary action against higher-ranked academics who fail to register their corporate assignments.” Recently, “[h]undreds of senior academics are quitting lucrative seats on the boards of Chinese companies.”

III. CRITICISMS OF INDEPENDENT DIRECTORS AND ANALYSES IN THE CHINESE CONTEXT

Although the independent director system has been instated in many countries including China, it is not a perfect solution to corporate governance problems. This Part outlines classical criticisms of the independent director institution. The analysis is further explored in the context of Chinese corporate governance. In addition, comparative analysis based on the experiences in the United States will be discussed.

A. “Independence” of Independent Directors and Related Concerns

One of the most fundamental criticisms of the independent director institution is that naming “independence” does not actually guarantee the independence of directors. Indeed, defining/qualifying the “independence” is extremely difficult. Many jurisdictions attempt to set conditions, albeit not perfectly, for “independence.” In China, the Guidance Opinion provides disqualifying conditions for the “independence” of directors. Under the short list with enumerated “negative standards,” as discussed, there are many ways to circumvent by inventing a creative situation, where an individual is not really independent, but does not fall within the stipulated disqualifying conditions for the independence. Of course, it also creates dilemma to attempt to define “independence” of directors based on “positive standards.” Irrespective of having negative standards or positive standards of being independent directors, the court may ultimately determine whether a board is independent in a specific case when there is a
dispute. In many jurisdictions outside the United States, however, it is likely that at least three different forms of obstacles exist. First, it is probable that courts, particularly in civil law jurisdictions, are reluctant to interpret the meaning of statutes in a wide and aggressive manner. They tend to stick with a short list with negative standards or positive standards. Second, even if a court is willing to actively interpret, the inefficiency of litigation—in terms of expeditiousness in a court—may generate uncertainty: prolonged uncertainty in relation to “independence” of directors in litigation would be counterproductive to corporations and the business circle. It is also possible that a party, who challenges management or corporate insiders of a company, raises a question of “independence” on purpose as a litigation strategy. Third, a more fundamental issue in such jurisdictions is that the frequency of shareholder litigation is very low, since shareholder litigation (for example, shareholder derivative suit) is not often used in many countries. Under these circumstances, there would be virtually no chance to discuss in court the “independence” of a board or a particular director. For instance, although a derivative suit system was adopted in Korea in the early 1960s, it was not used until 1997. In China, a derivative suit system did not work well partly due to the high shareholding threshold.

Also, even in the United States, it seems that a board’s independence—if there are a majority of “independent directors”—is presumed at large. In Unocal, for example, the court pays attention to the “composition” of a board where outside directors constitute a majority of directors. Perhaps, In re Oracle Corp. Derivative Litigation is special in the sense that the Delaware court pointed out the outside directors’ lack of independence in the case where corporate insiders and (so-called) independent directors in a special litigation committee had the intimate social network (the Stanford University network in this case).
If the court does not provide a solution to the difficult question of “independence,” an alternative could be a government agency to judge whether a board collectively or a particular individual director is truly independent. In China, the CSRC, the watchdog in the capital market, is a main candidate that can provide case-by-case positive and negative standards for independence of directors. On the one hand, relying on a decision made by a government agency would markedly improve the administrative/litigation efficiency in terms of a quick response to the question of the “independence” that the market raises. On the other hand, however, a government agency’s decision would pose a risk of substantial government intervention in a boardroom, the locus of corporate governance.

B. Lack of Information and Expertise

Another conventional criticism of the independent director institution is that independent directors, compared with inside directors, do not have the expertise on business issues of the corporation that they work for. Even if an independent director is an expert in business in general (for example, business strategies, finance, economics, marketing, and law), it does not mean that she/he has expertise in the particular business and industry that a corporation is engaged in. On the other hand, even if an independent director has the expertise in a specific technology, this expertise does not necessarily extend to a macro level.

Corporate insiders tend not to voluntarily give a large amount of significant, meaningful information to independent directors. For this tendency, at least three explanations can be suggested. First, corporate insiders may believe that the presence of informed independent directors, whose loyalty for the organization (i.e., the corporation) is not guaranteed, would be potentially dangerous. Second, independent directors tend to work for a corporation for a short period of time. Accordingly, some corporations—even if they do not deliberately keep independent directors less informed—consider providing information to independent directors to be inefficient and unjustifiably costly. Third, it is probable that providing information to independent directors enables them to have merely “shallow knowledge.” From the standpoint of (at least some) corporate insiders, independent directors with “shallow knowledge” could be far riskier than independent directors with “zero knowledge.”

Independent directors, who usually have other jobs (e.g., a professor) outside a corporation where they serve as directors, do not

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64 See Shen & Jia, supra note 13, at 229 (“[E]ven truly independent and diligent directors lack information and resources to effectively monitor management.”).
have enough time to handle complicated transactions and corporate governance problems. This tendency is reinforced when an independent director holds multiple directorships. In such cases, while managers concentrate their human capital in one corporation, independent directors diversify their human capital across several corporations. As a result of diversifying human capital, an independent director would not have a strong incentive to explore information in a corporation where she/he serves.

According to the Guidance Opinion, in principle, an independent director is allowed to work for up to five corporations. It is generally true that when an independent director has more directorships, the independent director can spend less work time for each corporation and is less informed. On the other hand, an independent director with multiple directorships would be able to take advantage of the “economies of scope” of being an independent director, meaning that she/he can improve efficiency by applying her/his knowledge from experience as a director in another corporation in a different industry. “Economies of scale” of independent directorships is also theoretically possible if an independent director works for multiple corporations in the same industry. In that case, a similar set of expertise and knowledge, which the independent director learns from a corporation, can be directly used in the other corporations. Accordingly, the problem in relation to an independent director’s lack of information, expertise, and time to work for one corporation would be, at least partially, mitigated. On the contrary, it is also risky that each corporation in the same industry has the same information repository (namely, an independent director) that could leak crucial information to other competitors.

C. The Presence of Independent Directors and a Corporation’s Performance

Under the shareholder wealth maximization norm, the ultimate goal of a corporation is to improve corporate performance for

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65 See, e.g., Jeffrey A. Sonnenfeld, What Makes Great Boards Great?, 80 HARV. BUS. REV. 106, 107 (2002) (“[S]ome WorldCom directors were on more than ten boards, so how well prepared could they be?”).
66 Inside directors face a similar situation. See Bhagat & Black, supra note 1, at 264 (“Inside directors lack independence, but have their human capital, and often most of their financial capital, committed to their company.”).
67 Guidance Opinion, art. 1 (2).
68 Economies of Scale and Scope, THE ECONOMIST (Oct. 20, 2008), http://www.economist.com/node/12446567 (Economies of scope are “factors that make it cheaper to produce a range of products together than to produce each one of them on its own.”).
69 Id. (“Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output increases.”).
Regarding the independent director institution, a relevant question is whether the institution—for instance, if a corporation’s board is comprised of more independent directors—really enhances the corporation’s performance and ultimately, stock price. In theory, when more independent directors work for a board, they can monitor management more effectively: then, an independent board can prevent executives from shirking responsibility, wasting corporate resources, or taking illicitly corporate assets, so that the level of a corporation’s income would be improved, resulting in a higher stock price. If so, agency problems, generated by corporate insiders, are expected to be lessened to a large extent, and the corporate value—that will ultimately accrue in favor of shareholders, the residual claimants—could be significantly enhanced.

Such a prediction based on the theory, however, is not firmly supported by empirical corporate governance studies. Often, “correlation between the presence of independent directors and the firm’s economic performance” is weak, or nonexistent. Moreover, an empirical study showed even “a negative correlation between the proportion of independent directors and firm performance.” In China, the effect of an independent director on a firm’s performance is mixed including outcomes with a negative effect; indeed, few studies in China conclude either the positive or negative effect of independent directors in a statistically significant manner. For this puzzling phenomenon (particularly when there is a negative correlation or no significant correlation), there are at least four possible explanations.

First, it is possible that the “independence” of a board is one thing, and the “efficiency” of a board is another thing. While an “efficient” board can improve corporate performance, an “independent” board is not necessarily designed to improve

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70 See, e.g., Mark J. Roe, The Shareholder Wealth Maximization Norm and Industrial Organization, 149 U. Pa. L. Rev. 2063, 2065 (2001) (“Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles.”).

71 See, e.g., Bhagat & Black, supra note 1, at 233 (“[D]oes greater board independence produce better corporate performance, as conventional wisdom predicts?”).


76 Id. (“A prevailing majority of 30 studies report that board independence in terms of the proportion and number of independent directors on the board of directors and the adoption of the independent director institution has no significant impact on firm performance.”).
corporate performance. This explanation can also be supported by the point discussed earlier: an independent director is not necessarily a business expert,\textsuperscript{77} and she/he does not have enough time to develop her/his skills for a specific business model.\textsuperscript{78} Second, as discussed before, it is also possible that directors, who are labeled as “independent” are not really independent.\textsuperscript{79} Thus, even if truly independent directors might improve the performance of a corporation, independent directors in name only would not improve the performance of a corporation. Third, as Jeffrey Gordon explained, at least in the United States, it is likely that “corporate governance . . . [i]s already quite good, and thus marginal improvements in a particular corporate governance mechanism would expectedly have a small, perhaps negligible, effect.”\textsuperscript{80} Fourth, it is also probable that “underperforming firms may add more independent directors in the hope that the governance change will improve performance; on cross-sectional comparison, that causal connection will be blurred.”\textsuperscript{81}

The first explanation—i.e., independence and efficiency are different—relates to the concern that independent directors are not well informed and do not have expertise in monitoring and advising corporate issues.\textsuperscript{82} In China (like other countries), many independent directors have social connections with corporate insiders, but they are not necessarily efficient monitors and advisors. Under some circumstances, a corporation might benefit from independent directors who are celebrities; their presence might work as a means of advertisement and draw attention from the media and general public. If the purpose of having a movie star independent director is to advertise a corporation to the general public, however, a similar (and more efficient) goal can also be achieved by having the corporation directly advertise the product, service or the corporation itself through a commercial film with the movie star.

The third explanation—namely, the marginal improvements of an independent director system for shareholder protection would be tiny in a jurisdiction with the sufficient corporate governance mechanisms—highlights another implication of the independent director institution in China. As opposed to the situation in the

\textsuperscript{77} See supra Part III. B.
\textsuperscript{78} See supra Part III. B.
\textsuperscript{79} See supra Part III. A; see also Bhagat & Black, supra note 1, at 266 (“[It is possible] that some directors who are classified as independent are not truly independent of management, because they are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of ‘independence.’”).
\textsuperscript{80} See Gordon, supra note 73, at 1468.
\textsuperscript{81} Id. at 1500 n.141.
\textsuperscript{82} See also supra Part III. B.
United States, the general quality of the corporate governance in China still has huge room for improvement. Thus, it is probable that adding more independent directors would greatly enhance a corporation’s performance. For instance, shareholder litigation, such as a derivative suit system, is not well developed in China. If the Chinese corporate governance regime does not provide an effective derivative suit system for investors, it is possible that the marginal benefits of adding an efficient independent director institution would be significant, as opposed to the situation in the United States.

The extent of the marginal improvements of the independent director system in China is a critical inquiry that empirical studies of corporate governance ultimately have to answer. Also, it is noteworthy that in China, a regulation requires that a third of directors in a listed corporation be independent directors. By contrast, a U.S. exchange rule requires a listed company to have a board with a majority of independent directors; one report explains that independent directors account for 83% of directors in S&P 500 companies. In other words, the independent director institution in China, compared with that in the United States, has a built-in limit as a monitoring and advisory mechanism, since independent directors generally do not comprise the majority of board members. Accordingly, it is likely that other things being equal, the impact of independent directors in China—even if they are truly independent—is smaller than in other countries where independent directors comprise the majority of board members.

D. Independent Directors’ Pecuniary and Non-Pecuniary Benefits

Independent directors enjoy various types of benefits, both pecuniary and non-pecuniary, from their directorship. First, they receive basic remuneration. An independent director could gain a decent amount of financial benefits when she/he holds multiple directorships, in addition to her/his own main job. Also, independent directors often take advantage of a variety of perquisites provided by corporations.

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83 See supra note 61 and accompanying text.
84 See supra note 80 and accompanying text.
85 For extant empirical studies, see e.g., supra notes 75-76 and accompanying text. For a recent study, see Yu Liu et al., Board Independence and Firm Performance in China, J. Corp. Fin. 223, 224 (2015) (concluding that “board independence improves firm operating performance in China”).
86 Guidance Opinion, art. 1 (3).
Second, if independent directors receive stock options (or other types of stock-related compensation), they can anticipate future economic interests from the rise of a corporation’s stock price. A compensation mechanism based on stock options and stock, if available to independent directors, has two opposing effects on the independence of directors. On the one hand, independent directors would have a stronger incentive to monitor corporate insiders, and enhance the corporation’s value in favor of shareholders, since they personally can gain financial benefits from increased stock price. On the other hand, with such a compensation package, the economic incentives of independent directors are highly correlated to those of corporate insiders: accordingly, there is no clear distinction between corporate insiders and independent directors. Then, independent directors would not be independent anymore. As discussed, the Guidance Opinion does not allow an independent director candidate to hold more than 1% shareholding in a corporation that she/he intends to work for. Perhaps, one reason for such regulation in China is that the CSRC is concerned about the economic alignment between an independent director and a corporation. Another unintended consequence of stock options as a compensation mechanism for independent directors is that independent directors might not monitor corporate insiders as tightly as they should, particularly when the stock price of a corporation (and thus, the value of stock options for corporate insiders and independent directors) is unjustifiably inflated. Without investigating the possibility of fraud, independent directors would enjoy pecuniary benefits from the inflated value of stock options.

89 See, e.g., Eliezer M. Fich & Anil Shivdasani, The Impact of Stock-Option Compensation for Outside Directors on Firm Value, 78 J. BUS. 2229, 2229 (2005) (“[S]tock-option plans help align the incentives of outside directors and shareholders, thereby improving firm value.”); see also Shen & Jia, supra note 13, at 241 (“Equity ownership would put independent directors in the shoes of the minority shareholder, which would give them a ‘shareholder orientation’ and ‘a genuine interest’ in the corporation.”) (citing Letter from Warren Buffett).
90 See Gordon, supra note 73, at 1488.
91 Guidance Opinion, art. 3 (2).
92 For instance, it is plausible that independent directors holding a significant amount of a corporation’s shares would not be willing to reveal any bad news that will lower the stock price. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1242 (2002) (“[S]tock-based director compensation may enhance the board’s vigor as a shareholder agent but also increase its ambivalence about uncovering embarrassing facts that will reduce the share price.”).
93 For instance, Enron’s independent directors holding stock and stock options did not properly monitor corporate insiders. See id., at 1241 (“[Enron’s] board was a splendid board on paper, fourteen members, only two insiders . . . Most of the directors owned stock, some in significant amounts, and almost all had received stock options or phantom stock as part of the director compensation package.”).
94 See, e.g., Gordon, supra note 73, at 1488 (“The director receiving stock-based compensation, like the similarly compensated CEO, may be tempted to accept aggressive accounting rather than stock-price-
Third, in addition to pecuniary benefits, independent directors take advantage of psychological benefits from serving as directors: they can enjoy special treatment and fame in their field, a product market and a capital market, and society in general. Indeed, “a directorship is also likely to provide prestige and valuable business and social connections.”\(^{95}\) By being an independent director of a large corporation, she/he becomes a VIP. Accordingly, an independent director will have an opportunity to expand the scope of her/his social network and influence. For instance, it is also likely that within an inner circle, an independent director has a chance to be recommended for an independent directorship of another corporation (and thus she/he will receive director compensation). As a result, psychological benefits from being an independent director—whether directly or indirectly—are often related to monetary benefits.

According to a report, in 2011, the range of compensation for independent directors in China is wide from 1 thousand RMB to 1 million RMB \(^{96}\) (1 thousand RMB and 1 million RMB are approximately $154 and $154,000 respectively).\(^ {97}\) For instance, in 2011, Alberto Tongni, an independent director of Bank of China, received 1.08 million RMB (approximately $166,000).\(^ {98}\) In 2013, the “most expensive” independent director in China was Ba Shusong (巴曙松) who worked in China Minsheng Bank: his compensation was 1.05 million RMB (approximately $161,500).\(^ {99}\) It is reported that, in 2013, the average of independent director compensation in China was 68,400 RMB (approximately $10,500).\(^ {100}\) Another report released that, in 2012, the amount of the average compensation was 71,300 RMB (approximately $11,000).\(^ {101}\) Also, it is generally known


\(^{96}\) See Significant Pay Gap Among Independent Directors, supra note 37.

\(^{97}\) During the recent two years (2015 and 2016), the exchange rate between the Chinese Renminbi (RMB) and the U.S. dollar had varied from 6.2: 1 to 6.9:1. For simplicity, in this Article, I apply the 6.5: 1 exchange rate between RMB and the U.S. dollar.

\(^{98}\) See Significant Pay Gap Among Independent Directors, supra note 37.


\(^{100}\) See Yang Liuhan (杨柳晗), Dunong Xinchou Zuigao Jingda Baiwan (独董薪酬最高竟达百万) [Highest Compensation for Independent Director Unexpectedly Reaches One Million Yuan], YICAI.COM (May 5, 2014, 10:34), http://www.yicai.com/news/2014/05/3774495.html (introducing a survey of 6,950 independent directors in China in 2013).

that independent directors working in the finance sector (banks, securities firms, insurance companies, etc.) tend to receive a higher level of compensation.\textsuperscript{102}

One may argue that a large amount of compensation for independent directors is costly to corporations and ultimately to investors of such corporations. As of 2012, according to a report, the average total pay for independent directors in surveyed U.S. companies was approximately $171,000.\textsuperscript{103} Another source reports that the pay amount of directors in S&P 500 corporations in 2015 was $255,026 (83% of directors were independent directors).\textsuperscript{104} In this respect, the absolute level of compensation for independent directors in China does not seem to be high,\textsuperscript{105} unless there is a huge amount of hidden compensation. Thus, from the standpoint of corporations and investors, the compensation for independent directors is not very burdensome in China: a claim that the compensation for independent directors in China damages the corporate value, if any, seems an exaggeration in cases where the issue of corruption does not arise in regard to the compensation of independent directors.

A more relevant problem, however, is that the level of compensation for directorship would be high enough, from the standpoint of at least some independent directors, whose main vocations do not provide high compensation. For instance, Ministry of Education published cases of “two senior academics who each

\footnotesize{(citing 第一财经日报). According to another report, on average, the total compensation of independent directors who worked for more than one corporation was 92,500 RMB (approximately $14,200). See id (introducing a survey of 5,360 independent directors in China in 2012).\textsuperscript{102} See “Most Expensive” Independent Director, supra note 99.\textsuperscript{103} ERNST & YOUNG CORPORATE GOVERNANCE CENTER, GOVERNANCE TRENDS AND PRACTICES AT US COMPANIES: A REVIEW OF SMALL- AND MID-SIZED COMPANIES 17 (2013), available at http://www.ey.com/Publication/vwLUAssets/Governance_trends_practices_at_US_companies/$FILE/Governance_trends_practices_at_US_companies.pdf. According to the report, the average pay amounts for independent directors in large-cap, mid-cap, and small-cap companies in the United States were approximately $258,000, $207,000, and $138,000 respectively.\textsuperscript{104} See Francis & Lublin, supra note 88 (citing MSCI and MyLogIQ (pay)). According to another report, the average pay amount for directors in certain U.S. banks in 2011 was $328,655. See Susanne Craig, At Banks, Board Pay Soars amid Cutbacks, NYTIMES.COM (Mar. 31, 2013, 9:57 PM), http://dealbook.nytimes.com/2013/03/31/pay-for-boards-at-banks-soars-amid-cutbacks/?_r=2 (explaining the director pay in banks based on data from Equilar, a compensation data firm). For instance, the average pay level for a director in Goldman Sachs in 2011 was $488,759 (but note that it was $670,292 in 2007). See id. “In a regulatory filing explaining the pay of its board, Goldman noted that directors could not sell the stock grants until they left the board, and even then there was a waiting period. The firm also said independent directors did not get paid to attend meetings, a practice on some other boards.” Id.\textsuperscript{106} For example, the dollar amounts of compensation for the “most expensive independent director” and average independent directors in China were approximately $166,000 and $10,500, respectively. See supra notes 96-102 and accompanying text.\textsuperscript{105} Of course, for a more rigorous comparative analysis of independent director compensation, the chance of director liability should be also taken into account. Similar view was provided by Merritt Fox during the discussion with him (July 2016).}
received more than 1 million yuan ($154,000) from their multiple
corporate directorships.”

“One million yuan is more than eight
times the average 121,681 yuan salary professors in Beijing were
paid in 2010.”

In this respect, independent directors and candidates
in China, who can hold up to five directorships, would have strong
incentives to be elected (and re-elected). Since corporate insiders,
specifically controlling shareholders, are highly influential during the
independent director nomination process and the director election,
there is reasonable concern that independent directors would have an
incentive to be friendly to corporate insiders and work as rubber
stamps for them.

E. Independent Director Institution: Defensive Mechanism?

Another weakness of an independent director system, particularly
in China, is that it can be abused as a defensive mechanism to
approve proposals that corporate insiders (e.g., a controlling
shareholder) suggest. In other words, the approval of independent
directors is designed to make conflict-of-interest transactions official
and legitimate, thereby shielding the controlling shareholder from
criticism and legal liability. This is a credible concern, especially
given extremely high approval rates of independent directors in
board meetings. Despite this concern, this Section explores the
possibility that the presence of independent directors in China could
generate corporate governance benefits to some extent.

1. Possible Misuse (or Abuse) of the Independent Director
System

In the United States, the 1980s are referred to as the “deal
decade,” when a large number of corporations were exposed to the
risk of being targets of hostile takeovers. Management in target
corporations, of course, resisted such unwanted bids from outside, by
implementing a variety of defensive tactics. In evaluating the
validity of defensive tactics of target corporations, the courts in
Delaware—the center of U.S. corporate law, where most of major
U.S. corporations are incorporated—paid more attention to whether

107 See BLOOMBERG, supra note 52. “The extra pay was confiscated from both individuals, one of
whom was dismissed, while the other was demoted.” Id.
108 Id.
109 For an individual’s incentive to be elected and re-elected as a director (including an independent
director), see generally Bebchuk & Fried, supra note 95.
110 Among defensive tactics, a poison pill is “[t]he most powerful tool to incumbents in impeding bids.”
See Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory
Competition, 87 VA. L. REV. 111, 119 (2001). For a further explanation of the effect of adopting the
poison pill in controlling shareholder economies, see generally Sang Yop Kang, Transplanting a Poison
[hereinafter Kang, Poison Pill].
an independent board exercised its role in a corporation in question.\(^{111}\) To the court—which, in a takeover, would like to avoid direct intervention into the fate of a target corporation—trusting a target board consisting of a majority of outside directors, as long as it was informed and presumed to be disinterested and independent, was a workable solution, at least in theory.

As discussed in Unocal\(^{112}\) and Moran v. Household International, Inc.,\(^{113}\) the business decision made by an independent board, comprised of a majority of independent directors, has been considered more legitimate.\(^{114}\) Given favorable court decisions with an independent board, management began to understand independent directors “as a critical element in the intellectual and legal architecture necessary to preserve managerial autonomy against the pressure of the market in corporate control.”\(^{115}\) Thus, U.S. managements accepted independent directors as “‘[t]he price of the power to ‘just say no’ to a hostile bidder’.”\(^{116}\) As such, U.S. managements reasonably accommodated themselves by taking advantage of a *theoretically* independent board (even if it was not independent in reality) as a major defensive measure in response to a challenge against managements’ autonomy.\(^{117}\)

Similar concern exists in China. “The CSRC requires independent directors of a firm to issue an opinion report following board meetings that have discussed a material corporate matter. An opinion report clearly states which director(s) agreed, and which director(s) disagreed or abstained on a focal managerial proposal at the board meeting.”\(^{118}\) According to a study conducted by Juan Ma and Tarun

\(^{111}\) See Gordon, supra note 73, at 1523 (“Director independence was a touchstone of Delaware takeover cases even before the tumultuous 1980s, but it became especially critical then because of the extraordinary, unprecedented measures undertaken by targets to thwart hostile bids.”).

\(^{112}\) Unocal Corp. v. Mesa Petroleum Co., 493 A.2d. 946 (Del. 1985).


\(^{114}\) Unocal Corp. v. Mesa Petroleum Co., 493 A.2d. 946 (Del. 1985).

\(^{115}\) See Gordon, supra note 73, at 1526.


\(^{117}\) For a similar view, see Shen & Jia, supra note 13, at 229-30 (“[I]nsiders of public corporations welcome independent directors because they shield management from the aura of impartiality and legal liability.”) (citing Donald E. Pease, Outside Directors: Their Importance to the Corporation and Protection from Liability, 12 DEL. J. CORP. L. 25, 35-40 (1987)).

\(^{118}\) Ma & Khanna, supra note 7, at 4. A similar survey was conducted in Shanghai Stock Exchange in 2012. See Shanghai Zhengguan Jiaoyisuo Ziben Shichang Yanjiusuo (上海证券交易所资本市场研究所) [Shanghai Stock Exchange Capital Market Research Institute], 2012 Niandu Hashi Shangshi Gongsi Zhili Zhuanzhuang Diaocha He Yanjiu Baogao (2012年度沪深上市公司治理专题调查和研究报告) [2012 Special Investigation and Research Report on Corporate Governance of Listed Companies in
Khanna, 211 out of 24,212 opinion reports issued by independent directors, from August 2001 to June 2010, were identified as dissenting opinions; in other words, dissenting opinions—which included abstention as well as disagreement—accounted for only 0.9% of all opinions issued by independent directors. The survey shows that independent directors in China generally act as rubber stamps. Moreover, the survey indicates that the independent director system is abused as a defensive mechanism that justifies decisions made by controlling shareholders and corporate insiders. The hierarchical command system has been simply transformed from the system, where a controlling shareholder issues orders to executives directly, to another system, where a controlling shareholder issues orders to executives from behind the shield of independent directors.

2. Independent Directors: Rubber Stamp, But Not Absolutely
Nonetheless, it is likely that extremely high approval rates in the surveys (higher than 99%) are overstated. This is because an approval rate is calculated based on proposals that are already passed during the informal discussion session between directors and corporate insiders. It is known that, when a controversial proposal is discussed before an official board meeting, independent directors sometimes raise objections to the proposal that corporate insiders plan to suggest in a board meeting. In such cases, it is possible that corporate insiders may make the decision not to deliver the proposal to a board meeting room, and thus some controversial transactions and proposals would be screened out during the informal discussion session or private conversations before the official board deliberation (i.e., independent directors’ “direct deterrence”). In addition, being concerned about possible controversies, it is probable that corporate insiders voluntarily—even without having an informal discussion session—withdraw problematic topics from a list of a board’s proposals (i.e., a controlling shareholder’s “self-censorship”).
Independent directors often have close relationships with a controlling shareholder. Vis-à-vis a controlling shareholder, however, outsiders, such as professors and retired government

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See Ma & Khanna, supra note 7, at 11.

Id. ("We define disagreement as an overt dissent, and abstention as a situation in which a director chose not to issue an opinion. In the rest of the paper, for brevity, we refer to either disagreement or abstention as 'dissent'.") (emphasis in the original).

officials, are subject to a less established hierarchy than inside directors. Thus, at least sometimes, a controlling shareholder is reluctant to even talk privately with independent directors—let alone discuss officially in a board room—about an egregious transaction. Put differently, the controlling shareholder would not really trust independent directors who are professors, retired government officials, former judges and prosecutors; these independent directors might be beholden to the controlling shareholder, but not fully obedient to her/him. In such case, it is probable that the controlling shareholder would not want to share her/his secret, illegitimate plans with independent directors, and thus the controlling shareholder voluntarily (but reluctantly) refrains from business policies with serious conflicts of interest. In this respect, the independent director system, despite its embedded weaknesses, works, to some extent, as a monitoring mechanism even in a controlled corporation. This issue will be discussed further in Part IV.B with respect to recent regulations in China, imposed on the business roles of individuals with government/party experience (and professors).

F. Controlling Shareholder Ownership

In a typical U.S. corporation, there are numerous shareholders who hold fractional share-ownership. In most countries outside the United States, in general, a controlling shareholder has control over a corporation. China belongs to a group of countries with controlling shareholder ownership. China is special in the sense that most of large corporations are SOEs and the state is the controlling shareholder. As the Chinese economy has developed, the significance of privately owned enterprises with individual controlling shareholders has grown.

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122 See infra Part IV. B.
123 See infra Part IV. B.
125 See generally Rafael La Porta et al., Corporate Ownership Around the World, 54 J. FIN. 471 (1999).
127 Note that some commentators explain that in China there is no significant difference between privately-owned companies and state-owned companies. See Curtis J. Milhaupt & Wentong Zheng, Beyond Ownership: State Capitalism and the Chinese Firm, 103 GEO. L. J. 665, 665 (2014) (“Due to China’s institutional environment, large, successful firms—regardless of ownership—exhibit substantial similarities in areas commonly thought to distinguish SOEs [(state-owned enterprises)] from POEs [(privately owned enterprises)]: market dominance, receipt of state subsidies, proximity to state power and execution of the state’s policy objectives.”).
When a system in one jurisdiction is imported to another jurisdiction, it is generally of significance to consider whether market infrastructures, the underlying institutions, and legal systems of an importing jurisdiction are similar to those in a jurisdiction exporting the system. In this respect, regarding the independent director system, which has been relatively successfully implemented in the United States (although the efficiency of the system has also been criticized in the United States), it is worth examining whether the system fits the specific ownership structure of an importing jurisdiction. This is because an ownership structure significantly affects a check-and-balance system, various types of agency problems, incentives of corporate insiders and shareholders, and power-play among corporate constituencies.

As Lucian Bebchuk and Jesse Fried pointed out, a CEO has huge influence on nominating and electing directors. Since (independent) directors have a strong incentive to be re-elected, incumbent independent directors and candidates would like to show that they are compliant to corporate insiders. As such, independent directors would not be effective monitors who supervise corporate insiders. Rather, (independent) directors and management scratch each other’s backs. For instance, a CEO supports an independent director in the director recommendation, nomination and election process, and the independent director supports (or acquiesce) the CEO’s high level of executive compensation: in any case, both are generous to each other by spending “other people’s money” (at large, shareholders’ money).

In a corporation where shares are widely held, a CEO is generally the most powerful decision-maker. However, she/he is the “first among equals” (primus inter pares) in a corporation. In addition, a CEO in a corporation with dispersed ownership is not able to stay in her/his office permanently. Sometimes, though infrequently, a CEO is fired by board members including independent directors. On the other hand, in a corporation where shareholding is concentrated, the most powerful decision-maker is a controlling shareholder. Within a corporation, a controlling shareholder and other corporate insiders

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128 See Bebchuk & Fried, supra note 95, at 655 (“And because the CEO has had significant influence over the nomination process, displeasing the CEO has been likely to hurt one’s chances of being put on the company slate.”).
129 See supra Part III. D.
130 The expression of “you scratch my back, I’ll scratch yours” is often used in relation to the high compensation level of CEOs. See, e.g., *Fat Cats Feeding: Why Are Company Bosses Being Paid Such Large Sums of Money?*, *The Economist* (Oct. 20, 2003).
131 In this sense, there is virtually no arm’s-length contracting relationship between a CEO and independent directors. See Bebchuk & Fried, supra note 95, at 654-59 (explaining the limits of arm’s length contracting between a CEO and directors).
have a strictly hierarchical relationship. Unless a corporation goes bankrupt or a controlling shareholder sells the corporation, the controlling shareholder can maintain her/his capacity as controlling shareholder for her/his lifetime. What is more, when a controlling shareholder retires or dies, her/his children will succeed the controlling shareholder’s title. In this respect, a controlled corporation is a corporate dynasty. 132 In addition, generally a controlling shareholder—if she/he holds a majority of voting power—cannot be replaced by an external threat such as a takeover. In sum, while a CEO in a corporation with diffused ownership is like a “consul” in the Roman Republic, a controlling shareholder in a controlled corporation is more like an “emperor” in the Roman Empire. 133

Accordingly, it is impractical (if not impossible) for independent directors, who can ostracize a CEO in a corporate republic, to overthrow a corporate empire reigned by a controlling shareholder. Thus, in terms of stability to maintain a title and a post, the relative power of a controlling shareholder is much stronger than that of a CEO. As a result, during the processes of recommendation, nomination, and election of independent directors, a controlling shareholder has more power to choose candidates and elect independent directors. In a corporation with diffused shareholding, a CEO—although she/he is the most powerful among corporate insiders and influential to shareholders—is not the person who ultimately selects independent directors: although candidates recommended by a CEO often win director elections, all a CEO can officially do is merely request that shareholders cast their votes in favor of candidates whom the CEO supports, since the CEO by herself/himself does not hold the sufficient number of votes to elect independent directors. In a controlled corporation, in contrast, by relying on her/his own voting power in a director election, a controlling shareholder can directly elect the independent directors she/he likes. 134

The independent director institution is not perfect even in the United States, where the general quality of corporate governance is very high and the economy is based on the dispersed ownership. If

132 See, e.g., Sang Yop Kang, Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace, 16 UNIV. PA. J. BUS. L. 843, 872 (2014) (“A controlling shareholder can stay in office as long as he is alive, and eventually his children will succeed his throne.”).

133 Id. (“A top manager of a large public corporation in the United States is analogous to a consul in ancient Rome. To the contrary, a controlling shareholder in a developing country is comparable to an emperor (or princeps, i.e., the first citizen like Augustus) of Rome.”).

134 It is possible that a jurisdiction can impose limits on controlling shareholders’ voting power. See also infra note 147.
so, the independent director institution in China, where the general quality of corporate governance is not high and the economy is based on the controlling shareholder ownership, is worse than that in the United States. Particularly in an economy with the controlling shareholder ownership, “tunneling” (i.e., wealth transfer from a corporation to a controlling shareholder) is perhaps the most serious corporate governance problem.  

A main purpose of the independent director system in an economy with controlling shareholder ownership, like China, is to reduce the agency problems that controlling shareholders generate. Due to the low quality of corporate governance and the innate drawbacks of the controlling shareholder ownership, however, it is difficult to have a well-functioning independent director institution in China.

Under such circumstances, in order to protect non-controlling shareholders of a corporation from a controlling shareholder’s expropriation, it might be useful to implement a cumulative voting system in a corporation. This is mainly because cumulative voting is more advantageous to non-controlling shareholders than straight voting. A cumulative voting system, however, is basically effective only to a small number of large non-controlling shareholders (often institutional investors), who potentially compete with a controlling shareholder for the corporate control. Thus, a large number of small non-controlling shareholders, who are usually dispersed individual investors, do not generally take advantage of a cumulative voting system. In addition, since institutional investors, who potentially are powerful non-controlling minority shareholders,

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136 See JEFFREY D. BAUMAN & RUSSELL B. STEVENSON, JR., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 384 (8th ed. 2013) (“With cumulative voting, each share [ ] carries a number of votes equal to the number of directors to be elected, but a shareholder may ‘cumulate’ her votes.”).

137 See id. (“In a straight voting regime, any shareholder or group of shareholders controlling more than 50% of the shares can elect all of the members of the board. Cumulative voting, an alternative method, allows shareholders to elect directors in rough proportion to the shares they own even if that number is less than 50%.”).

are not well developed in Chinese capital markets, cumulative voting in listed corporations is less useful. Moreover, a controlling shareholder is able to neutralize the effect of cumulative voting by reducing the size of a board and/or by implementing a staggered board. Given the situation in China, in this respect, so far cumulative voting is not a useful corporate governance tool to the independent director institution.

IV. OTHER CONSIDERATIONS OF THE INDEPENDENT DIRECTOR SYSTEM IN CHINA

Part III discussed classical criticisms of the independent director system and potentially more serious obstacles in Chinese corporations. Based on the preceding discussion, Part IV explains other considerations of the independent director system in China.

A. Reputation-Based Mechanism of the Independent Director System

According to the traditional corporate governance view, it is often suggested that an independent director has an incentive to monitor corporate insiders tightly, partly because the independent director would like to develop reputation as a good monitor in the independent director market, a special type of labor market. When a particular independent director fails to monitor corporate insiders in an efficient way, the logic continues, market participants—shareholders and prospective investors in a capital market—perceive the independent director as a director with poor performance or as merely a rubber stamp, who blindly concedes to corporate insiders’ decisions to the detriment of minority shareholders. Then, shareholders of the corporation, whom the poorly performing independent director serves, would punish the inefficient independent director by not supporting her/him in the next director election. Thus, the market mechanism based on word-of-mouth works and maintains the quality of independent directors’ service, i.e., monitoring corporate insiders.

For a few reasons, however, such a reputation-based reward/punishment system does not ideally work well. Most of all, shareholders—or more broadly, prospective investors in a capital

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140 See BAUMAN & STEVENSON, supra note 136, at 385.

141 See, e.g., Kang, supra note 59.

market—are not able to evaluate well the efficiency, the extent of monitoring, and the independence of a particular independent director. What most capital market participants can observe are final resolutions of a board meeting.

For the detailed information on the votes, capital market participants may be able to see minutes of a board through disclosure and shareholder information rights (or it could be required for directors to disclose their votes to government agencies and/or the market). As discussed before, however, the approval rate—namely, a director’s vote in favor of a proposal proposed by corporate insiders—is likely to be overstated. This is because corporate insiders sometimes do not propose a proposal in a board meeting, when directors are opposed to it in advance in informal discussion or when the proposal is seriously problematic and corporate insiders are concerned about the later information leakage, through independent directors, to the public and/or enforcement agencies. As a result, some tainted proposals or transactions do not survive before a formal board meeting. The problem is that capital market participants are not able to discern a particular independent director’s successful monitoring activity and contribution in the pre-board meeting stage.

Particularly in China, people who work for an organization are culturally encouraged to do their best to solve a problem within the organization. Accordingly, when independent directors find problems about the corporation that they work for, it is highly likely that they prefer privately discussing problems with management or a controlling shareholder to disclosing such information to the public. As a result, the reputation-based reward/punishment system, which should rely on publicly available information on specific independent directors’ monitoring activities, could be significantly distorted.

More fundamentally, in evaluating an independent director’s monitoring activity and independence, capital market participants are subject to the collective action problem: from a standpoint of an individual investor, the private benefit from checking monitoring and the independence of a particular independent director is negligibly small because benefits are shared with a great number of investors, while the private cost of time and resources to check is attributed to the one individual investor who does evaluate independent directors. As a result, capital market participants are “rationally
apathetic”\textsuperscript{145} to the seriousness/efficiency of a particular independent director’s monitoring.

In theory, this type of rational apathy can be possibly alleviated, at least to some extent, by the presence of strong institutional investors that have a large amount of shareholding. In China, however, institutional investors are neither well developed nor major market players. In addition, in SOEs, it is difficult for institutional investors to be against a specific independent director, who is in reality supported by the government: many institutional investors are either related to the government or under its influence. Also, if the economic interests of institutional investors are fractional (although institutional investors have often more economic interests in a corporation than fragmented individual shareholders), the role of institutional investors is limited as well.

A more serious obstacle of the reputation-based mechanism in the independent director market is that shareholders of a corporation and prospective investors in the capital market are not the only audience. Particularly in China, another important audience of independent directors’ reputation is the group of controlling shareholders, since China is an economy where controlling shareholders (either individuals or the government) are dominant market players.\textsuperscript{146} Since directors are elected at a shareholder meeting, a controlling shareholder, who holds a majority of (or a great number of) votes in a corporation, can elect directors including independent directors. Thus, voting of non-controlling shareholders might be even futile, in a context of electing directors.\textsuperscript{147} In this respect, it is important to

\textsuperscript{145} Rational apathy is originally explained in a context of shareholder voting and control in a highly dispersed shareholding system. See Eisenberg & Cox, supra note 15, at 300 (“[I]t will not be rational for a shareholder who owns only a miniscule percentage of the share to invest time in reviewing the corporation’s affairs in depth. As a result, the shareholders of a corporation . . . will be rationally apathetic concerning those affairs.”) (emphasis in original).

\textsuperscript{146} See Kang, Poison Pill, supra note 110, at 650 (“Once an outsider is stigmatized as recalcitrant toward a controlling shareholder in one business group, her reputation will spread rapidly among other controlling shareholders and business groups. Given that public investors are powerless vis-à-vis dominant shareholders, such an outside director has a high chance of being ostracized by all business groups, and in essence, by the entire economy.”). According to a recent study on independent directors’ dissenting opinions in China, “on average, dissenters are 26% less likely to stay on the director labor market, compared to those who have voted ‘yes’ on the same proposals.” Ma & Khanna, supra note 7, at 25. Note that “[exit[ing labor market] could also be the result of directors voluntarily opting out of the director market following dissenting, even absent of penalties from the director labor market.” See id. at 27.

\textsuperscript{147} It is possible that a jurisdiction may impose limits on controlling shareholders’ voting power, particularly if their voting power is enhanced by voting leverage such as stock pyramiding, dual-class equity structures, and circular shareholding. These regulations, however, should be carefully considered, after taking into account many aspects (e.g., an uneven regulation issue may arise, if controlling shareholders, who rely on voting leverage to a different extent, are subject to a same, one-size regulation).
have a fair, efficient independent director nomination process, which is insulated from a controlling shareholder’s influence.

B. Nonetheless, the Independent Director Institution Works in China to Some Extent

So far, we have seen that the independent director system does not well fit with underlying institutions in China. In particular, given the firmly established controlling shareholder ownership in privately-owned corporations and SOEs, it is difficult for independent directors in China to maintain their independence. However, it does not mean that the system is totally meaningless in China.

In general, independent directors have two main roles: (1) advising corporate insiders; and (2) monitoring corporate insiders. Though limited due to potential problems regarding expertise and time issue, independent directors in China, compared with inside directors, can advise a controlling shareholder on corporate policies in an atmosphere of greater freedom. While inside directors are subject to the strict hierarchical relationship with a controlling shareholder, outsiders such as professors, retired government officials, and high-profile party members are not. As discussed, in terms of the monitoring function as to seriously tainted corporate policies or transactions, independent directors, compared to inside directors, can raise concerns in a relatively less uncomfortable way during the informal, private discussion session with corporate insiders (i.e., “direct deterrence” effect). In addition, understanding the risk of publicizing the information of egregious conflict-of-interest transactions through the channel of independent directors, a controlling shareholder would often use censorship against herself/himself, at least when it comes to outright self-dealing or massive tunneling (i.e., “self-censorship” effect).

In this light, regulations of independent directorship on professors with certain positions as well as retired government officials and party members should be carefully reviewed. There are two opposing effects when restricting the business role of professors and individuals with government/party experience. On the one hand, by cutting questionable connections between businesspeople and individuals with political backgrounds, anti-corruption campaigns, one of the most important policies that the current Chinese government pursues, are expected to be more successful. On the other hand, however, corporations in China may lose the most capable and (perhaps) most independent director candidates in

148 See supra Part III. E. 2.
149 See supra Part III. E. 2. The controlling shareholder’s “self-censorship” effect can be referred to as the independent directors’ “indirect deterrence” effect.
society. As discussed, independent directors with political/educational backgrounds, although they might be beholden to a controlling shareholder, are not fully obedient to her/him.\textsuperscript{150}

If restrictions on their business role are too strict, there will be a sudden vacuum for the current independent director group. Of course, then mostly individuals with business backgrounds will fill the vacancies. The problem, however, is the lack of assurance that the new group of independent directors will be more independent and more ethical (e.g., not to facilitate a controlling shareholder’s corruption) than individuals with political/educational backgrounds. Also, it is noteworthy that the capability—that politically powerful individuals take illicit financial benefits in favor of themselves and a controlling shareholder—has almost nothing to do with official corporate titles like independent directorship. These individuals’ corruption, ironically, would be more efficient without independent directorships, since it is harder for the public and the government/party law enforcement (or disciplinary) agencies to recognize these individuals and their corruption.

In sum, it is important to examine the net effect of the two opposing factors that the recent restrictions may bring. I do not say that the effect from maintaining a certain, though not satisfactory, level of independence (by employing former government officials, high-positioned party members, or professors as independent directors) is greater than the effect from cutting questionable connections (by firing them from directorship). Rather, what I propose is that in any case, we have to recognize and analyze, at least theoretically, the two opposing factors and their ripple effects.

V. Conclusion

The independent director institution is not perfect (even in the United States where the quality of corporate governance is high), and there are many problems and risks associated with the institution in China. To illustrate a few, for instance, independent directors, in fact, might not be independent, or/and lack information and expertise.\textsuperscript{151}

As explained, particularly the controlling shareholder ownership in China poses additional weaknesses on the independent director system. Accordingly, one may argue that the independent director system is a classical example of “Ju Hua Wei Zhi (橘化为枳).”\textsuperscript{152} It is partially true. Nonetheless, I believe that maintaining the

\textsuperscript{150} See supra text accompanying note 122.

\textsuperscript{151} See supra Part III.

\textsuperscript{152} “Ju Hua Wei Zhi (橘化为枳)” is used to describe a potential problem of transplanting a system in a jurisdiction where legal and economic infrastructures are very different from the jurisdiction where the system has been originally developed.
independent director system will bring net benefits to the Chinese corporate economy: independent directors in China can play the role of an advisory and monitoring board, albeit in a limited manner. Given the prevailing tunneling and corruption problems in Chinese corporations, the presence of independent directors, even if they are weak and inefficient, could provide a safety net, and thus will reduce (although will not eradicate entirely) the frequency and the scope of such corporate misconduct.\textsuperscript{153}

\textsuperscript{153} See supra Part III. E. 2. (explaining the "self-censorship" effect and the "direct deterrence" effect that an independent director system can bring).