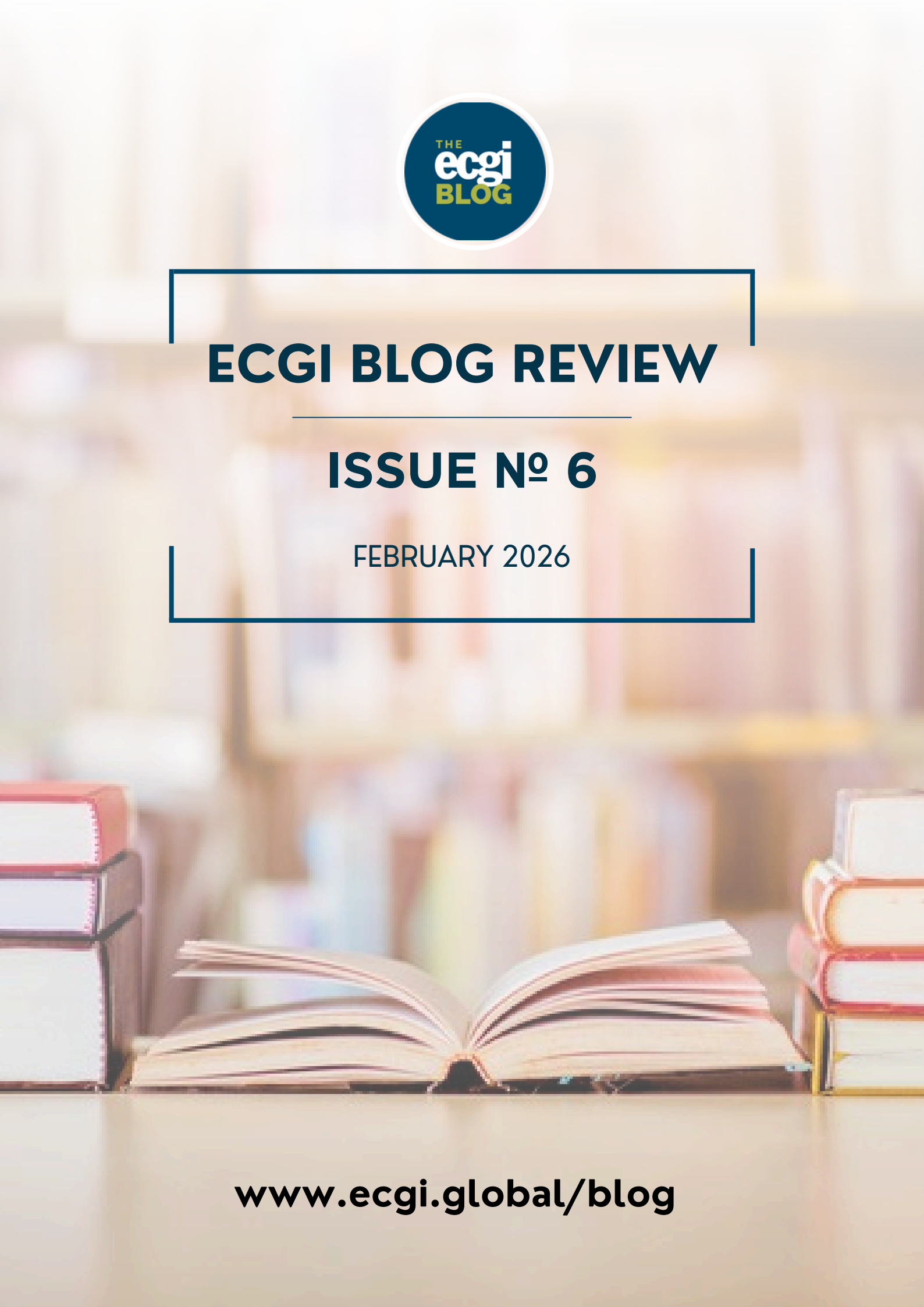

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The BF has three operating units: the Swiss Board School (SBS), the Swiss Institute of Directors (SIoD), and the International Center for Corporate Governance (ICCG).

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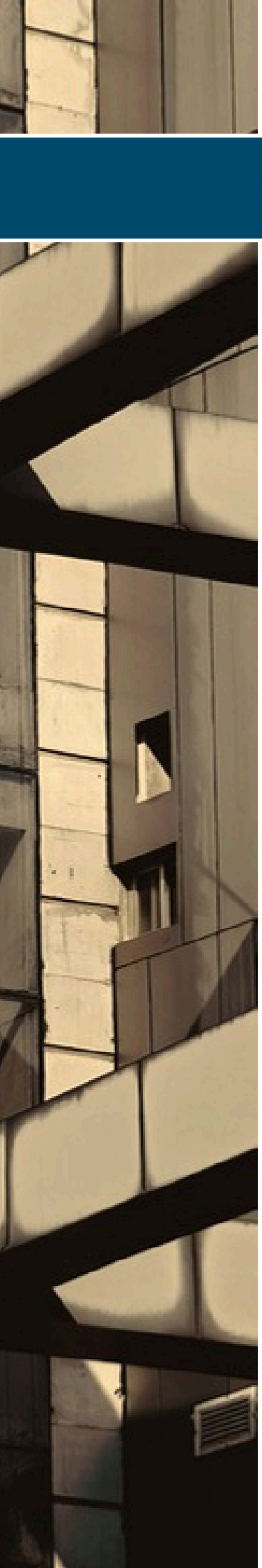

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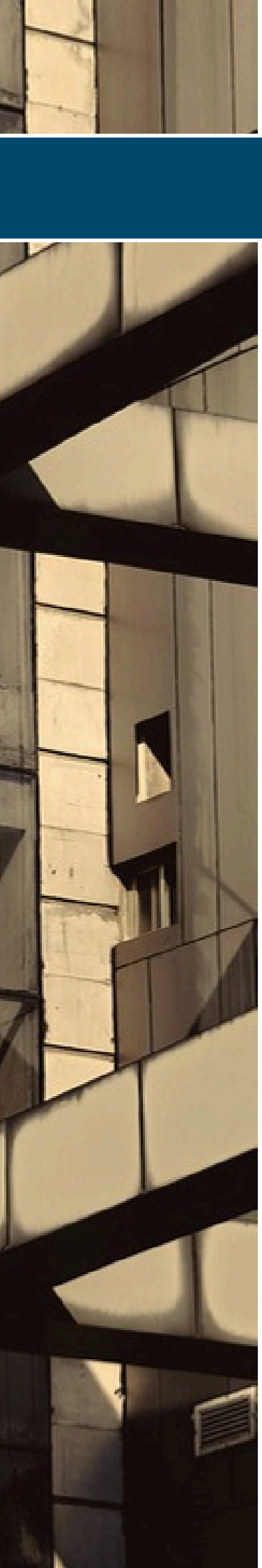

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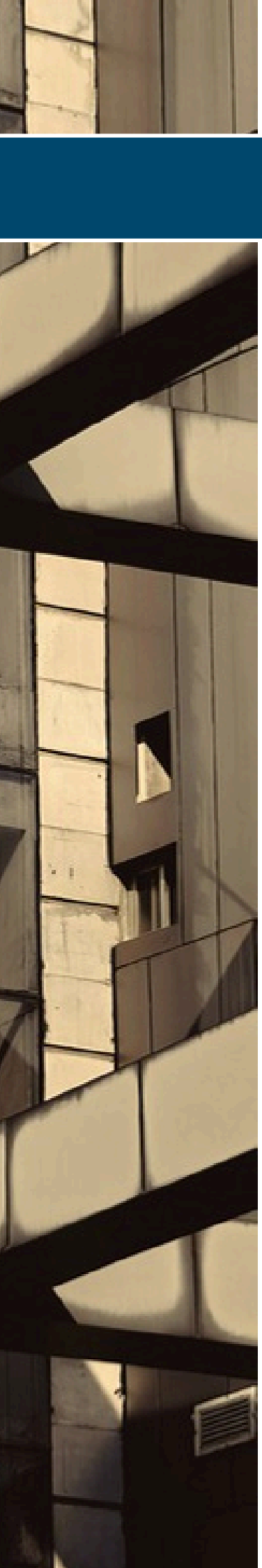

THE ecgi BLOG

About the Blog

Launched in February 2022, the ECGI Blog has become a key global platform for sharing insights and fostering dialogue on corporate governance, stewardship, and corporate responsibility. The blog showcases commentaries and analyses contributed by members of the ECGI network and experts from around the world, with the goal of broadening the understanding of research and igniting informed discussions that influence global perspectives.

Throughout the year, the ECGI Blog highlights emerging themes, current debates, and challenges in corporate governance, while also revisiting well-established topics of widespread interest. The articles, written by experts in their field, showcase diverse global perspectives from academics, practitioners, and policymakers on the topics, aimed at general readership. The blog strives to inspire fresh ideas, prompt new research, and stimulate conversations that contribute to the advancement of corporate governance practices worldwide.

For further reading and to access all hyperlinks and article references, please visit the Blog section of the ECGI website: www.ecgi.global/blog

Past issues of the ECGI Blog Review

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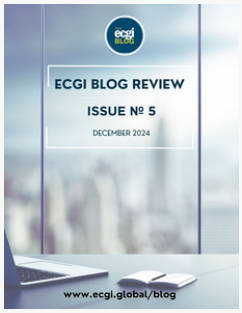

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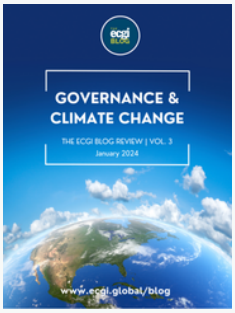


'Governance & Climate Change' **January 2024**

'Technology & Governance' **January 2023**

'Responsible Capitalism' **September 2022**

ECGI Blog Review - Issue Nº 6

Welcome to the **ECGI Blog Review – Issue Nº 6**, a curated exploration of the ideas, debates, and developments shaping contemporary corporate governance. This edition brings together a rich collection of ECGI blog contributions that span jurisdictions, disciplines, and perspectives, reflecting the increasingly global and interconnected nature of governance challenges.

A defining feature of this issue is its strong focus on **Asia's evolving corporate governance** landscape. From **Korea**'s paradoxical market for corporate control and the resurgence of shareholder activism in **China**, to **Japan**'s rethinking of hostile takeover regulation and the distinctive performance of listed family firms, the articles reveal governance systems in motion. **Indonesia**'s abolition of independent directors challenges long-standing Anglo-American orthodoxies, while debates on climate-related shareholder activism and "acting in concert" rules highlight the tension between legal frameworks and emerging sustainability imperatives. These contributions demonstrate that governance models cannot simply be transplanted; they must respond to local ownership structures, political economies, and institutional histories.

Beyond Asia, this issue examines the **architecture of modern capital markets** and the shifting boundaries of **corporate power**. Contributions explore the **growing influence of private equity**, the evolution of **venture capital ecosystems**, the agency costs of multi-product PE suites, and the design of **startup governance** in the age of AI. Analyses of **proxy advice**, common ownership, SPACs, sustainable debt, and TLAC instruments underscore how financial innovation both disciplines and destabilizes corporate actors. At the same time, reflections on **index funds**, prosocial investing, and ESG disclosure interrogate whether the **rise of stewardship** and sustainability signals meaningful change—or simply more words with less impact.

Climate change and sustainability remain central themes throughout the volume. Articles investigate how climate shocks reshape **investor engagement**, how venture capital financing catalyzes climate-tech solutions, and how green certifications and **sustainable debt** instruments can either advance or undermine environmental objectives. Yet the collection also cautions against simplistic narratives: managers' social commitments may conflict with organizational sustainability, ESG proposals may rise and fall with regulatory tides, and the **globalization of corporate purpose** may blur the line between universal values and regulatory overreach.

Several contributions probe the deeper normative **foundations of corporate law**. Book reviews and essays revisit shareholder primacy, corporate democracy, bankruptcy reform, and the moral limits of markets. Discussions of insolvency protection for workers, political entanglements, and corporate personality in a de-globalizing world remind us that governance is never merely technical—it reflects contested visions of power, responsibility, and justice.

Issue Nº 6 captures a field in transition. Corporate governance is being reshaped by geopolitical realignments, sustainability pressures, financial innovation, and the growing assertiveness of investors and regulators alike.

We hope this collection sparks reflection, dialogue, and further research. Thank you for exploring Issue Nº 6 of the ECGI Blog Review with us.

George Dallas
Head of Content, ECGI
✉ george.dallas@ecgi.org

Kateryna Varava
Blog Manager, ECGI
✉ blog@ecgi.org

The views

Sang Yop Kang

Korea's corporate control market is a paradox—weak takeover defenses strengthen family-controlled chaebols, making hostile takeovers almost impossible but incredibly impactful if they succeed.



Zhou Chun, Zhang Wei & Dan Puchniak

The recent wave of shareholder activism in China appears to be primarily driven by rules-based market forces.


Bruce Aronson & Manabu Matsunaka

One measure of progress in the attempted transformation from the old "fortress Japan" to a new "market-oriented Japan" is the treatment of hostile takeovers.




Hokuto Dazai, Takuji Saito, Zenichi Shishido & Noriyuki Yanagawa

Family influence can persist in Japanese corporations despite low ownership stakes.

Surbhi Kapur

Corporate insolvency laws should go beyond the paradigm of neoclassical economics, which treats workers merely as factors of production.



Royhan Akbar, Nathaniel Mangunsong & Dan Puchniak

Indonesia did what most in the global corporate governance community would see as unthinkable: abolish the requirement (or even suggestion) for boards of listed companies to have independent directors.


Dan Puchniak & Umakanth Varottil

Institutional investors are caught between their growing commitment to address climate change and the legal risks associated with collective action.

Akshaya Kamalnath

Finfluencers bringing populism into the market and finfluencers helping increase financial inclusion and eventually ensuring active engagement of retail investors on governance issues are two sides of the same coin.


Roza Nurgozhayeva & Dan Puchniak

The globalization of corporate purpose is not unambiguously a force for good.

Gen Goto

The directors' duty of oversight is highly contextual and is contingent on the type and the nature of the risks and externalities in question.

The views

Jan Starmans

When the manager becomes more committed to social causes than the owner, it can actually lead to the organization becoming less sustainable.

Tove Forsbacka

ISS is more likely to promote decisions that soften competition for firms with higher levels of common ownership.

Marc Moore & Chris Hale

The time is now ripe for shifting towards a new, post-Jensenian theoretical paradigm of PE, which is both cognizant of and responsive to today's markedly different organizational climate.

Gad Weiss

Recalibrating startups' control and cash flow rights to protect society from safety and ethics risks will undermine these efforts—particularly in startups that lack the rare concentration of talent, experience, and star power found in 'celebrity startups' like OpenAI or Anthropic.

Narae Lee

The Korea Fund of Funds has been pivotal in shaping the VC investment landscape.

Abraham Cable

In the aggregate, equity compensation works, but we could still make things easier for the startup workforce.

Raphael Andrade & Alvaro Pereira

While the Cayman Sandwich structure has facilitated the growth of Latin American startups by attracting global VC investment, it comes at a significant cost to the region's institutional and VC markets development.

Yijia (Eddie) Zhao, Douglas Cumming, Ruiyuan (Ryan) Chen & Binru Zhao

PE sponsors may leverage their relationships with lender law firms in loan contract negotiation to extract value from creditors.

Danielle A. Chaim & Asaf Eckstein

Institutional investors' deviation from their traditional governance approach reflects a deliberate choice to cede control to other corporate constituencies better positioned to increase firm value.

Narine Lalafaryan

Modern debt investment in the private capital domain looks a lot like equity, and, where necessary, modern equity may also be designed to look akin to debt.

The views




Anat Alon-Beck, John Livingstone, Moran Ofir & Miriam Schwartz-Ziv

Big Tech's use of SPACs represents a sophisticated strategy to extend their market dominance under the radar of antitrust regulators.



Luca Enriques, Alessandro Romano & Andrew Tuch

Without accurate green certifications, the promise of demand-side climate change mitigation strategies—such as altering lifestyles and consumption patterns—may be squandered.



Stefano Pegoraro, Antonino Emanuele Rizzo & Rafael Zambrana

Prosocial investors possess proprietary insights into firms' compliance and ethical practices.


Adelina Barbalau & Federica Zeni

The effectiveness of financial market solutions for combating climate change depends on well-designed contracts that align incentives, foster accountability, and curb manipulation.

Kristina Lalova

Disruptions stemming from managerial and squad turnover – a hallmark of PE restructuring – undermine team cohesion, which is especially critical during high-pressure away games.



Shirley Lu, George Serafeim & Simon Xu

VC investment plays a transformative role, serving as a signal of the commercial potential of climate technologies and prompting established firms to increase their focus on climate solutions.

Yingxiang Li

By facilitating intermediation, regulatory oversight of PE funds mitigates the potential capital misallocation resulting from the disintermediation of PE markets.




Matthew Gustafson, Ai He, Ugur Lel & Zhongling Qin

Investors' exposure to climate disasters via one portfolio firm impacts the way investors engage on climate-related issues at other (non-disaster hit) firms in their portfolios.

Hoa Briscoe-Tran

Firms strong on D&I suffered greater losses in operating efficiency compared to less diverse firms.

The views


Todd Gormley & Hwanki Brian Kim

Index funds aren't dragging down governance or firm value. If anything, they're holding steady—or even helping.




Yan Lin, Rui She, Jasmine Wang & Y. Julia Yu

The explosion of ESG disclosure in annual reports might seem like a victory for transparency and accountability.

Dirk Schoenmaker

To effectively meet global net zero goals, the corporate sector must evolve from traditional models to integrated value models—an approach that merges financial decision-making with environmental and social imperatives.

Anat Admati

Powerful parties transformed bankruptcy into "a legal Swiss army knife" that undermines civil justice and can rob people of their legal rights without consent even when debtors' obligations are due to bad behavior.


Dan Puchniak & Curtis J. Milhaupt

TikTok's identity crisis reveals the limitations of standard corporate law doctrines in satisfying policymakers focused on national security and geopolitical rivalry.

Urs Lendermann

The proposed automatic TLAC conversion mechanism stabilizes a bank's balance sheet before liquidity issues escalate, while ensuring that solvency criteria are met for coordinated liquidity support among central banks.

Paúl Noboa-Velasco

Ecuador's recent corporate reforms offer important solutions to protect non-controlling shareholders and promote accountability in corporate governance.

Event | 12 - 13 April 2024 | Organised by:

The Centre for Commercial Law in Asia at Singapore Management University – ECGI

Asia's share of global GDP has more than tripled since the 1960s, now accounting for 47%. In 2023, Asia was home to over half of global IPOs, and this year will account for over 60% of global economic growth. Despite this, comparative corporate governance research has had a propensity to use an Anglo-American lens to understand Asia.

The blogs uncover the diverse complexities of Asian corporate law and governance, from Indonesia's controversial abolition of independent director requirements to Japan's unique approach to family firms and hostile takeovers. In China, contrary to Western assumptions, shareholder activism is thriving, with private shareholders successfully challenging state-owned enterprises. Korea's market for corporate control exemplifies the complex interplay between chaebols, legal frameworks, and emergent shareholder activism.

In a generation, Asia has transformed from the West's workshop to the world's engine of economic growth. Environmental, Social, and Governance (ESG) issues appear to possibly be reshaping corporate practices across Asia. Japan's landmark TEPCO case, resulting in an unprecedented $85 billion liability for directors, may portend a growing recognition of ESG factors in Japanese corporate governance. China's recent adoption of the "double materiality" principle in sustainability reporting ostensibly aligns it with EU standards. However, in practice, China has emphasised state sovereignty and non-interference, contrasting sharply with the EU model of using its market and regulatory power to project its concept of corporate purpose beyond EU borders.

Emerging phenomena are further transforming Asia's incredibly diverse corporate governance landscape. The rise of retail investors and "finfluencers" in countries like South Korea and India is democratising financial markets and challenging traditional power structures. Evolving insolvency laws across Asian jurisdictions increasingly prioritise workers' interests, reflecting a broader trend towards stakeholder considerations. However, on the flip side, legal frameworks like "acting in concert" rules, which exist in Asia and elsewhere, are impeding effective climate-related shareholder activism, highlighting the need for regulatory reform to address global challenges.

These developments challenge the notion that corporate governance models based on Anglo-American experiences can be universally applied and demonstrate that local jurisdiction-specific knowledge is required to accurately understand Asia's diverse corporate governance environment.

Diverse Dynamics of Korea's Market for Corporate Control

Sang Yop Kang, Peking University

In the U.S., hostile takeovers reached their peak during the 1980s. However, the introduction of the poison pill, the "game changer" of the market for corporate control, made hostile takeovers impractical, if not impossible. Throughout the 1980s and 1990s, the poison pill, the most effective anti-takeover defense measure, evolved into the "Just Say No" pill (though not the invincible "Just Say Never"). Another game changer was the development of large executive compensation packages, including severance payments (e.g., golden parachutes). These two factors shifted takeovers to friendly deals, with sufficient compensation to a target company's senior executives as a "legalized bribe," facilitating a change in control of corporations with disperse ownership. Thus, a market for corporate control still survives even without many hostile takeovers.

What about other countries? In this blog post, I would like to explore the complicated terrain of Korea's market for corporate control from diverse aspects that are not often discussed in depth by the existing literature.

In Korea, historically, there have been several events involving the market for corporate control where foreign investors engaged, but there are hardly any successful cases, and none involving large family-controlled corporate groups, i.e., chaebols. Accordingly, many scholars, experts, and policymakers seem to consider it virtually impossible for a control change to occur through hostile takeovers, especially with chaebols.

Despite the dormant market for corporate control in Korea, the legal system for defending against hostile takeovers is considerably weak. For instance, poison pills are not permitted.

For instance, poison pills are not permitted. Also, Korean companies are not allowed to issue shares or convertible bonds to friendly third parties for the purpose of control-contest defense.[1] As an alternative defense measure, Korean companies often rely on the disposal of treasury shares to friendly third parties. However, compared to poison pills, this method is quite limited in terms of effectiveness. Additionally, this method requires substantial preparation over a long period from the target corporation's side. By contrast, in the case of a poison pill, due to the legal availability of a "shadow pill," it can be adopted within just a few hours if the board of directors believes it is needed.

In this light, the business circle in Korea argues that the takeover legal system should adopt more effective defense measures. Although this complaint seems valid, it only considers half of the overall situation. Korean chaebols often rely on a "controlling minority structure (CMS)", where controlling shareholders own a mere 2-3% of shares while leveraging voting rights (such as 40 or 50%) through pyramiding or complicated cross-ownership among affiliated companies. From the standpoint of controlling shareholders, the CMS serves as a built-in anti-takeover defense system within the corporate ownership structure, reinforcing control. Under these circumstances, the aforementioned weak defense system could potentially be justified by the built-in anti-takeover defense with severe CMS and high voting leverage in favor of controlling shareholders. However, this situation indicates that companies with a less severe CMS and low voting leverage, which are relatively favorable to public investors, end up with the same weak defense system as those with a severe CMS and high voting leverage.

As a result, ironically, these companies with low voting leverage—i.e., companies with a better ownership structure for investors—are often put at a disadvantage in terms of control contests.

Additionally, it is noteworthy that to dispose of treasury shares to a third party, a company must pre-purchase its own shares using its corporate funds. In other words, this method distorts the company's capital structure, funding operations and plans, and related business strategies, potentially diverting funds that could otherwise be used for business development, new product development, or R&D. By contrast, poison pills do not generate these distortions since they are similar to a "neutron bomb": they are effective in warding off only bidders, but they do not change or distort the company's capital structure, funding operations and plans, or related business strategies. Also, it is noteworthy that share repurchases only achieve the goal of promoting shareholder wealth maximization when the repurchased shares are retired. However, share repurchases for the purpose of defending control do not aim to retire the shares, as they are intended to be disposed of to third parties favorable to the current controlling shareholders.

Another point is that, although there have been no successful cases of hostile takeovers involving chaebols, this does not mean that it is impossible, just highly improbable. The impact of a hostile takeover of one chaebol would be significantly greater in Korea than that of a large company in the U.S. or China. This is because the size of Korea's economy is much smaller compared to the U.S. or China, and the scale of chaebols is global, with their domestic stature being massively dominant. Thus, in Korea, with a very low probability of a chaebol experiencing a control change, the magnitude of such an event, if it were to occur, would be astronomical. This can be likened to the 2011 Fukushima tsunami and its subsequent catastrophic impact—a low-probability event but with extremely significant effects. In this regard, Korea's takeover laws and policies need to pay attention to and prepare for this small probability.

Indeed, in 2003, Sovereign Asset Management, a foreign institutional investor, almost deprived the controlling shareholder of SK Group of control over the entire group.[2]

As discussed, until recently, challengers in control contests involving chaebols and other large corporate groups have tended to be foreigners. This is perhaps because in Korea, it was politically and socially unacceptable for a chaebol's affiliated company or its funds to acquire control of another chaebol company, and there have been many legal restrictions, including the Monopoly Regulation and Fair Trade Act (competition law in Korea). In recent years, however, Korean funds independent of chaebols have also been engaged in shareholder activism and the market for corporate control. Examples include the KCGI Fund, which was actively involved in the control contest of Hanjin Group, and Align Partners, which challenged SM Entertainment, a famous K-Pop powerhouse. In the SM Entertainment case, Align Partners was not a bidder, but its shareholder activism can be seen as the catalyst that ultimately led to the control change at SM Entertainment.

Moreover, shareholder activism by the National Pension Service (NPS), the largest institutional investor in Korea, represents a new variable in the context of Korea's market for corporate control. In 2015, the NPS cast a pivotal vote in favor of the merger of two affiliated companies within the Samsung Group, which was crucial for Lee Jae-yong's succession within Samsung's controlling family. After a series of political upheavals, then-President Park Geun-hye was ultimately impeached in 2017. One of the reasons for this unprecedented impeachment was closely related to the Samsung succession and the Park administration's support for it. Eventually, the NPS's vote in the Samsung merger faced significant criticism, and the NPS chairperson at the time was imprisoned as a result of the fallout from this incident. Later, the Korean government also lost an investor-state dispute with Elliott Management, a hedge fund and challenger in the Samsung merger case.

Having experienced enormous political trauma from this period of turmoil, the NPS finds it nearly impossible to support a chaebol's side in future control, even if there are rational reasons to do so.

Indeed, I support the NPS taking a leading role in shareholder activism as Korea's largest institutional investor and criticize the use of voting rights in corporate decisions for political deals. However, I also view it as undesirable for the NPS to be structurally pushed to one side in control contest situations, making decisions unfavorable to chaebols and favorable to bidders (including foreign bidders) without thorough consideration.

Finally, as discussed, in the U.S., the poison pill—a powerful defense mechanism—has been combined with advances in executive compensation, such as the golden parachute, to create a variant of the friendly but still active market for corporate control: inefficient management is replaced with a severance payment. In this light, the market for corporate control is not perfect, but its disciplinary mechanism—replacing incapable executives—works to some extent.[3] By contrast, in Korea, if strong anti-takeover defense measures such as poison pills are introduced, there would be much less room for the market for corporate control to occur, even in a friendly way, than in the United States.

This is because executive compensation in Korea is much lower than in the U.S., even when adjusted for GDP per capita, making severance payments for a change of control less attractive. In this respect, although the phenomenon known as the "golden parachute" exists in Korea, I argue elsewhere that it should be called the "bronze parachute." This difference in the magnitude of parachutes is partly due to cultural differences, and also because, contrary to the U.S., company ownership in Korea is skewed toward controlling ownership in family-controlled corporate groups. In a controlling shareholder system, it is the control premium for controlling shareholders, not the golden parachute for executives, that should be mainly considered in the market for corporate control.

In summary, the landscape related to Korea's market for corporate control is extremely complex. Naturally, there are many issues not mentioned here due to space limitations. I hope this blog post will spark new discussions on the market for corporate control in Korea.

By Sang Yop Kang, Peking University, School of Transnational Law

The Overlooked Reality of Shareholder Activism in China: Defying Western Expectations

Zhou Chun, Zhejiang University
Zhang Wei, Singapore Management University
Dan Puchniak, Singapore Management University and ECGI

China is known in the West for many things. However, a rules-based market for shareholder activism is not one of them. President Xi Jinping is (in)famous in the West for demanding "that businesses conform to the aims of the Communist Party". The newly appointed boss of the China Securities Regulatory Commission (CSRC) – China's equivalent to the US Securities and Exchange Commission (SEC) – has earned the sobriquet "Broker Butcher" for his alleged zealous crackdown on traders in the 2000s. Western media regularly reports on "[b]illionaire tycoons, including Jack Ma, the founder of Alibaba, [being] driven underground or imprisoned after criticizing the government".

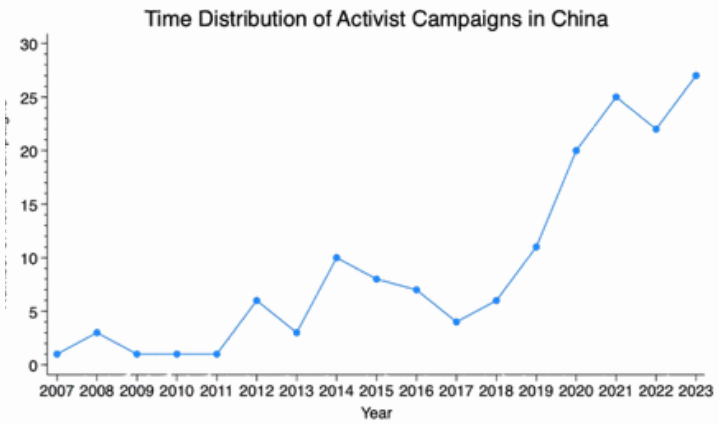
This is not exactly an environment in which one would expect to find a vibrant rules-based market for shareholder activism – especially with state owned enterprises as the target of such activism.

And yet, the in-depth empirical and case study evidence in our new ECGI Working Paper – The Overlooked Reality of Shareholder Activism in China: Defying Western Expectations – reveals that shareholder activism in China is thriving.

Based on our unique hand collected data, there were nine times as many publicly reported shareholder activist campaigns against listed companies in China in 2023 (27) as in 2008 (3) – with over two-thirds of all the shareholder activist campaigns since 2007 occurring in the last five years (see Table below).

More unexpectedly, our empirical analysis reveals that whether the target company is a private owned enterprise (POE) or state owned enterprise (SOE) has no statistically significant effect on the success of the activist campaign, no matter whether the activist is a state owned or privately owned investor. In fact, contrary to Western conventional wisdom, private shareholders undertake, and more often than not succeed, in activist campaigns against so called "national champions" – the name bestowed on the largest, most politically powerful, SOEs in China.

Surprisingly, 78% of activist campaigns against national champions were brought by private activist shareholders – 57% of which succeeded.



One such activist campaign involved retail investors organizing on a social media platform called "snowball" [雪球] to publicly object to the dividend policy of a powerful national champion. Led by an anonymous online investor who went by the colorful handle "Legend of the Red Scarf" (perhaps China's answer to "Roaring Kitty") the campaign forced the hand of the target's management to adopt a generous dividend payment policy after it had refused to pay dividends for over a decade – conjuring up images of WallStreetBets meets China.

The other side of the rules-based market coin is evident in our empirical findings that there is no statistically significant difference in the success rate for state-controlled activist shareholders (SAS) and private activist shareholders (PAS), regardless of the political status of their targets. Again, contrary to Western conventional wisdom, over 50% of activist campaigns launched by an ostensibly powerful state-controlled activist investor – that is, a national, rather than local, SAS – failed when the target was a POE. Our in-depth review of shareholder activist cases even revealed a POE using aggressive and illegal tactics to defeat the campaign of a state-controlled activist shareholder (SAS) and the state following due process to challenge the sharp practices of the POE in court. This reinforces the picture revealed by our empirical findings that China has developed a rules-based market for shareholder activism.

Another interesting feature of shareholder activism in China that our empirical and case study analyses illuminate are cases involving activist campaigns where state-controlled entities are both the activist shareholder and target company. The details of these cases suggest that shareholder activism in China may also serve as an important corporate governance mechanism among government entities to promote good corporate governance, improve efficiency, and weed out corruption. We also uncovered cases in which SASs from different provinces compete as activists to influence target companies akin to what one would expect to find between private parties – providing further evidence of a rules-based market for shareholder activism in China that promotes government and corporate governance efficiencies.

Taken together, our empirical evidence, including our regression analyses in which we coded shareholder activists and target companies based on their level of political power, suggests that shareholder activism in China is driven by rules-based market forces – the opposite of conventional wisdom about the rising influence of the Chinese Communist Party (CCP) in Chinese corporate governance in the President Xi era. This meteoric rise of shareholder activism in China since 2019 dovetails with regulatory changes in Chinese corporate governance that increased the incentives for shareholder activism – further suggesting the importance of rules-based market forces.

This conclusion is bolstered by empirical evidence that other aspects of shareholder activism in China conform to what one would expect in a rules-based market for shareholder activism driven largely by financial incentives. Shareholder activists that hold a larger percentage of the target company's shares have a statistically significant higher chance of succeeding in an activist campaign. Moreover, an analysis of the success rate of shareholder activism campaigns reveals that targets of successful activist campaigns had a return on investment (ROA) over 50% lower on average than those in unsuccessful campaigns. Again, ironically, this wave of shareholder activism has occurred at the precise time when both popular media and leading academics suggest that China, under the tightening grip of President Xi, has been decidedly moving in the opposite direction – ostensibly enhancing the CCP's involvement in corporate governance and thwarting the rule of law.

The fact that much of what goes on in shareholder activism is unobservable is a universal characteristic that exists in markets globally and confounds empirical research on this topic. It is possible that there are unobservable cases in China in which politics prevents shareholder activism from arising in the first place – but if this were the case it would still not explain away our observable empirical evidence of the recent wave of shareholder activism in China. It is also possible that a high-level empirical analysis may fail to detect idiosyncratic individual cases in

which politics played a definitive role in a shareholder activist campaign.

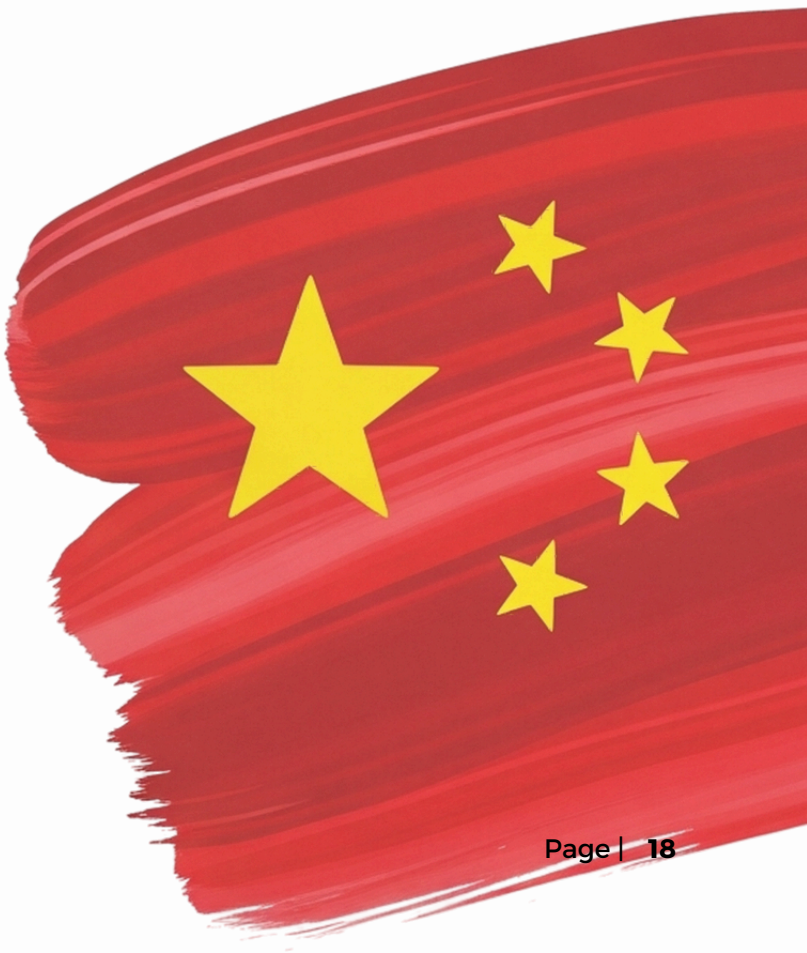
To interrogate this possibility, we undertook an in-depth case study analysis to find any evidence of political influence playing a significant role in individual cases of shareholder activism. It is noteworthy that we did not find a single case in which a local state-controlled shareholder activist attempted to even launch a campaign against a national champion – suggesting that the political hierarchy between local state entities that are shareholders and national champions may serve to quell such campaigns. It is also noteworthy that the nature of the campaigns in which SOEs – particularly national champions – are the targets may be permitted (or even promoted) by the government where they dovetail with a government policy to strengthen minority shareholder rights in China. Also, we uncovered a single case involving a national champion in which politics may provide an explanation for an unanticipated outcome. Overall, however, our case study analyses further confirm our empirical findings that ...

"...the recent wave of shareholder activism in China appears to be primarily driven by rules-based market forces."

which politics played a definitive role in a shareholder activist campaign.
Finally, it is worth noting that at the end of 2023, China's Company Law underwent a significant amendment, with the new Company Law taking effect on July 1, 2024. The 2024 Company Law, the second significant amendment since the enactment of China's first Company Law in 1993, has as one of its key focuses the empowerment of minority shareholders. Among the changes, the threshold for shareholder proposals in listed companies has been lowered to 1% from 3%, and shareholders are explicitly granted broad inspection rights, with the scope of inspection extending even to wholly-owned subsidiaries. Additionally, shareholders are now allowed to initiate double derivative suits. This portends that the recent wave of shareholder activism in China is only likely to grow.

Fans of rules-based markets should be heartened by our findings. Chinese companies have become world leaders in many important industries. Over the past 15 years, China has had the world's largest market for initial public offerings and the world's second largest stock market, which has grown five-fold in the past decade. To think that this success is the result of a system in which the government uses its political influence to dictate corporate governance outcomes gives far too much credit to the Chinese government – and far too little credit to rules-based markets. There is a reason why the USSR regularly had shortages of toilet paper and why it did not have shareholder activism. China now has an abundance of both.

By Zhou Chun (Guanghua School of Law, Zhejiang University), Zhang Wei (YPHSL, Singapore Management University), & Dan W. Puchniak (YPHSL, Singapore Management University and ECGI)



Designing a New Framework to Regulate Hostile Takeovers in a Changing Japan

Bruce Aronson, NYU School of Law
Manabu Matsunaka, Nagoya University Graduate School of Law

Could Japan finally be at a turning point in its decade-long effort at reform in order to achieve sustained economic growth?

"One measure of progress in the attempted transformation from the old "fortress Japan" to a new "market-oriented Japan" is the treatment of hostile takeovers."

Japan's regulatory system for hostile takeovers remains incomplete, complicated and uncertain. As the country seeks to reignite economic growth and attract foreign investment, there is new urgency to reform this system. In our recent ECGI Working Paper – Designing a New Framework to Regulate Hostile Takeovers in a Changing Japan – we examine Japan's current takeover regime, analyze its shortcomings, and propose a revised framework that could better serve Japan's evolving needs.

Japan's existing takeover regulation is an unwieldy mix of US and UK elements, reflecting difficulties in balancing the conflicting goals of market efficiency and investor protection. Historically, the regime featured relatively weak regulation of board defenses by courts, which generally favored management autonomy over shareholder monitoring.

However, significant changes in Japan's corporate governance landscape and operating environment over the past decade have set the stage for potential reforms.

These changes include the gradual unwinding of cross-shareholdings, increased influence of institutional investors and shareholder activists, ongoing corporate governance reforms, and evolving attitudes toward hostile acquisitions. Recent court decisions on hostile takeovers and new policy initiatives by government agencies have indicated a shift in traditional attitudes and provided some new rules and processes. However, they have also highlighted continuing weaknesses in the current regulatory regime.

In reconsidering the analytical framework for hostile takeover regulation, we utilize Australia as a new point of reference, in addition to the traditional US and UK models. The Australian system formally separates the rulemaking and enforcement functions and has a takeover panel with substantially limited authority compared to the UK panel. Incorporating this model into our analysis, we discern three basic roles in a framework for takeover regulation: (1) a Rule-maker, who decides the legal principles/rules for making decisions on bids and takeover defenses, (2) a Bid Decision-maker, who makes the initial decision for the target company about the merits of a hostile takeover bid, and (3) an Umpire, who can apply the relevant principles and rules to review this decision from a broader social perspective, and also act to create and spread standards of conduct and new commercial norms relating to best business practices.

Applying this revised framework to Japan, we find that although all relevant institutional players have improved their capabilities, the strength of shareholders has increased substantially more than that of courts and independent directors. Thus, the main weakness in the Japanese system is having the courts as the primary Umpire. Our main recommendation is that Japan consider an Australian-style, limited takeover panel for its Umpire, together with a separate Rule-maker.

This proposed panel would apply general principles/rules formulated by a separate Rule-maker to hostile bids and also act to create and spread commercial norms. It would represent a more appropriate Umpire than courts in a revised regulatory scheme that more clearly emphasized commercial norms over legal fiduciary duties. More importantly, such a panel could achieve credibility through a conflict-free, expert, independent, and predictable process for resolving takeover disputes.

We acknowledge that implementing such a proposal faces significant obstacles. These include the difficulty of selecting conflict-free experts to serve on the panel who would be acceptable to all relevant constituencies, and the uncertain relationship between the new panel and the existing court system. To address these challenges, we suggest starting with a "voluntary" takeover panel without exclusive jurisdiction, which would allow time for the panel to develop experience and credibility. Our other recommendations include creating a permanent interagency council to adopt, administer and periodically review METI's 2023 Guidelines as the principles for hostile takeovers (Rule-maker) and relying on shareholder voting for the Bid Decision-maker, but with boards retaining the ability to initiate defensive measures approved by shareholders.

In conclusion, Japan's pivot to sustained economic growth requires a regulatory framework for takeovers that is commensurate with its current economic importance and aspirations in global business and capital markets. By separating the roles of Rule-maker and Umpire and introducing the Australian takeover regime as a point of reference, we hope our analysis provides greater analytical flexibility and aids in developing a takeover regime that better fits Japan's circumstances and needs. While challenges remain, the proposed reforms could significantly enhance the speed, fairness, and consistency of Japan's takeover regulation, ultimately promoting investment and improving corporate performance and governance.

By Bruce E. Aronson (NYU School of Law) & Manabu Matsunaka (Nagoya University Graduate School of Law)

Corporate Governance and Firm Performance: Insights from Japanese Listed Family Firms

Hokuto Dazai, Nagoya University of Commerce and Business
Takuji Saito, Keio Business School
Zenichi Shishido, Hitotsubashi University
Noriyuki Yanagawa, The University of Tokyo

Corporate governance has long been a topic of intense scrutiny and debate among scholars, practitioners, and policymakers. The relationship between governance structures, ownership patterns, and firm performance continues to evolve, particularly as we examine these dynamics across different cultural and economic contexts. In this light, the unique characteristics of Japanese corporate governance, and more specifically, Japanese family firms, offer a fascinating case study that challenges many conventional assumptions in the field.

In our recent working paper – Corporate Governance and Firm Performance: Insights from Japanese Listed Family Firms – we explore the relationship between corporate governance and firm performance through a unique lens: Japanese listed family firms. Our study, which examines data from 1991 to 2010, reveals distinctive characteristics of these firms that set them apart both globally and within the Japanese corporate landscape.

One of our most striking findings is that many Japanese founding families maintain control over top management positions without owning substantial stock. This phenomenon is relatively rare outside of Japan, where low family ownership typically leads to the abandonment of family management. We focus on "heir managing firms," where a family member serves as the senior manager after the founder's death. Interestingly, we find that the vast majority of heir managing firms in Japan have less than 20% family ownership, with a significant number (37%) having less than 5% ownership. This stands in stark contrast to family firms in other regions, where ownership tends to be more concentrated.

Despite the low family ownership, these heir managing firms demonstrate accounting performance that is at least comparable to, and in some cases slightly better than, that of non-family firms in Japan. This is particularly noteworthy given that Japanese firms generally suffered from low accounting performance compared to their Anglo-American counterparts during the study period.

We attribute this relatively good performance to several factors, chief among them being the high level of management ownership in heir managing firms. On average, management ownership in these firms is 4.416%, compared to just 0.226% in non-family firms. This significant difference persists even in firms with less than 5% family ownership. Our regression analysis reveals that management ownership is positively correlated with firm performance, as measured by Return on Assets (ROA) and Return on Equity (ROE). Importantly, this positive effect is observed even in firms with low family ownership, suggesting that management incentives play a crucial role in driving performance.

In addition to higher management ownership, we find that heir managing firms exhibit other characteristics that distinguish them from typical Japanese non-family firms. Heir managers often gain work experience at other companies before joining the family firm, their career paths are accelerated compared to salaryman managers, and they tend to have longer tenures as presidents. These features stand in stark contrast to the traditional Japanese corporate governance model, which is characterized by consensual decision-making, lifetime employment, and a stakeholder-oriented approach. We argue that heir managing firms are uniquely positioned to break free from the constraints of the "company community" norms that have hindered change in many Japanese firms during the period of economic stagnation. To illustrate our findings, we present four case studies of prominent Japanese companies - Mitsubishi Pencil, Brother Industry, Nisshin Seifun, and OMRON. These examples highlight the diverse ways in which...

"... family influence can persist in Japanese corporations despite low ownership stakes."

Our research has several important implications for corporate governance theory and practice. First, it suggests that management's equity incentives may play a crucial role in driving firm performance, even in the absence of strong shareholder-oriented corporate governance. This challenges conventional wisdom about the relative importance of shareholder monitoring versus management incentives. Second, our study demonstrates that different corporate governance mechanisms can coexist within the same country and influence each other. The unique characteristics of Japanese listed family firms appear to be a product of their interaction with the broader Japanese corporate governance environment. Finally, our research raises questions about the optimal balance between shareholder monitoring and management incentives in driving firm performance.

We suggest that future research should explore which of these factors has a more significant impact and whether they are complementary or substitutable.

In conclusion, our study offers valuable insights into the complex relationship between corporate governance, ownership structures, and firm performance. By highlighting the unique characteristics of Japanese listed family firms, we challenge conventional assumptions and open up new avenues for research in corporate governance. As companies and policymakers continue to grapple with questions of effective governance, the lessons drawn from our analysis of Japanese family firms may prove invaluable in shaping future practices and regulations.

By Hokuto Dazai (Nagoya University of Commerce and Business), Takuji Saito (Keio Business School), Zenichi Shishido (Hitotsubashi University), and Noriyuki Yanagawa (the University of Tokyo)

The Abolition of Independent Directors in Indonesia: Rationally Autochthonous or Foolishly Idiosyncratic?

Royhan Akbar, Universitas Gadjah Mada
Nathaniel Mangunsong, Universitas Indonesia
Dan Puchniak, Singapore Management University and ECGI

The independent director is the paradigmatic example of Anglo-America's influence over global corporate governance. The concept of the independent director was created in the United States in the 1970s and quickly became a defining feature of American corporate governance. In the 1990s, the United Kingdom made America's concept of independent directors a hallmark of its inaugural code of corporate governance. Over the next decade, UK-style corporate governance codes, with independent directors at their core, proliferated around the world. By the 2000s, the global ubiquity of independent directors transformed them into a universal litmus test for "good" corporate governance. Following the 2008 Global Financial Crisis, some countries questioned the extent to which independent directors should be relied on to promote good corporate governance. However, despite some rethinking of their role and ambiguous empirical evidence of their effectiveness, today conventional wisdom suggests that no credible system of corporate governance can exist without independent directors.

At first glance, Asia exemplifies the global adoption of the Anglo-American idea that independent directors are required for "good" corporate governance. Prior to the 1997 Asian Financial Crisis, boards in Asia were dominated by corporate insiders, with independent directors being either non-existent or playing a marginal role on boards throughout Asia.

Legal reforms following the Asian Financial Crisis resulted in "many of the laws and regulations in Asia's leading economies [appearing] to do more to promote or require 'independent directors' on the boards of listed companies than those in many leading Western economies".[1] The past decade has even seen Japan and Taiwan, which traditionally have championed insider dominated boards, reform their laws to make independent directors mandatory in their listed companies. As one of us concluded in a book on "Independent Directors in Asia" published in 2017, "it is now indisputable that the 'independent director' is a ubiquitous feature of corporate governance throughout Asia – and its rise appears to have no immediate end in sight'".[2]

Then, in 2018, ...

"... Indonesia did what most in the global corporate governance community would see as unthinkable: abolish the requirement (or even suggestion) for boards of listed companies to have independent directors – ..."

the culmination of a movement that began in 2006 resulting in the elimination of a feature of Indonesian corporate governance that existed for over a decade. Despite Indonesia having the world's fourth largest population, seventh largest economy (GDP PPP), and being on a trajectory of high economic growth, this surprising corporate governance development has received scant attention from comparative corporate law scholars. To the best of our knowledge, there has been no in-depth analysis, either within Indonesia or internationally, of Indonesia's abolition of the requirement for independent directors to be on the boards of its listed companies.

In our recent paper – The Abolition of Independent Directors in Indonesia: Rationally Autochthonous or Foolishly Idiosyncratic? – we aim to fill this gap in the literature by undertaking a quantitative and qualitative analysis of this significant development in Indonesian corporate governance. Our empirical analysis of the annual reports of Indonesia's 20 most valuable public companies reveals that in the year following the abolition of the requirement for independent directors, 81% of the companies that previously reported having independent directors had none. By 2023, there was not a single independent director in any of Indonesia's 20 largest listed companies – a fact that, to the best of our knowledge, was unknown prior to our research. This watershed development raises three questions which we seek to answer.

First, despite conventional wisdom that independent directors are required for good corporate governance, why did Indonesia abolish its requirement for independent directors in its listed companies? To answer this question, we undertook an in-depth review of all publicly available information surrounding the legal amendment. It appears that the requirement for independent directors was abolished because it was seen as functionally redundant in the context of Indonesia's ostensibly "two-tier board" system – in which a supervisory board – called "the board of commissioners" – was viewed as fulfilling the role of independent directors.

Relatedly, the original implementation of the American concept of the independent director was done under extreme economic pressure from the International Monetary Fund (IMF), which was seen as an affront to Indonesia's civil law "two-tier board" tradition and its national sovereignty. Regardless of the rationale, this reform has made independent commissioners on the board of commissioners (rather than independent directors on the board of directors) the focal point for good corporate governance in Indonesia.

Second, given that independent commissioners have become the focal point for good corporate governance in Indonesia, what impact is this likely to have on Indonesian corporate governance? To answer this question, we conducted semi-structured interviews with ten independent commissioners in several of Indonesia's large and midsize listed companies involved in various industries. Based on these interviews and an analysis of the corporate law, it appears that independent commissioners provide only a partial substitute for independent directors for promoting good corporate governance in listed companies in Indonesia. In addition, evidence based on these interviews suggests that the ability of independent commissioners to promote good corporate governance may be compromised by controlling shareholders' influence, their limited legal authority, and potential pressure placed upon them from corrupt government practices. Moreover, based on our hand-collected data, which aims to illuminate the level of political connections between independent commissioners and the government, it appears that there may be a risk of the independence of "independent" commissioners being compromised by political interests – especially in Indonesia's powerful state-owned enterprises. Ultimately, we conclude that Indonesia's reliance on independent commissioners – rather than independent directors – may, have some tenuous theoretical validity based on its ostensibly "two-tier board" system; but even this rationale suffers from the fact that its so-called "two-tier board" may not even qualify as a "two-tier board" when viewed through a comparative lens. Given this legal impediment and the practical risks we have highlighted above, reforms to Indonesia's independent commissioner system are required to ensure that independent commissioners in practice can fulfil the heavy responsibility that has been placed upon them.

Third, given Indonesia's substantial reliance on independent commissioners and the weaknesses that exist in its current regulatory framework and controlling shareholder dominated corporate governance context, what reforms could be made to ensure that independent commissioners provide an effective tool to address Indonesia's corporate governance challenges? We draw on information from our semi-structured interviews with independent commissioners, hand-collected data on political connections between independent commissioners and the government, and leading comparative corporate law and governance research on board independence. Based on our analysis of this information, we suggest bespoke reforms to improve the effectiveness of Indonesia's independent commissioner system that takes account of Indonesia's level of development, its concentrated shareholder landscape, the dominance of its state-controlled and family-controlled listed companies, and its ongoing battle with endemic corruption. These suggested reforms, which are another significant contribution of our research, aim to transform Indonesia's current system of independent commissioners into an autochthonous corporate governance mechanism that "fits" Indonesia's local context and quells the corporate governance maladies that may jeopardize Indonesia achieving its enormous potential.

We conclude by illuminating what Indonesia's idiosyncratic abolition of its requirement for independent directors may suggest about the global evolution of corporate law. The original transplant of Anglo-American-cum-global independent directors into Indonesia's civil law, "two-tier", corporate board system over a decade ago was unsurprising. It was part of a global trend, which was accentuated in Asia, of "legal misfits" being imported into systems of corporate governance to demonstrate adherence to Anglo-American-cum-global norms of "good" corporate governance. However, as regionalization replaces globalization and Asia's economic prowess continues to rise, green shoots of autochthonous solutions to corporate governance maladies have recently been sprouting across Asia. In this new era of more bespoke local corporate governance solutions, Indonesia's previously unthinkable break with a hallmark of Anglo-American-cum-global "good" corporate governance – the independent director – perhaps portends the "new normal" in what may be a more regional and autochthonous future for corporate governance globally.

By Royhan Akbar (Universitas Gadjah Mada), Nathaniel Mangunsong (Universitas Indonesia), and Dan W. Puchniak (Singapore Management University and ECGI)

Corporate governance and climate-related shareholder activism: A call for reform

Dan W. Puchniak, Singapore Management University and ECGI
Umakanth Varottil, National University of Singapore and ECGI

Climate change has emerged as one of the most pressing issues of our time, with far-reaching implications for businesses, investors, and society at large. As the urgency to address this global challenge intensifies, there is a growing recognition that corporate governance plays a crucial role in driving sustainable practices and mitigating climate risks. Institutional investors, armed with trillions of dollars in assets under management, are increasingly viewed as potential catalysts for transformative change in corporate behaviour. However, the path to effective climate-related shareholder activism is not without obstacles, particularly in the realm of corporate law and governance regulations. This tension between the need for urgent action on climate change and the legal frameworks governing shareholder activities presents a complex challenge that demands innovative solutions.

In our recent ECGI Working Paper, "Climate-Related Shareholder Activism as Corporate Democracy: A Call to Reform 'Acting in Concert' Rules," we examine the potential for climate-related shareholder activism to drive significant changes in corporate governance, particularly in promoting sustainability. However, we argue that the current legal framework governing "acting in concert" poses substantial barriers to effective climate-related shareholder activism.

Our research highlights the growing influence of institutional investors and initiatives like the Principles for Responsible Investment (PRI), which now represents over $120 trillion in assets under management.

This shift, coupled with the evolution of stewardship codes worldwide to focus on environmental, social, and governance (ESG) factors, sets the stage for potentially transformative green activism in corporate governance.

However, we identify a critical obstacle: the legal rules concerning "acting in concert" were designed primarily to regulate takeovers and contests for control, not to address modern forms of shareholder activism focused on issues like climate change. These rules can disincentivize or even functionally disenfranchise institutional investors from using aggressive tactics to drive environmental agendas, even when such agendas are supported by a majority of shareholders.

Our working paper provides a comparative analysis of "acting in concert' regimes across several jurisdictions, including the UK, EU, US, and notably in the context of this Asian focused ECGI Blog series, Japan. In the Japanese context, we discuss the emergence of anti-activist poison pills and their recent judicial scrutiny. We highlight a case involving Mitsuboshi, where an institutional shareholder, Adage Capital, challenged a shareholder rights plan with an expansive concept of acting in concert. The Japanese courts, including the Supreme Court, ruled against such broad definitions of concerted action, criticizing the overly expansive and nebulous nature of the group definitions and prohibited acts that would trigger the poison pill.

This Japanese example illustrates a broader trend observed in other jurisdictions, where courts rightfully are becoming increasingly sceptical of overly broad definitions of acting in concert, particularly when they may impede legitimate shareholder activism. We note that ESG activism, including climate-related initiatives, is becoming increasingly influential in Japan and is a source of concern for Japanese managers.

We argue that the current legal landscape, exemplified by cases like Mitsuboshi in Japan and similar developments in other countries, creates a situation where ...

"... institutional investors are caught between their growing commitment to address climate change and the legal risks associated with collective action."

This dilemma often results in what we term "faux green activism," where investors engage in soft forms of engagement but avoid more aggressive tactics that could lead to real change.

To address this issue, we propose a novel model for reforming "acting in concert" regimes. Our model aims to distinguish between climate-related activism campaigns and traditional takeover contests. Key elements of our proposal include:

1. Recognizing the distinction between shareholder activism and control changes, allowing for more aggressive forms of engagement, including the threat or execution of board changes, when aimed at achieving specific environmental objectives.

2. Creating a safe harbour for intermediary-led climate-related activism, acknowledging the role of organizations like the PRI in coordinating shareholder actions.

3. Focusing initially on climate activism rather than broader ESG issues, given the universal importance and clearer definition of climate-related objectives.

We argue that such reforms are crucial not only for promoting effective corporate governance but also for addressing the existential threat of climate change. We suggest that the failure to adapt "acting in concert" regimes may miss a significant opportunity to leverage the collective power of institutional investors in driving sustainable corporate practices.

Our insights are particularly relevant for corporate governance in Asia, where countries like Japan are grappling with the intersection of traditional corporate structures, emerging shareholder activism, and growing ESG concerns. The Mitsuboshi case in Japan exemplifies the tension between established corporate defenses and the evolving landscape of shareholder rights and the potential (or lack thereof) in the future for environmental shareholder activism.

Due to the more dispersed shareholder structure in Japan than in any other country in Asia and its high level of institutional investor ownership compared to the rest of Asia, the implications of "acting in concert" rules are likely to be particularly salient in Japan – the world's fourth largest economy. However, even in Asia's concentrated shareholder environment, the reform of "acting in concert" rules could have important implications as institutional investors exercise their voice as important minority shareholders. Moreover, as the shareholder landscape of Asia's largest economies continues to evolve, countries like China – Asia's largest economy – have seen a significant increase in the percentage of shares owned by institutional investors. In this context, empowering institutional investors in Asia as either important minority blocks or even collective majority owners to more effectively engage with companies on climate issues by reforming their acting in concert rules may potentially lead to significant improvements in corporate sustainability practices across the region. This much is certain: given Asia's size, population and economic power, climate change cannot be effectively addressed without Asia .

In conclusion, we present a compelling case for reevaluating and reforming "acting in concert" regulations globally, including within Asia. By aligning these rules with the realities of modern climate-related shareholder activism, there is potential to unlock a powerful force for positive change in corporate sustainability practices, both in Asia and worldwide.

By Dan W. Puchniak (Yong Pung How School of Law (YPHSL), Singapore Management University and ECGI) & Umakanth Varottil (National University of Singapore and ECGI)

The human(e) side of corporate insolvency: Protecting workers and employees in Asian economies

Surbhi Kapur, O.P. Jindal Global University

In the bustling economies of Asia, where skyscrapers rise and fall like the tides of fortune, there is a hidden story unfolding behind the gleaming facades of corporate success. It is a tale of human resilience in the face of financial turmoil, of workers caught in the crossfire of corporate collapse, and of legal systems striving to balance economic efficiency with social justice. As businesses navigate the treacherous waters of insolvency, the fate of countless employees hangs in the balance. Their stories, often overshadowed by financial figures and legal jargon, reveal the true human cost of corporate failure. But amidst this uncertainty, a new narrative is emerging – one that recognizes the vital role of workers in the corporate ecosystem and seeks to protect their interests in times of crisis.

Corporate insolvency is often viewed through a financial lens, focusing on creditors, assets, and debt restructuring. However, my recent working paper sheds light on a crucial yet often overlooked aspect of corporate failure: the impact on workers and employees. In "The Social Dynamics of Corporate Insolvency Law and Workers/Employees of Distressed Companies: Comparing Select Asian Jurisdictions," the research compares and examines how corporate insolvency laws in five Asian economies – Hong Kong, India, Singapore, Thailand, and Vietnam – address the rights and interests of workers and employees caught in the turmoil of corporate distress.

The research comes at a critical time. The recent rise of modern states and market-driven economies in Asia has been accompanied by a modernization of insolvency laws. These updated frameworks emphasize improved inclusivity, time-bound resolution of corporate distress, and a growing focus on viable rescue, social welfare, and preservation of human capital. This shift recognizes that the collapse of a corporate entity can have substantial and wide-ranging effects on the lives and livelihoods of many people associated with it.

> "Corporate insolvency laws should go beyond the paradigm of neoclassical economics, which treats workers merely as factors of production."

Instead, the research argues for a more holistic approach that considers the human and social dynamics of corporate insolvency. This perspective aligns with the growing emphasis on stakeholder capitalism and the recognition that businesses have responsibilities beyond shareholder value maximization.

One of the key findings of the research is the varying degrees to which different Asian jurisdictions recognize workers as creditors in insolvency proceedings.

In India, for example, the Insolvency and Bankruptcy Code, 2016 (IBC) classifies workers and employees as "operational creditors," empowering them to initiate insolvency proceedings against their employer. This recognition of workers' claims as a form of operational debt is a significant step towards protecting their interests in times of corporate distress.

Similarly, in Vietnam and Singapore, employees are granted the status of creditors and can petition for the commencement of insolvency proceedings. These jurisdictions also allow for employee representation in creditors' committees, giving workers a voice in key decision-making processes during insolvency resolution.

The research also highlights the importance of distinguishing between different types of employee claims. These are categorized as "service claims" (such as unpaid wages and salaries) and "welfare claims" (including provident fund, pension, and gratuity). The treatment of these claims varies across jurisdictions, with some offering greater protection than others. In India, for instance, the IBC provides for a "waterfall" mechanism that prioritizes the payment of workers' dues in the event of liquidation. Workmen's dues for the preceding 24 months from the liquidation commencement date are given a second priority ranking alongside secured creditors. This approach recognizes the vulnerable position of workers and aims to ensure they are not left empty-handed when a company fails. Hong Kong takes a different approach, utilizing a Protection of Wages on Insolvency Fund to provide ex gratia payments to employees of insolvent companies. This system aims to provide quick relief to workers without waiting for the completion of often lengthy insolvency proceedings.

One of the most intriguing aspects of the research is the exploration of the changing nature of directors' duties in the context of corporate distress.

It argues for an expansion of the "creditor duty" concept to include workers and employees as creditors of a distressed company. This novel interpretation recognizes the shift in workers' legal status that occurs when a company becomes insolvent, potentially offering them greater protection.

The research also delves into the challenge of balancing corporate rescue with employment protection. It examines various mechanisms used in Asian jurisdictions to preserve jobs during insolvency proceedings, such as the sale of businesses as going concerns. In India, for example, there is a growing trend of continuing the business of insolvent companies as going concerns, even in liquidation, to preserve value and protect employment.

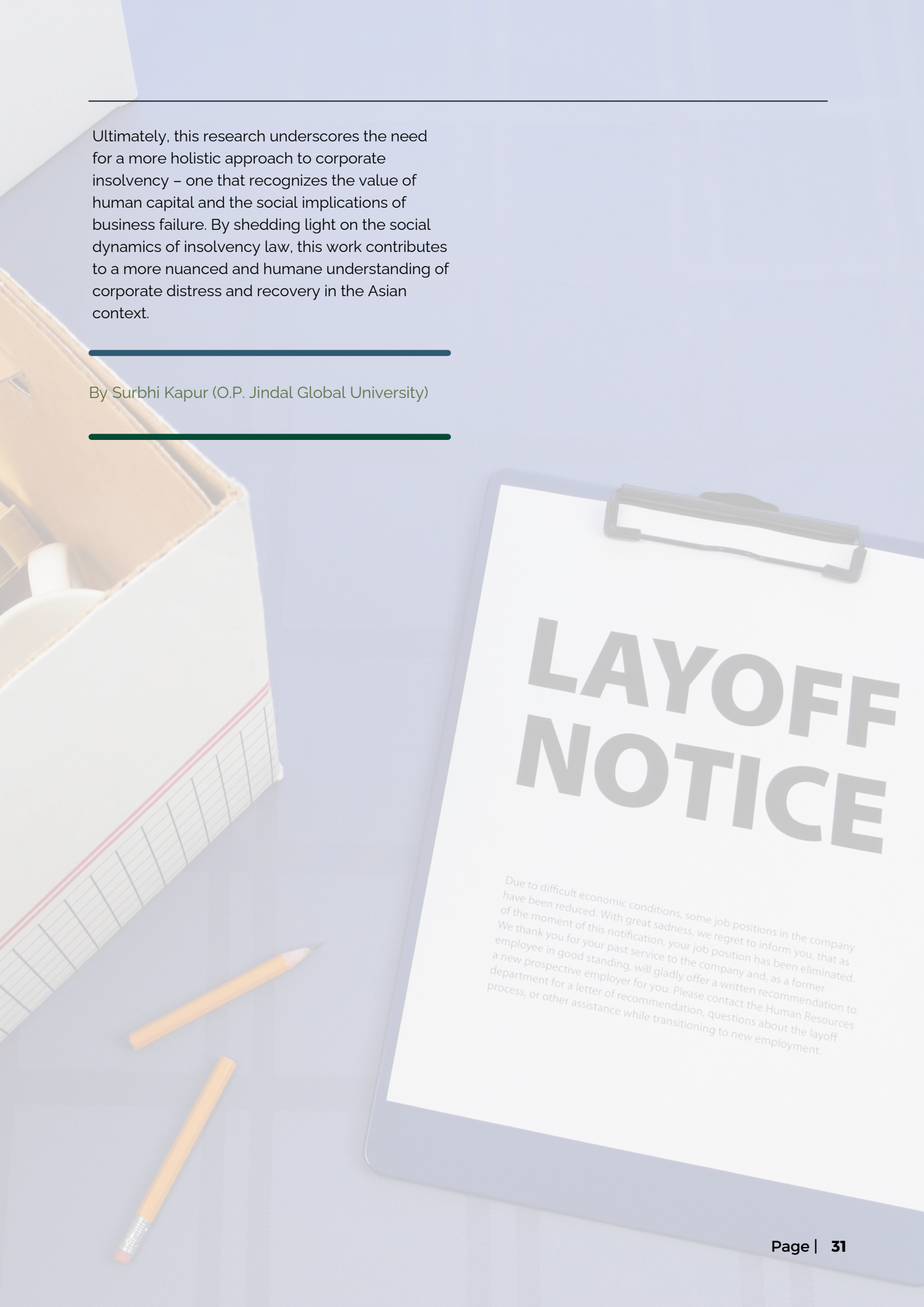
Perhaps one of the most valuable contributions of this work is the emphasis on the need for better data collection and analysis in insolvency proceedings. While financial outcomes are well documented, there is a lack of data on the human impact of corporate insolvencies. How many jobs are saved or lost? What happens to employees' wages and benefits? These are critical questions that often go unanswered.

The research concludes with a powerful analogy, comparing workers and employees of distressed companies to "shape memory alloys" in material science. Just as these alloys can recover their original shape after deformation, workers often demonstrate remarkable resilience in the face of corporate distress. They "remember" their pre-insolvency dedication and commitment, potentially playing a crucial role in the company's turnaround.

This work serves as a timely reminder that behind the financial figures and legal proceedings of corporate insolvency are real people whose lives and livelihoods hang in the balance. The comparative analysis of Asian insolvency regimes offers valuable insights for policymakers, practitioners, and scholars alike. As economies continue to evolve and face new challenges, ensuring that insolvency laws adequately protect workers and employees while facilitating an efficient corporate rescue will remain a critical balancing act.

Ultimately, this research underscores the need for a more holistic approach to corporate insolvency – one that recognizes the value of human capital and the social implications of business failure. By shedding light on the social dynamics of insolvency law, this work contributes to a more nuanced and humane understanding of corporate distress and recovery in the Asian context.

By Surbhi Kapur (O.P. Jindal Global University)



The impact of Finfluencers and social media on corporate law – Notes from South Korea and India

Akshaya Kamalnath, Australian National University

The story of the rise of finfluencers is tangled in the story of the rise of retail investors, social media, the Covid-19 pandemic, and investing apps that made it easy and fun for laypersons to make and manage investments. The GameStop episode brought all this into sharp focus. At the epicentre of the GameStop movement was a finfluencer, Keith Gill, who went by the name of Roaring Kitty. Gill influenced people's decisions to buy shares in GameStop even when the price of a share had gone from $4 to $80 and then to not sell the shares even when they could have made a profit by selling. The fact that retail investors continue to matter even today is reflected in the recent proxy contest at Disney where, amongst other things, management got George Lucas, the creator of the Star Wars franchise to publicly support the company. George Lucas is an example of a celebrity finfluencer in this context.

In South Korea, retail investing had begun even before the pandemic, although Gamestop definitely inspired some copycat behaviour in the country. A thread called kstreetbets was formed on Never Café, Korea's equivalent of Reddit. Korean retail investors have also felt short-changed by short sellers who were mainly big institutions at the time. However, by 2021, retail investors accounted for about 60% of the daily stock market turnover, and so in theory, they could have both market and political heft if their trading is coordinated. Yet, because of concerns about violating regulations, the retail investors have focused on lobbying government to change the rules rather than working against the short sellers through coordinated trading. These efforts have been partially successful with the Korean government temporarily imposing a ban on short-selling, and then extending it up to 2024.

Finfluencers as popular as Gill, if not more, have also triggered GameStop-esque episodes in South Korea. In 2023, retail investors caused the shares of EcoPro and its subsidiary, EcoPro BM (which is a battery company), to go up nine times, based on recommendations and encouragement of local finfluencers like Park Soon-hyuk (affectionately called 'Battery Ajeossi'). Just like in the GameStop episode, according to experts, this stock price too did not reflect the fundamentals of that company. While nostalgia for GameStop coupled with other pandemic related factors might have contributed to retail investors rallying for GameStop, in this case, retail investors in South Korea seem to have made a calculated decision. They were betting that 'South Korean battery makers and material producers will benefit from a booming market in electric vehicles and US president Joe Biden's landmark programme of subsidies for clean energy', which has restricted Chinese components in green technologies that were able to qualify for carbon credits. Retail investors have also begun to actively participate as shareholders of the companies they hold shares in, and a domestic activist fund, Align Partners, seems to be actively engaging with retail investors for its campaigns. The retail investor cohort in South Korea also seems to be mature enough to assess information and vote based on issues at stake.

In India, the story is more about financial inclusion, with finfluencers reaching different slices of the population by offering content in local languages. Since they are targeting first time investors, the content often focuses on basics like 'how to buy your first share'.

An incident worth highlighting is that of Hindenburg Research, a firm that engages in short selling, publishing a report about the Adani group of companies, stating that the group's stocks were overvalued, and accusing Gautam Adani, founder of the Adani group, of accounting fraud and stock market manipulation. Since Adani is seen to be close to the Indian prime minister, the issue became a politically charged debate. The fact that many finfluencers supported the report should caution us about finfluencers diluting their content in favour of entering politically charged debates to increase their online followers and/ or viewership.

In terms of regulatory approaches, the market regulator in South Korea is actively engaging with retail investors and finfluencers in determining rules about short selling. While the market regulator in India initially sought to ban finfluencers, they are currently undertaking a consultation process to determine the best way forward.

"Finfluencers bringing populism into the market and finfluencers helping increase financial inclusion and eventually ensuring active engagement of retail investors on governance issues are two sides of the same coin."

In determining risks and benefits of finfluencers, regulators across jurisdictions would do well to consider the developments in South Korea and India.

By Akshaya Kamalnath (Australian National University)

Corporate purpose beyond borders: A key to saving our planet or colonialism repackaged?

Roza Nurgozhayeva, Nazarbayev University
Dan W. Puchniak, Singapore Management University and ECGI

The "corporate purpose" debate has captured the attention of academics, lawyers, policymakers, and entrepreneurs around the world. Leading corporate governance scholars see it as one of the "hottest public policy issues" of our time. Governments have embraced legislation to make corporations more purposeful and financial titans have pledged over 100 trillion dollars under their management to foster a broader conception of corporate purpose globally. The realization that climate change is likely the issue of the century and that any chance of successfully addressing it will require a change in the way corporations are governed, seems to justify the attention that the corporate purpose debate is receiving. And yet, the corporate purpose debate, while extremely important, has largely been built on an understanding of corporate law and governance that is local – jurisdiction bound – while the issue of climate change is global; pollution does not respect jurisdictional borders.

As Roza Nurgozhayeva and Dan W. Puchniak explain in their recent ECGI Working Paper – Corporate Purpose Beyond Borders: A Key to Saving Our Planet or Colonialism Repackaged? – this myopic, jurisdictionally bound, conception of corporate purpose forms the logical foundation for Milton Friedman's (in)famous 1970s New York Times article "The Social Responsibility of Business Is to Increase Its Profits". In Friedman's jurisdictionally bound world, local elections and each country's democratic process are the linchpins holding together his theory that policy decisions related to social responsibility should be left to governments – not the management of companies – justifying his core argument that the focus of companies should be maximizing shareholder value. The idea that externalities, such as pollution, may cross jurisdictional borders and that, in turn, those impacted by extraterritorial externalities would not be part of the democratic process, was not contemplated in Friedman's seminal article – a fact that those who both love and loath Friedman's article have almost entirely overlooked.

Friedman's domestic, jurisdictionally bound, understanding of corporate purpose is not an aberration in the leading academic discourse on corporate purpose – it is the norm. The Anatomy of Corporate Law, which is widely considered to be the world's leading comparative corporate law treatise, frames its discussion of corporate purpose around "local communities" and the interests of "society". The primary tension in the corporate purpose debate among legal academics – whether to protect non-shareholder stakeholders inside or outside the corporate law – presupposes that the company in question is within the jurisdiction of the government making this policy decision. This illustrates how the extraterritorial effects of companies, and the formal and informal legal mechanisms used to manage those effects extraterritorially, have almost entirely escaped the current academic understanding of corporate purpose.

However, many of today's pressing environmental and societal issues, including climate change, are clearly global.

As a result, a panoply of informal and formal legal mechanisms has been produced by states, multinational firms, and transnational organizations that aim to shape corporate purpose beyond jurisdictional borders. Collectively, these mechanisms have created the "globalization of corporate purpose", raising myriad possibilities for effectively addressing global issues, the most prominent of which is climate change.

"The globalization of corporate purpose is not unambiguously a force for good."

When powerful-states, powerful-firms, and powerful-organizations define corporate purpose beyond borders it risks corporate purpose being defined in the interest of these powerbrokers, to the detriment of less powerful communities around the world.

Especially in the context of this special ECGI Blog series on Asia, China's role in shaping corporate purpose beyond borders deserves special attention. As the world's second-largest economy and a major player in global trade and investment, China's approach to corporate governance and sustainability has significant implications for the global business landscape. Our research reveals that China's stance on extraterritorial corporate governance differs markedly from that of the EU or the United States, and specifically California. While the EU has aggressively pushed its stakeholder-focused conception of corporate purpose globally through initiatives like the Corporate Sustainability Reporting Directive (CSRD), China has taken a more restrained approach.

This is rooted in China's principle of non-interference in the domestic affairs of other states, which extends to its corporate governance policies. The Belt and Road Initiative (BRI), China's ambitious global infrastructure development strategy, provides a prime example of this approach.

Despite its enormous scale and potential for shaping corporate behaviour across multiple jurisdictions, the BRI has not explicitly push for standardized sustainable corporate governance practices across its member states. Instead, it emphasizes state sovereignty and the right for each country to pursue its own developmental goals.

This non-interventionist stance is further reflected in China's approach to its multinational corporations. Unlike their Western counterparts, which often act as conduits for exporting corporate governance standards, Chinese multinational firms are encouraged to respect a "host country standard" by adapting to local governance norms rather than imposing their own. This creates a stark contrast with the "IKEA Effect" or "BlackRock Effect" observed with Western multinational companies and investors. Moreover, our research indicates that China has largely insulated itself from the influence of Western-driven corporate governance trends. For instance, while institutional investors now play a significant role in shaping corporate governance in many markets, almost all shares owned by institutional investors in Mainland China are held by Chinese entities. This limits the impact of initiatives like the "BlackRock Effect" within China's borders.

China's Ministry of Finance followed the same trend in May 2024, when it issued a draft of the Chinese Sustainability Disclosure Standards for Business Enterprises (CSDS) – Basic Principles that set general requirements for corporate sustainability disclosure and apply to companies established in China. The Ministry plans to introduce climate-related disclosure standards by 2027 and roll out China-wide corporate sustainability disclosure standards by 2030. There is no intention to adopt a "one-size-fits-all mandatory approach", but rather gradually phase-in voluntary and mandatory reporting for listed and non-listed companies to consider the development stage and disclosure capabilities of Chinese companies. While the CSDS seems to focus on Chinese companies, another landmark initiative introduced by China's major stock exchanges in Shanghai, Shenzhen, and Beijing may have a potential extraterritorial effect through supply chains and dual listing. The three stock exchanges have released mandatory sustainability reporting guidelines effective from 1 May 2024.

The guidelines require listed companies with a large market capitalization, as well as those with dual listings, to disclose a broad range of sustainability topics, including climate change, pollution control, ecosystem protection, rural revitalization, and ethics of science and technology.

Although both the CSDS and the guidelines build on the ISSB Standards, there is a fundamental difference – the adoption of the double materiality principle that requires companies to report on issues they find financially material as well as their impact on the economy, society and the environment (impact materiality). The adoption of double materiality makes China the second jurisdiction in the world, along with the EU, to follow this path.

This raises the question of whether China is moving towards the EU standard of stakeholder-focused sustainable corporate purpose, which calls for future research. At this point, it seems unlikely. Both CSDS and the guidelines introduce sustainability disclosure with "Chinese characteristics," drawing on China's market conditions, domestic disclosure systems, national values, and priorities. They primarily target companies within China's jurisdiction, which means they uphold China's noninterference philosophy.

The rise of BRICS+ and China's recent watershed initiatives and economic influence suggest a potential shift in the global corporate governance landscape. As these emerging economies gain more say in international affairs, we may see a move away from a EU conception of a one-size-fits-all approach to corporate purpose. Instead, a more diverse, regionally focused model of corporate governance may emerge, with China playing a pivotal role in shaping this new paradigm.

In conclusion, understanding China's approach to corporate purpose beyond borders is crucial for grasping the full complexity of the global corporate governance landscape. As the world grapples with pressing issues like climate change, the interplay between China's non-interventionist stance and the more aggressive approaches of other major economies, exemplified by the EU, will significantly influence how corporate purpose evolves on a global scale.

By Roza Nurgozhayeva (Graduate School of Business, Nazarbayev University) and Dan W. Puchniak (Yong Pung How School of Law (YPHSL), Singapore Management University and ECGI)

ESG, externalities, and the limits of the business judgment rule - TEPCO derivative suit on Fukushima nuclear accident and the expansion of Caremark –

Gen Goto, University of Tokyo

On March 11, 2011, an enormous tsunami caused by the Eastern Japan Great Earthquake struck the Fukushima 1st Nuclear Power Plant of Tokyo Electric Power Company (TEPCO). The tsunami went over the seawalls and flooded the vital facilities of the power plant, causing the loss of electricity necessary for cooling nuclear reactors. This resulted in the meltdown of the reactors and the emission of radioactive materials on a massive scale. A group of TEPCO's shareholders filed a derivative suit against its former directors, who were at the time of the incident the chairman of the board of directors, the president, and the directors in charge of the nuclear power branch, for damages suffered by TEPCO because of the Fukushima incident.

On July 13, 2022, the 8th Civil Division of the Tokyo District Court held that four of the five defendants had breached their duty of care for not taking appropriate preventive measures against the occurrence of a huge tsunami (TEPCO Decision). A primary basis for the TEPCO Decision was that the directors disregarded a report by a scientific government council noting the possibility that a huge tsunami may occur at some point that would impact the power plant. As a result of the breach, the Court ordered the four directors to jointly pay TEPCO 13.321 trillion Japanese Yen (approximately $85 billion USD).

This was a landmark decision as the quantum of damages awarded against the directors dwarfed any previous award in Japanese history.

Equally as important as the quantum of damages was the court's rationale for its decision relating to how it applied the duty of care in this case:

> "if the defendants who were directors of TEPCO had recognized or had been able to recognize the possibility of the occurrence of a severe incident at the Fukushima 1st Power Plant due to a huge tsunami that can be predicted by current scientific knowledge, but had failed to order taking measures necessary to avoid such an incident, such directors shall be deemed to have violated their duty of care against TEPCO *regardless of whether such failure constitutes a violation of a particular law or regulation applicable to the corporation."* (emphasis by the author)

When viewed through a comparative lens, it appears that the TEPCO Decision dovetails with recent developments in the Delaware courts with respect to the duty of oversight. Specifically, recent Delaware decisions, such as Marchand v. Barnhill (Del. 2019) and In re Boeing Company Derivative Litigation (Del. Ch. 2021) have expanded the scope of the so-called Caremark duty of oversight in cases where there was no specific violation of laws or regulations (for the development of Delaware case law, see Shapira 2022).

This expansion of the duty of oversight in Japan and the United States might be welcomed by some as a step toward a more sustainable society – one in which directors can more easily be held liable in cases where companies are involved in incidents that produce enormous negative externalities. However, it must be noted that the expansion of the duty of oversight may collide with the business judgment rule – a foundational corporate law principle that is seen as essential to incentivize optimal risk-taking, maximize corporate value, and promote economic growth. The combined impact of limiting the business judgment rule, with the imposition of an unimaginable quantum of personal liability which is exempt from D&O liability insurance, is likely to have a significant chilling effect on risk-taking by directors. From this perspective, the TEPCO Decision may discourage directors from engaging in an optimal level of risk-taking, which would be detrimental to corporations, their shareholders, and the economy.

To avoid such a chilling effect, my recent working paper, "ESG, Externalities, and the Limits of the Business Judgment Rule: TEPCO Derivative Suit on Fukushima Nuclear Accident and the Expansion of Caremark", seeks to clarify when and why the business judgment rule should be limited when corporations are involved in businesses which may produce large negative externalities. The working paper analyzes the TEPCO Decision and recent discussions regarding the expansion of the Caremark duty of oversight. It analyzes multiple perspectives supporting the expansion of the duty of oversight to illuminate possible justifications for the expansion and depicts how the differences in these perspectives affect their scope of application.

"The directors' duty of oversight is highly contextual and is contingent on the type and the nature of the risks and externalities in question."

It is well-known that "ESG" is a broad concept encompassing a variety of issues, ranging from climate change to local environmental pollution, and from human rights in supply chains to consumer protection from company's products. As such, to avoid the deleterious consequences of an over-expansion of the duty of oversight, while still addressing the need to mitigate serious negative externalities, the concept of "ESG" must be unpacked to ensure that it is applied appropriately based on the specific characteristics of the externality in question. Such an approach does not provide an elegant, one-size-fits all, rule for applying the oversight duty. But, we do not live in a one-size fits all world.

By Gen Goto (Graduate Schools for Law and Politics, The University of Tokyo)

Event | 27 - 28 August 2024 | Organised by:

The Swedish House of Finance- ECGI

The selection of articles covers a range of topics, beginning with the need to expand the concept of board diversity beyond demographics, such as gender and race, to include professional experience, educational background, and political viewpoints, and exploring organisational strategies for ensuring that boards are both effective and reflective of broader societal values. Another article challenges the traditional profit-maximisation model, advocating instead for a shareholder welfare maximisation approach that considers societal and environmental impacts, and provides a deep dive into the real-world challenges and practicalities of shareholder influence, corporate responsibility, and governance.

Overall, the edition sheds light on the complex dynamics between pro-social stakeholders and organisational sustainability, and examines how proxy advisors influence competition among firms with high levels of common ownership.

The campaign to free shareholders

Reflections on the keynote speech by Luigi Zingales

Luigi Zingales' keynote speech on corporate democracy at the SHoF-ECGI Corporate Governance Conference on 27th August 2024, offered a powerful critique of the current state of corporate governance and a radical rethink of how we understand shareholder responsibility.

Zingales kicked off his speech by taking us back to 1970, when Milton Friedman famously argued that the sole responsibility of corporations is to maximize profits. This simple, elegant idea has shaped decades of corporate governance theory and practice. But, as Zingales pointed out, this approach is no longer fit for purpose in a world where corporations wield significant political power. In fact, the world Friedman described—a world where corporations operate within the bounds of law and regulation—has transformed dramatically.

As Zingales reminded us, many corporations today are powerful enough to influence, and even change, the rules themselves.

One of the most compelling examples Zingales gave was the case of ExxonMobil. He referenced a shocking recording in which a lobbyist for the oil giant admitted that the company had "aggressively fought against some of the science" around climate change. This wasn't just a corporate decision to protect their short-term profits—it was a deliberate effort to manipulate public discourse and policy for financial gain. For Exxon, this was simply good business, as it maximized shareholder value. But for the rest of society, it's a stark reminder of how profit maximization can lead to dangerous and socially harmful behaviors.

Zingales didn't stop there. He also raised the provocative question of whether private prisons have a fiduciary duty to lobby for longer sentences. After all, their profitability increases with higher incarceration rates. While this sounds absurd on the surface, it highlights a critical flaw in the way we think about corporate responsibility: when the primary goal is maximizing shareholder value, corporations may feel justified—even obligated—to pursue actions that harm society.

Zingales' proposed solution? We need to move beyond the narrow concept of shareholder value and toward what he calls "shareholder welfare". Shareholders aren't just profit-hungry investors; they're people with diverse interests and values. Some may prioritize environmental sustainability, others may care about ethical governance, and many likely don't want their companies undermining democracy or exploiting loopholes to skirt regulation. Zingales argued that corporations should reflect these broader preferences, not just the financial bottom line.

But how do we do this? How can we ensure that corporations act in the interest of shareholders' welfare rather than just their financial returns? Zingales suggested an innovative idea: citizen assemblies for corporate governance. Inspired by a concept from political science, this model would see randomly selected shareholders coming together to deliberate on key issues facing a corporation. Instead of expecting every shareholder to vote on complex governance matters, these assemblies would make informed decisions on behalf of the broader shareholder base. It's a practical way to ensure that shareholders' voices are heard without overwhelming them with the day-to-day complexities of corporate decision-making.

What was most striking about Zingales' proposal was its practicality. Corporate democracy doesn't mean turning every boardroom into a town hall. It's about giving shareholders a say in how their companies engage with the world, while still recognizing the importance of efficiency and expertise in governance.

The idea that shareholders should care about more than just profits—and that they should be able to express those values through corporate governance—is both refreshing and necessary in today's world.

Zingales ended his speech with a stark warning: if we don't address the growing disconnect between corporations and the societies they serve, we risk undermining the very foundations of capitalism itself. His call for corporate democracy isn't just about fairness—it's about survival. We cannot continue to allow corporations to operate in a vacuum, focused only on short-term profits while ignoring the long-term impacts of their actions on society, the environment, and even democracy.

It is important to reflect on how we, as investors, customers, and citizens, can influence the direction of corporate behavior. The current system may reward profit maximization, but Zingales showed us a glimpse of a better future—one where corporations are guided by the broader welfare of their shareholders and society. It's a bold vision with endless possibilities.

Zingales' message is clear: the time for corporate democracy is now, and the stakes couldn't be higher. Later in an interview, Zingales reiterated his message with a call for a campaign to "free shareholders like we freed Britney Spears!"

Directly following this thought-provoking keynote, a panel discussion offered a fascinating dive into the real-world challenges and practicalities of shareholder influence, corporate responsibility, and governance. The panelists brought a wealth of experience, blending academic insight with hands-on corporate governance roles. One of the key points raised was the question of how to balance profit maximization with long-term societal considerations, particularly in cases where corporate actions—such as lobbying or environmental decisions—may conflict with the broader good.

Petra Hedengran, General Counsel at Investor AB, emphasized the importance of long-term value creation through engaged ownership. She argued that sustainability is crucial not just for shareholders but for the longevity of the business itself.

Hedengran's defense of long-term shareholder value tied back to Zingales' challenge: Is long-term value really aligned with societal value, or can corporations hide damaging actions behind a reputation-based facade? Zingales pushed further, pointing out that, historically, firms like IBM and DuPont engaged in ethically questionable activities without suffering significant reputational damage. This led to a broader discussion on corporate accountability, with Mireia Giné suggesting that boards need to face greater scrutiny and responsibility when it comes to meeting shareholders' evolving expectations around social and environmental issues.

The panel highlighted the tension between theoretical ideals and real-world governance challenges. Zingales' proposal for shareholder assemblies, while innovative, met with practical concerns from panelists, who noted that real-world decisions often blur the lines between value-driven and business-driven choices. For instance, the question of whether firms should divest from controversial markets like Russia brought out differing views on how values and business interests intersect. Ultimately, the panel underscored the complexity of navigating shareholder influence in a world where ethical concerns are becoming increasingly central, yet are often difficult to quantify or prioritize.

Reflections on the keynote speech by Luigi Zingales (University of Chicago, Booth School of Business and ECGI)

Has there been a “partisan realignment” within corporate America?

Reflections on the keynote speech by Wei Jiang

At the SHoF-ECGI Corporate Governance Conference, Professor Wei Jiang delivered a deeply insightful keynote on the multifaceted nature of board diversity. In her presentation, titled “A Diverse View of Board Diversity”, Jiang shared rigorous empirical data that challenged conventional wisdom around the benefits and outcomes of diverse corporate boards. The speech was data-heavy but offered profound lessons about how we view diversity in boardrooms today, particularly within the U.S. context.

Immediately striking was Jiang’s nuanced take on diversity. Rather than positioning diversity as an unqualified good, she emphasized that diversity itself is complex, involving trade-offs. As she pointed out, diversity is often pursued for its potential to generate robust decision-making by bringing together individuals with independent perspectives. This is critical in ensuring that board decisions are not only informed but resilient against rapidly changing market and societal landscapes. But, as Jiang reminded us, diversity is also about variance—something that finance professionals usually seek to minimize in decision-making processes. Her balanced perspective invited the audience to consider board diversity as more than just a box to tick—it’s a dynamic factor with both benefits and challenges.

A particularly interesting point from Jiang’s research was her finding on political diversity within U.S. boards. Historically, corporate boards in the U.S. leaned Republican, reflecting a pro-business, conservative ethos. But in recent years, this has shifted. Jiang’s study uncovered what she called a “partisan realignment” within corporate America.

As boards have diversified along gender and racial lines, they have also become more politically aligned with the Democratic Party. In fact, when Republican-leaning boards appoint minority directors, these new directors are often politically progressive, further tilting the board’s political orientation toward the Democratic side. This finding suggests that efforts to increase gender and racial diversity in boardrooms are, perhaps unintentionally, contributing to a broader ideological shift in corporate governance.

Jiang’s analysis of the COVID-19 shock further illustrated the importance of board diversity. During the pandemic, boards with greater skill and experience diversity performed better, reflecting the practical value of having a range of expertise in times of crisis. While racial diversity also showed positive effects, it was skill diversity that had the most significant impact. This highlights an essential takeaway: not all forms of diversity carry the same weight in every situation, and companies need to consider what kinds of diversity are most relevant to their strategic needs.

Jiang’s speech reinforced the idea that diversity is not a one-size-fits-all solution. Her data-driven approach encouraged the audience to rethink how we measure and value diversity on corporate boards, and to recognize the complex trade-offs involved. By framing diversity as both a social and a strategic imperative, Jiang provided a thoughtful and evidence-based contribution to the ongoing conversation about how to build better boards.

The panel discussion following Professor Wei Jiang's keynote further explored the complexities of board diversity and the practical challenges of implementing it across different organizations. With participants from various sectors, including Ann Grevelius, Wilhelm Mohn, and Catharina Belfrage Sahlstrand, the conversation delved into how large institutional investors like Norges Bank Investment Management and Handelsbanken approach the issue of diversity in board composition. Each panelist provided insights into their respective strategies for ensuring that boards are both effective and reflective of broader societal values.

The panel broadly agreed on the importance of moving beyond the more easily measurable aspects of diversity, such as gender, to focus on more nuanced attributes like skill sets, experiences, and perspectives. Ann Grevelius argued that relying solely on demographic factors risks creating boards that look diverse on paper but lack the functional diversity needed to drive real value creation. Wilhelm Mohn echoed this sentiment, explaining that while gender balance is a critical first step, boards must also prioritize a diversity of expertise to remain agile and effective in today's complex business environment.

The panel also grappled with the growing trend of boards being required to recruit specific experts—whether in sustainability, cybersecurity, or other critical areas—often leading to a narrow pool of candidates. As Catharina Belfrage Sahlstrand pointed out, this can create challenges when boards try to fulfill both expertise and diversity mandates simultaneously. The discussion highlighted the need for a more flexible approach that balances the technical skills required for effective governance with the broader goals of diversity, ultimately ensuring that boards are equipped to handle the evolving challenges facing today's corporations.

Reflections on the keynote speech by Wei Jiang (Emory University Goizueta Business School and ECGI)

The growing influence of ESG: A double-edged sword for organizational sustainability

Jan Starmans, Stockholm School of Economics and ECGI

In recent years, environmental, social, and governance (ESG) concerns have moved to the top of the agenda of many organizations. Stakeholders, such as employees, managers, and investors, are now placing greater emphasis on sustainability within their organizations. Sustainable investing, for instance, has surged dramatically, reflecting a fundamental demand for companies to prioritize ESG factors. However, these developments also raise some challenging questions: How do pro-social stakeholders influence organizational sustainability? Does the impact of these stakeholders vary based on their roles within the organization? And perhaps most intriguingly, can pro-social preferences sometimes lead to conflicts within the organization, and how are these resolved?

To unravel these questions, we must understand how interactions between different stakeholders shape an organization's approach to sustainability. To this end, we develop a theoretical framework in which an owner and a manager collaborate to execute a project. The owner is the controlling stakeholder, but the manager's involvement is critical for the day-to-day running of the organization.

The Top-Down vs. Bottom-Up Approach

Interestingly, while it seems intuitive that stronger pro-social preferences would universally benefit an organization's sustainability, our research suggests otherwise. Our analysis highlights the importance of distinguishing between a top-down and a bottom-up approach to addressing sustainability concerns.

A top-down approach, where the pro-social initiative comes from the owner, tends to consistently enhance organizational sustainability. However, the same is not always true when adopting a bottom-up approach, in which the pro-social initiative originates from the manager.

"When the manager becomes more committed to social causes than the owner, it can actually lead to the organization becoming less sustainable."

How? As the manager becomes more pro-social, the potential for conflicts of interest intensifies between the owner and the manager. The owner may even limit the manager's authority as the conflict of interest becomes too severe. This results in control shifting from a more pro-social manager to a less pro-social owner, and the organization's sustainability declines. To illustrate this result, we can consider the case of Danone's CEO Emmanuel Faber, who was removed from his position in 2021 after attempting to transform Danone into a company that focuses on profits and environmental sustainability.

The Conundrum of Managerial Authority

The owner's decision to delegate authority to the manager involves a trade-off. On the one hand, delegation can allow a more informed manager to make decisions and reduce the owner's cost of implementing a project.

On the other hand, if the manager's pro-social preferences differ significantly from the owner's, delegation can lead to the implementation of an undesirable project from the owner's perspective, prompting the owner to reclaim control and choose a project themself.

Implications for Organizational Strategy

Our findings challenge the view that more pro-social stakeholders within an organization will automatically lead to better sustainability outcomes. Strengthening the owner's pro-social preferences generally improves these outcomes. However, enhancing the manager's pro-social preferences can either help or hinder organizational sustainability, depending on whether the changes in preferences lead to a change in control between the two stakeholders.

These insights have important implications for policymakers, stakeholders, and researchers. For policymakers aiming to promote sustainability, understanding the dynamics within an organization is essential. Simply encouraging more pro-social behavior is not enough; what matters is which stakeholders are effectively in control and how more pro-social concerns shape their actions. For stakeholders, particularly those in managerial roles, it is important to recognize that pushing too hard on sustainability could backfire if it leads to a loss of influence within the organization, for example, due to pushback from other parties within the organization. Finally, for researchers, our model offers a framework for exploring how pro-social preferences shape organizational outcomes and thus offers a way of interpreting empirical results.

The Paradox of Pro-Social Preferences

In trying to promote organizational sustainability, it is tempting to assume that more is always better—that more pro-social behavior will invariably lead to better outcomes. However, our research suggests a more nuanced view. While pro-social preferences can drive positive change, they can also create conflicts that undermine sustainability, particularly when the push for change comes from within the ranks rather than the top. The key takeaway is that the effectiveness of pro-social behavior in promoting sustainability depends not just on the presence of such behavior but on the structure of control within the organization.

By Jan Starmans (Stockholm School of Economics and ECGI)

The proxy advice industry and common owners' coordination

Tove Forsbacka, Norwegian School of Economics

Do high levels of common ownership weaken product market competition? The concentration of ownership to large institutional investors means that many competing firms today end up sharing the same owners. In theory, it would be in investors' financial interests that commonly held firms competed less intensely. Holding minority stakes, however, in practice, institutional investors don't have the power to significantly influence firms.

The most influential participants in the stewardship ecosystem – proxy advisors – have thus far been overlooked in this debate. Proxy advisors issue recommendations to investors on how to vote at shareholder meetings. The largest proxy advisor, Institutional Shareholder Services (ISS), is used by 70% of institutional investors. Most institutional investors rely heavily on proxy advisors when they cast their votes and passive investors, in particular, often outsource voting completely to proxy advisors. Studies have found that ISS can influence as much as 25% of investors' votes, which is multiples of any individual institutional investor's voting power.

In a recent working paper, I study how proxy advisors, by coordinating investors' interests, can lower competition for commonly held firms. As private, for-profit businesses, proxy advisors get their revenue from fees paid by their clients. They have a fiduciary duty, i.e. a legal obligation to act in the best interest of their clients. Empirical studies have shown that proxy advisors cater to their clients' interests, by updating their recommendations when clients have disagreed with their advice in the past. In a theoretical framework, I show that a proxy advisor maximizing client value would promote softer competition for firms with higher levels of common ownership. Importantly, this is not a result of collusion but rather what happens if the proxy advisor fulfils its fiduciary duty.

I investigate this using data on ownership structure and shareholder meetings for all publicly listed U.S. firms from 2003 to 2017. I find that common ownership among investors advised by ISS is significant. I measure common ownership based on my theoretical framework, by aggregating the cashflow rights investors hold across competing firms. These high levels of common ownership indicate that the incentives for ISS to promote softer competition are empirically important.

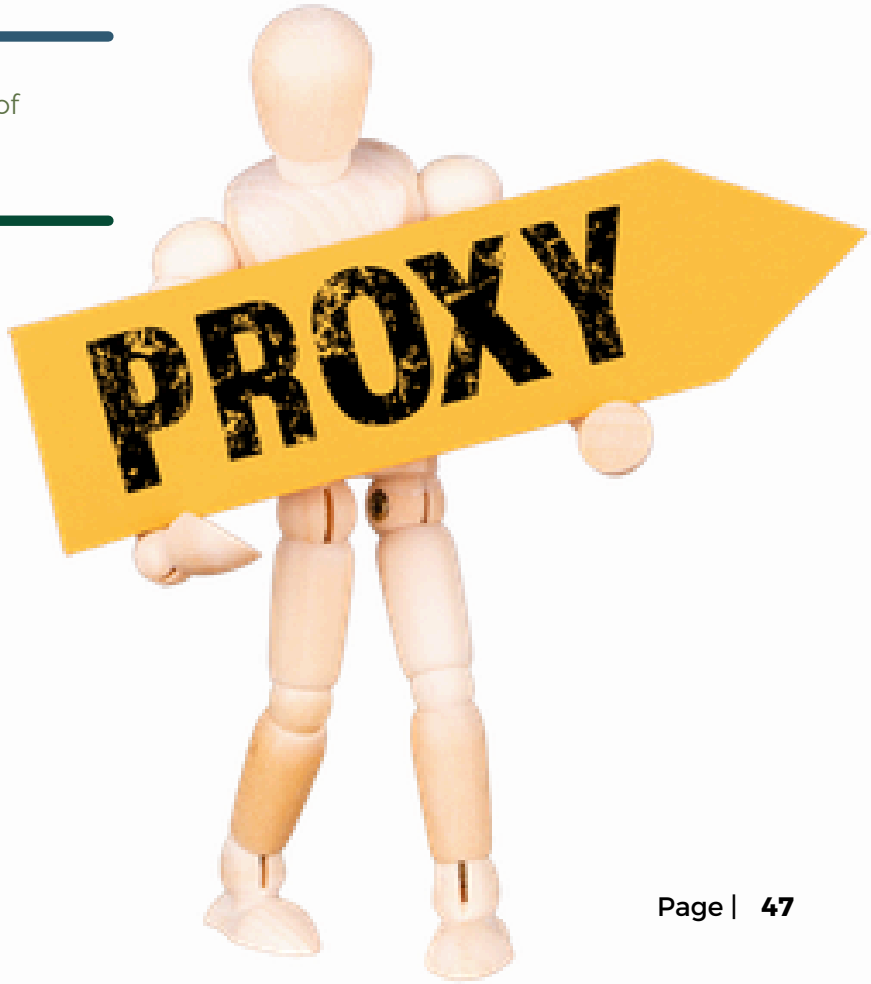
I then analyze whether ISS is more likely to promote corporate governance decisions that soften competition for firms with higher levels of common ownership. I focus on three decisions that are central for how firms compete and examine the voting advice given by ISS. First, I study director elections that result in competing firms sharing a board member. Interlocking directors across competing firms are prohibited by the Clayton Act, but in practice the law is rarely enforced. Firms that share an interlocking director have been found to compete less intensely, by setting higher prices and being more likely to collude. Second, I investigate mergers, which is a major focus area of antitrust authorities. A large empirical literature finds that consolidation generally reduces competition and leads to higher prices. Third, I look at managerial incentives, specifically equity compensation. Managers whose compensation is more tightly linked to firm performance have stronger incentives to compete and equity compensation is commonly used to align managers' incentives with firm performance.

"ISS is more likely to promote decisions that soften competition for firms with higher levels of common ownership."

For board members, in particular, I find that an increase in common ownership from the 10th to the 90th percentile implies that ISS is 3 percentage points more likely to support an interlocking director, with the effects on mergers and managerial incentives being lower but also statistically significant.

Not only do publicly traded firms share the same owners, these investors generally rely on the same proxy advisor when they vote at shareholder meetings. By bringing attention to the coordinating role of proxy advisors, I show how competition can be softened for commonly held firms. This has important economic implications as ISS' clients hold USD 22 trillion in assets and control around 20% of the equity traded on U.S. stock markets.

By Tove Forsbacka (Norwegian School of Economics)



Event | 12 - 13 June 2024 | Organised by:

The Institute for Law & Economics at the University of Pennsylvania – Faculty of Law of the University of Oxford – LSE Law School – The DFG LawFin Center at the Goethe University in Frankfurt – ECGI

The conference brought together leading experts to examine recent developments in private equity (PE) and venture capital (VC) law and finance. This blog edition explores key themes shaping the PE and VC landscape, from evolving governance and incentive structures to regulatory challenges and market power.

The articles revisit foundational theories of PE buyouts, assess innovative governance models in AI ventures, analyse state-driven VC markets, and examine issues ranging from employee equity compensation and cross-border investment structures to conflicts of interest in leveraged buyouts and the growing role of institutional investors in startups. The edition also considers how private capital and regulatory shifts are reshaping traditional boundaries between equity and debt, and how Big Tech may use SPACs to expand under the radar of antitrust scrutiny.

The collection offers deeper reflection on the interaction between corporate governance, regulation, and market power in contemporary PE and VC markets.

The agency costs of Multi-Product Private Equity Suites: Towards a post-Jensenian paradigm

Marc Moore, UCL
Chris Hale, Travers Smith LLP

In 1989, the late Professor Michael C. Jensen predicted the eclipse of the public corporation at the hands of the US private equity sector. In so doing, Jensen provided what was, and largely still is today, the dominant intellectual rationalization of private equity as a market-institutional phenomenon.

Jensen presented private equity buyouts as a golden bullet for the so-called agency costs problem in widely held companies, which he had first expounded over a decade earlier in his landmark 1976 article (co-authored with William Meckling) 'Theory of the firm: Mangerial behavior, agency costs and ownership structure'.

However, over the course of the succeeding three and a half decades, the private equity sector has changed almost beyond recognition. Consequently, a world which in the 1980s was heavily US-centric and characterized by relatively small-scale, boutique finance firms has morphed into a globalized arena dominated by very large, multi-divisional and bureaucratically complex financial conglomerates, which are largely indistinguishable from their more established investment banking and financial-accounting counterparts. Notwithstanding these seismic contextual changes, the Jensenian model of private equity, together with its now-simplistic focus on mitigating owner-manager agency costs, remains the central theoretical paradigm through which private equity buyouts are understood within law and finance scholarship.

In our article 'The Agency Costs of Multi-Product Private Equity Suites: Towards a Post-Jensenian Paradigm', which we presented at the 2024 ECGI Conference on the Law and Finance of Private Equity and Venture Capital, we posit that a critical reappraisal of the continuing descriptive relevance of the Jensenian theory of private equity is consequently now long overdue.

The article charts the rise of multi-product suites ('MPSs') within the larger-scale segment of the PE sector today, explaining the powerful structural factors and economic pressures that have driven the progressive move away from monoline, purely-buyout-focussed platforms. It then identifies the ensuing agency costs arising from MPSs—specifically, between General Partners ('GPs') and Limited Partners ('LPs') of PE buyout funds—which have arguably just supplanted the traditional Jensenian owner-manager agency problem with a new, more latent, and more complex one.

Jensen's agency theory rationalization of LBOs was predicated on capital gains being the core and dominant source of returns for LBO partnerships and, in turn, the buyout firms who acted as their GPs.

It was therefore of critical importance that ultimate capital gains, as opposed to ongoing revenue streams from fees, remained the principal driving motivation for GPs' dealmaking and subsequent portfolio management activities. However, as larger PE firms come to operate an ever-greater variety and scale of funds for clients, the ongoing fees charged on those funds become an ever more prominent component of such firms' overall profitability. The negative flipside to this is that the actual performance-sensitive component of PE firms' client income, namely the carried interest accrued on their funds, increasingly becomes the proverbial 'icing on the cake' as opposed to the principal performance driver for GPs.

In the case of many larger (and especially multi-product) PE firms, moreover, there is a common belief that management fees have now become a more important revenue stream than carried interest. This is especially so in the case of those PE firms (eg Blackstone, KKR, and Apollo) which have listed their management companies on public markets, where regular and periodic management fees typically constitute a more stable and predictable source of quarterly earnings growth than the relatively irregular, episodic, and variable nature of carried interest payments that depend on terminal dissolution of the relevant fund or asset for their realization.

Because of these developments, GPs who fail to meet the requisite (typically 8%) hurdle rate of return to earn carried interest on any fund can often still earn significant profits on their annual management fees alone. Moreover, since management fees are calculated by reference to funds under management rather than overall returns, there is a natural incentive for GPs to seek to maximize their aggregate volume of funds under management by utilizing drawdown facilities that permit them to make demands on existing LPs to release additional funds. This can, in turn, encourage an asset-gathering mentality whereby the relevant GP seeks continually to increase the scale and scope of its fund management activities to maximize its range and variety of potential fee streams, potentially at the expense of maximizing the capital value of its existing individual funds.

However, whereas market practice has been typically quick to move with the times, academic theorizing has by contrast been characteristically slow, such that the now-largely-outmoded, 1980s-inspired Jensenian model of PE remains largely dominant on a conceptual level today. Accordingly, we believe that ...

"...the time is now ripe for shifting towards a new, post-Jensenian theoretical paradigm of PE, which is both cognizant of and responsive to today's markedly different organizational climate..."

and the more latent but complex agency cost challenges it presents.

Accordingly, just as the Blackstones of this world adapted the basic 1970s monoline LBO firm to a new scale and scope of sophistication in later decades, we hope to do the same here with Michael Jensen's pathbreaking thinking on private equity. In so doing, we hope to help ensure that whilst the inventor may sadly no longer be with us, his invention unquestionably lives on for generations to come.

By Marc Moore (UCL) and Chris Hale (Travers Smith LLP)

Aligned Structuring of AI startups

Gad Weiss, NYU's Pollack Center for Law & Business

In recent years, two high-profile AI startups—OpenAI and Anthropic—have introduced innovative business structuring models that challenge traditional startup structuring conventions. Most startups optimize their governance and capital structures to maximize enterprise value by helping attract investments and talent. These new models, conversely, are designed to ensure that the need to protect society from AI risks guides startup managers' discretion and that startup managers are insulated from pressures to maximize enterprise value.

In a new working paper, I ask whether these new startup architectures (here, 'Aligned Structuring' models) are likely to be adopted by other AI startups that care about the societal implications of their technology and whether society would benefit from their broad-based adoption. To do so, the paper does not directly extrapolate from OpenAI and Anthropic's experiences or judge the success of their specific setups; even assuming that all information necessary to do so seriously was publicly available, a sample of two firms is too small to draw reliable generalized conclusions. Instead, it questions the robustness of the theoretical foundations behind their innovative structures.

Aligned Structuring models defy startup structuring practices in three key aspects. First, startups are typically controlled by their entrepreneurs, investors, or both. In contrast, OpenAI and Anthropic have placed control rights with independent third parties committed to AI safety and ethics ('Alignment Champions')—the nonprofit parent in OpenAI and a bespoke purpose trust in Anthropic. Second, while allowing startup stakeholders to rake in exceedingly high profits in case of success is traditionally seen as vital for attracting capital and talent, OpenAI has decided to cap investors' and employees' financial upside.

Finally, due to concerns about the impact of directors' fiduciary duties on their ability to prioritize AI safety and ethics, Anthropic and OpenAI have opted for business entities with flexible or inclusive fiduciary duties—a public benefit corporation (PBC) in Anthropic and an LLC in OpenAI.

Shifting control to Alignment Champions has two main drawbacks. First, it focuses on reallocating the startup's formal controls while doing little to address the significant informal controls that profit-driven stakeholders may hold. Investors, entrepreneurs, and Big Tech supporters may exert significant informal influence over AI startups regardless of their formal controls, being the primary sources of the financial capital, human capital, or computing power and data the startup craves. Additionally, Alignment Champions' alignment with society's interests does not necessarily make them more prudent decision-makers. Unsafe or unethical conduct can result from prioritizing other considerations (a conflict problem), but it may also result from genuine failures to identify and address safety or ethics issues (a competence problem). Depending on product-specific circumstances, the relative advantage of Alignment Champions as less conflicted decision-makers may be set off by their inherent information disadvantage on product-related matters, which might make them less competent decision-makers compared to financially interested entrepreneurs.

Capping equity holders' profits similarly has two significant limitations. First, Big Tech firms and their innovation arms—major players in the AI startup ecosystem—are often driven by non-financial investment goals. Other equity holders may rely on related party transactions or other indirect means to generate returns. Capping such investors' formal cash flow rights might have little influence on their incentive structures.

Moreover, for a profit-seeking owner, the main reason to support managerial decisions on safety and ethics is the prospect that they may increase their holdings' value (for instance, by preventing reputational damage, stakeholder litigation, or unfavorable regulation). Capping owners' financial upside, however, means they have less to gain from increases in the startup's enterprise value, making them rationally risk-averse and less likely to support managerial decisions that sacrifice short-term for long-term profitability—including those based on stricter safety or ethics standards.

Lastly, using alternative business entities is aimed chiefly at protecting directors committed to AI safety and ethics from legal challenges by profit-driven shareholders. However, existing corporate structures offer ample protection for directors prioritizing broader societal interests. Even in a standard corporate setup, directors can justify safety and ethics considerations as part of long-term value maximization, and their discretion would likely be protected under the business judgment rule. Private ordering solutions, such as shareholder covenants not to sue and the non-litigious nature of the startup ecosystem, further mitigate the risk of fiduciary challenges.

While the utility of Aligned Structuring principles is questionable, their costs are clear and easily observable. Traditional startup structures strive to minimize information asymmetries and agency costs while incentivizing stakeholders with varying risk appetites and liquidity needs to collaborate effectively.

"Recalibrating startups' control and cash flow rights to protect society from safety and ethics risks will undermine these efforts—particularly in startups that lack the rare concentration of talent, experience, and star power found in 'celebrity startups' like OpenAI or Anthropic."

For example, alternative business entities might disadvantage competitors in raising capital. The threat of being replaced by Alignment Champion directors might disincentivize entrepreneur-managers from dedicating necessary time and attention to R&D. Capping employees' financial upside would make it challenging for the startup to compete for top talent.

This conclusion does not imply that Aligned Structuring, as a concept, is doomed to fail. There may be other ways startups' governance and capital structures could be harnessed to protect society from AI risks more effectively. Additionally, Aligned Structuring models may have different applications for startups that adopt them. Perhaps they are better understood as PR instruments designed to advertise startups' proclaimed commitment to safety and ethics rather than enforce it.

By Gad Weiss (NYU's Pollack Center for Law & Business)

Lessons from government-driven VC investments in Korea: Government-Sponsored VC Funds and publicly traded VC Companies

Narae Lee, Bliss Law Office

South Korea's venture capital ('VC') ecosystem has flourished due to the government's robust policies promoting startups. Unlike the US, Korea lacked investor pools willing to invest in unproven startups in the early 2000s. Therefore, the Korean government has encouraged VC investments to diversify the chaebol-concentrated economy. As a result, investments have surged, positioning the Korean VC industry as the fifth largest among OECD countries in 2021 (OECD, 2021). Since the government's role is key to understanding the Korean VC ecosystem, my new paper analyzes the unique characteristics of VC funds and VC firms in Korea and identifies challenges for further growth.

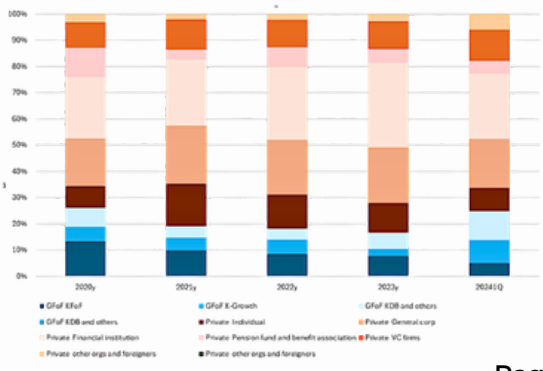
Growth of VC investments and the Government-Sponsored VC Funds

Most VC funds in Korea are government-sponsored funds, whose main investor is the government fund of funds. In response to the shortage of investors willing to invest in VC funds, the government established several funds of funds to bridge the financing gap. The Korea Fund of Funds, formed in 2005 with funding from 13 government ministries, has been pivotal in shaping the VC investment landscape. It has funded approximately 20% of Korea's total VC funds from 2014 to 2019, significantly contributing to the VC investment ecosystem (Kwak, 2019).

In government-sponsored funds, the power dynamic between the limited partners ('LPs') and the general partners ('GPs') differs from that of typical VC funds.

As opposed to independent VC funds, the fund-formation process of government-sponsored funds is initiated by the government fund of funds rather than by GPs. Although the government funds of funds don't interfere with the investment decisions of the GPs, they closely monitor the GPs' investment activities to mitigate moral hazard and agency problems for VC firms (KFoF Guidelines, 2022).

While this structure has been quite effective in mitigating GP agency problems, it also limits GP discretion and autonomy in VC funds, which may reduce the overall returns of VC funds. Since the legal frameworks related to VC funds have been established on the premise of government-sponsored funds as a standard, both the government-sponsored funds and independent VC funds are subject to the same legal frameworks (VIPA, 2023). Regulations for VC funds encompass the mandatory investment ratio, permitted investment instruments, and prohibited activities for VC funds and GPs. Due to these restrictions, some VC firms are compelled to invest in less promising startups that they would not otherwise choose in order to fulfill their investment ratios and avoid sanctions.



Publicly Traded VC firms

Korean VC firms that serve as GPs of government-sponsored funds are mostly structured as corporations, some of them being publicly traded companies (Kwak, 2021; Song, 2024). Although publicly traded VC firms ('PTVCs') account for only 6% of the total number of VC firms, they manage significant assets. The decision of VC firms to go public is related to the development of the Korean VC investment ecosystem through government-sponsored funds supported by government policies. Since public companies are perceived as more trustworthy, PTVCs have a greater chance of being chosen as GPs of government-sponsored funds and attracting other investors.

However, specific conflicts of interest may emerge in PTVCs between VC firm shareholders and VC fund LPs, especially if a fund is underperforming while a VC firm serves as a GP for multiple funds. In this scenario, a VC firm might be tempted to shift its attention from the underperforming fund to a well-performing fund in order to increase the likelihood of earning carried interest, potentially disregarding the interests of the underperforming fund's LPs (Birdthistel& Henderson, 2009).

Investor protection issues may arise due to information asymmetry between VC firms and their investors (Kim, 2017). While PTVCs must adhere to the same disclosure requirements as other listed companies, PTVCs' business models differ in that their earnings are linked to the performance of the VC funds they manage. Because there are no specific disclosure requirements for PTVCs regarding VC funds, public investors struggle to make informed decisions about them.

Total number of VC firms in Korea		247
Number of VC firms by the Business entity types	Corporate type	201
	LLC type	46
Number of VC firms by governing laws	VC firms registered under the VIPA	184
	VC firms registered under the CPA	63
Number of Publicly Traded VC firms	Publicly traded VC firms	19
	Non-publicly traded VC firms	228

[Table 1] Classification of VC firms in Korea (source: KVCA July 2024)

Challenges encountered by Korean VC funds and VC firms

In order to develop VC investment further at the current stage, it is crucial to focus on aligning legal frameworks and policies with entrepreneurial incentives while refining regulations governing VC firms and funds. First, legal frameworks for VC investment should be updated to support this transition by giving GPs more discretion and autonomy in managing their respective funds. For example, legal systems can be reformed to provide varying levels of regulation for government-sponsored funds and independent VC funds while allowing more discretion to GPs in the case of independent VC funds.

Second, regulations governing VC firms as GPs can be revised to strengthen their fiduciary duties when managing conflicting interests among stakeholders. Current rules inadequately address conflict of interest situations, suggesting a need for a revamped regulatory framework that clarifies and enforces VC firms' duties in managing conflicts fairly.
Finally, regarding PTVCs, stock exchanges should conduct additional reviews of the governance structure of VC firms seeking to go public, focusing on whether they have mechanisms in place to address conflicts between their shareholders and the LPs of their funds. In addition, disclosure frameworks for PTVCs need to be heightened to mitigate information asymmetry by disclosing to investors material information related to the VC funds that these firms manage.

By Narae Lee (Bliss Law Office)

Stock Options of Adhesion

Abraham Cable, UC Law San Francisco

When regulators and scholars call for increased regulation of mature startups, they often invoke recipients of employee stock options as a motivating concern. At first blush, the concern is understandable. Despite their impressive technical skills, startup employees are young and likely inexperienced in financial matters. They probably do not actively negotiate or fully understand their stock option agreements. Certain features of standard Silicon Valley equity grants—such as an exercise price equal to fair market value on the date of grant, the requirement to exercise within 90 days of being terminated as an employee, and a ten-year expiration date—can force a decision to exercise when stock is still illiquid and of uncertain value. Some of these concerns are amplified when companies stay private longer and accumulate complex capital structures that make the economics of an option even more opaque.

On the other hand, the overall market for equity compensation seems to work. Startups must compete with established tech companies for coveted talent, and equity compensation is thought to be an important reason why. Based on the impressive employment growth at VC-backed companies, startups seem to be holding their own. How can that be? How do outmatched and passive startup employees fare well enough to maintain the flow of human capital to Silicon Valley and other entrepreneurial hubs?

In 'Stock Options of Adhesion', I draw on a long-standing literature that theorizes how consumer 'contracts of adhesion' (website terms of use, product warranties, and the like) respond to market pressure even when the average consumer is passive and uninformed. I argue that the mechanisms identified in this literature likely operate in the market for equity compensation.

To give just one example, contract scholars have argued that product warranties for consumer goods might improve over time because an informed minority of consumers bothers to read them, sellers in competitive markets pursue these marginal customers, and all consumers benefit through standardized contracts. While I have my doubts that happens much with consumer product warranties, it seems quite plausible that some repeat players in the startup employment market learn lessons as they cycle through startups. Other beneficial mechanisms might include strong reputational markets, occasional exposure of overreaching through public scandal, and lenient enforcement of facially one-sided contract rights in the name of boosting employee morale.

Of course, a theory like this is hard to prove. I do think, however, that some recent developments over the last decade suggest the market is in fact responsive to the needs of startup employees. One example is the shift to restricted stock units (RSUs), which have a 'built in' value because they do not have an exercise price like a stock option. This feature suits the current environment where companies stay private longer and may plateau or decline in value in later stages of their private-company tenure. Another example is company liquidity programs through which companies or VCs purchase some portion of employee equity prior to a liquidity event, marking a major shift from the historical arrangement of mutual lock-in (no participant in the startup gets liquidity before all participants get liquidity). To be clear, these changes in equity compensation practices are not acts of charity. They suit the needs of startups and VCs as well as employees. But this is how competitive markets work. When circumstances change, market practices evolve in mutually beneficial ways.

If this optimistic view is right, then we are not facing the kind of widespread market failure that would justify a new securities law regime for mature startups. Instead, policy makers should go right to the source of the system's sharper corners: tax law. The specter of 409A drives companies to offer stock options with exercise prices at grant date fair market value (rather than less risky in-the-money options) and imposes difficult time limits on RSUs. The rules for incentive stock options sometimes force difficult exercise decisions within 90 days after termination of employment and at 10 years after grant date.

There are all sorts of favorable tax rules for founders and investors. Why then do rank-and-file employees have to suffer from so many tax traps and distortions?

"In the aggregate, equity compensation works, but we could still make things easier for the startup workforce."

By Abraham Cable (UC Law San Francisco)

The Cayman Sandwich: Risks for institutional and venture capital markets development

Raphael Andrade, Andrade Chamas Advogados
Alvaro Pereira, Georgia State University

The entrepreneurial landscape in Latin America has evolved dramatically in recent years, transitioning from mostly closed markets comprised of traditional business models to emerging innovation hubs. Global venture capital (VC) investors have increased their presence in the region, leading to the rise of unicorns in sectors such as fintech, e-commerce, healthtech, and agtech. Despite these advancements, international VCs are still hesitant to invest directly in Latin American startups. Instead, they usually require founders to create a three-layered corporate structure in which the Latin American startup is owned by a Delaware LLC, which in turn is owned by a Cayman Islands holding company. This structure, known in market jargon as the Cayman Sandwich, is primarily aimed at enhancing investor protection and has enabled a growing number of companies to access larger pools of capital. What, if any, are the tradeoffs of its adoption?

In a recent working paper, we offer the first critical analysis of the Cayman Sandwich. We begin by identifying two overlooked costs of this structure. On the one hand, direct costs associated with the creation and operation of legal entities in three different jurisdictions. On the other hand, and most relevantly, indirect costs for institutional and VC markets development. By exporting the finance and governance of startups, the Cayman Sandwich hampers opportunities for domestic contractual innovation and the development of a body of jurisprudence in corporate law and financial contracting that can assist judges and practitioners.

Furthermore, while in the wake of the 21st century, many Latin American countries have pushed legal reforms to corporate statutes and financial regulations that might ultimately help promote VC, the widespread use of the Cayman Sandwich makes it more difficult for local policymakers to distinguish the policies effecting positive change from those who are not.

To the extent that addressing the underlying motives for the use of the Cayman Sandwich can directly benefit startups and contribute to institutional and capital markets development, it is imperative to focus on investors' concerns. In that regard, we distinguish perceived from actual legal risks. We argue that the former are the result of outdated (if not plainly wrong) assumptions about limited freedom of contract in civil law jurisdictions as well as legal indexes, which are influential but imperfect measures of the quality of the law, especially as it relates to VC. Dissecting perceived risks requires better communication from governments and collaboration between domestic institutions, but not necessarily changes to legal systems.

Finally, we identify three sets of actual legal risks that merit further study and discussion:

- Investor liability. This risk emerges from inconsistent approaches to piercing the corporate veil that expose VC funds and their limited partners to potential liability. While some countries, like Brazil, have taken steps to limit the liability of limited partners through regulatory reforms, a clear, consistent approach to when corporate liability extends to shareholders is still lacking.

Addressing this issue through legal reforms could provide much-needed certainty for investors.

- Corporate law. Corporate laws in Latin America often prevent startups and investors from replicating standard US VC investment structures, limiting the flexibility to negotiate and enforce agreements. While some countries, such as Chile and Colombia, are making progress with more flexible corporate forms and binding shareholder agreements, these developments are not uniform across the region and have yet to be tested judicially.

- Enforcement. The lack of specialized decision-makers renders Latin American legal systems less adaptable to dynamic business environments. Two specific developments could inform solutions. One is requiring mandatory arbitration of corporate legal disputes in venture-backed companies, a solution adopted by Chile and Brazil. Another is Colombia's creation of a specialized court for corporate disputes that operates within the executive branch. To be sure, these measures have limitations. Arbitration restricts the development of a consistent, publicly available body of case law, and Colombia's quasi-judicial body raises concerns about judicial independence. Still, considering the difficulties of a comprehensive reform to the judiciary, they represent concrete alternatives to mitigate actual legal risks for international investors in the short and medium term.

"While the Cayman Sandwich structure has facilitated the growth of Latin American startups by attracting global VC investment, it comes at a significant cost to the region's institutional and VC markets development."

The indirect consequences of exporting corporate governance and financial transactions to foreign jurisdictions stifle local legal innovation and hinder the assessment of the impact of domestic reforms aimed at fostering a more vibrant VC ecosystem. Addressing both perceived and actual legal risks is crucial for reducing the need to rely on this structure. Governments, market participants, and academics should focus on dispelling obsolete assumptions about Latin American legal systems, while policymakers must consider implementing legal reforms that provide more robust investor protection, greater flexibility in corporate governance, and more reliable enforcement mechanisms. By doing so, Latin America can reduce the costs of the Cayman Sandwich, allowing its legal systems and VC markets to evolve alongside its entrepreneurial ecosystem.

By Raphael Andrade (Andrade Chamas Advogados) and Alvaro Pereira (Georgia State University)

Private equity sponsors, law firm relationship, and loan contracts in leveraged buyouts

Yijia (Eddie) Zhao, University of Massachusetts Boston College of Management
Douglas Cumming, Stevens Institute of Technology School of Business and ECGI
Ruiyuan (Ryan) Chen, West Virginia University
Binru Zhao, Bangor Business School

Leveraged buyouts (LBOs) are transactions in which a private equity (PE) sponsor acquires a target company's controlling ownership stake primarily using a significant amount of borrowed funds from banks. Our study, 'Private Equity Sponsors, Law Firm Relationships, and Loan Contracts in Leveraged Buyouts', focuses on a controversial issue in LBOs: many PE sponsors have prior relationships with law firms representing banks in LBO loan contract negotiation. In some cases, PE sponsors even designate their preferred law firms as banks' law firms (ie, lender-side law firms), a practice referred to as the 'designated law firm' arrangement.

The relationship between PE sponsors and lender's law firms in LBOs draws much attention from press media, practitioners, and regulators. For example, in January 2016, Andrew Ross Sorkin wrote an article in The New York Times titled 'A Growing Conflict in Wall St. Buyouts'. In the article, he raised significant concerns about the designated law firm practice, in particular, whether a law firm with strong relationships with PE sponsors can faithfully act in the best interests of lenders. More recently, the International Organization of Securities Commissions (IOSCO) also highlighted the concern voiced by market participants that the PE sponsors-lender law firm relationship could compromise the independence of legal advice received by lenders and thus potentially harm creditors' interests.

Our study examines how PE sponsors influence the selection of lender law firms in LBO loans and whether these pre-existing relationships between PE sponsors and lender law firms impact loan contract designs. We provide empirical evidence that, when a law firm has a strong pre-existing relationship with a PE sponsor, it is significantly more likely to be chosen as the lender's law firm for the LBO transaction. Moreover, we show that close relationships between PE sponsors and law firms result in weaker creditor protections, as evidenced by fewer covenants and a reduced likelihood of dividend restrictions being imposed. However, reputational concerns of PE sponsors or law firms can help mitigate these effects. Furthermore, we show that these loans are more likely to default: loans with strong PE-lender law firm relationships at origination are more likely to default within three to five years after issuance. This finding challenges the notion that more lenient covenants reflect better borrower quality or more efficient negotiations; instead, it points to a fundamental conflict of interest that harms creditors.

Our finding echoes the concern of diminished due diligence and monitoring incentives of lead banks in leveraged loan transactions. Under the structure of the originate-to-distribute (OTD) model, lead banks sell most loan shares to investors, such as collateralized loan obligations (CLOs) and loan mutual funds, and thus keep little 'skin in the game' themselves.

This reduces their incentive to perform thorough due diligence and monitoring. Moreover, banks may view accepting a PE sponsor's preferred law firm as a reciprocal arrangement, thereby increasing their chances of securing future deals from the same sponsor. Our results support this conjecture, showing that creditors are more likely to be involved in the next deals with PE sponsors if they agree to work with a law firm that has a closer relationship with the PE firm in the current transaction.

Our study also indicates that market awareness of these issues is growing, as seen in the higher risk premiums demanded by loan investors when these relationships are perceived to compromise the integrity of loan agreements. The market appears to recognize the risks associated with these relationships, as loans involving a law firm with a strong relationship with the PE sponsor tend to experience weaker demand from loan investors in the primary market. This lack of demand often forces lead banks to offer loans at higher interest rates or with greater discounts. That is, investors require a higher risk premium when they perceive that the law firm might not fully represent the lender's interests, ultimately resulting in the borrower bearing the increased cost associated with the potential conflict of interest.

The findings of our study have important implications for the ongoing debate about the role of private equity firms. While PE firms are often commended for creating value through operational and governance improvements of portfolio companies, there are also concerns about excessive leverage used in LBOs that incentivize PE firms to extract value from other stakeholders.

"PE sponsors may leverage their relationships with lender law firms in loan contract negotiation to extract value from creditors."

Given the higher spread and lower loan offering price, ultimately, the borrower bears the increased cost associated with the potential conflict of interest. Therefore, our paper suggests that any practice that can mitigate such conflict of interest will have important welfare implications. Our paper also highlights the agency problem of lead banks in the leveraged loan market under the originate-to-distribute (OTD) model.

By Yijia (Eddie) Zhao (University of Massachusetts Boston College of Management), Douglas Cumming (Florida Atlantic University and ECGI), Ruiyuan (Ryan) Chen (West Virginia University), and Binru Zhao (Bangor Business School)

A theory of trust-based governance in startups

Danielle A. Chaim, Bar-Ilan University
Asaf Eckstein, Hebrew University of Jerusalem

Recent years have seen a remarkable rise in startup investments by traditional public market investors, namely institutional investors. As public markets have gradually regressed, their private counterparts have seen immense growth and demand from sophisticated asset managers (Gözlügöl, Greth, & Troeger, 2023). As a result, these investors have begun crossing over into the private domain, increasing their exposure to private markets (Kwon, Lowry, & Qian, 2020). In a recent paper, we provide an in-depth analysis of this growing phenomenon and explore both the investment patterns of institutional investors in startups as well as their corporate governance approach in the private sphere.

Using hand-collected data spanning 2009-2023, we identify three giant institutional investors—BlackRock, Fidelity, and T. Rowe Price—that have emerged as prominent players in startup financing. Over our sample period, these institutions have substantially increased their holdings in the private market both in terms of the number of investments and average investment amount. In addition, they have gradually begun venturing into startups at earlier stages than in the past, sometimes as early as the seed round stage. Another interesting finding is that these investors increasingly assume lead or sole investor roles with substantial capital injections.

Our analysis of institutional investors' corporate governance preferences in their startup companies reveals a surprising pattern. Given that these sophisticated institutional investors are known as juggernauts of corporate stewardship in the public sphere, one might expect their governance approach to be similarly adopted among their private portfolio companies. In this Article, we reveal that this is not the case.

Despite institutional investors' significant equity investments and growing early-stage involvement in startups, these investors play a weak monitoring role in startups and systematically forego control rights. Our empirical analysis shows that they rarely demand meaningful control rights such as board representation, even in their capacity as lead investors. While BlackRock, Fidelity, and T. Rowe Price led nearly two-hundred investment rounds over our sample period, they only appointed seven board members and four board observers, deviating from the conventional practice of lead investors to designate board members. These findings align with previous studies suggesting that mutual funds, despite having significant cash-flow rights, tend to abstain from demanding effective control rights in their startups (Chernenko, Lerner, & Zeng, 2020), and rarely demand board representation (Adams, Hermalin, & Weisbach, 2010).

In our paper, we also explore how the participation of institutional investors in the startup ecosystem affects the internal corporate governance of startups and exposes a significant governance gap between public and private portfolio firms. We find that institutional investors are often willing to accept governance structures that diverge significantly from the conventional best practices they apply when investing in public companies and provide relatively weak shareholder protection. This includes accepting unequal voting rights, lackluster board independence, and CEO/Chair duality.

Why do institutional investors, practitioners of strong governance in public firms, depart from their traditional principles when investing in startup companies?

We argue that ...

"...institutional investors' deviation from their traditional governance approach reflects a deliberate choice to cede control to other corporate constituencies better positioned to increase firm value..."

and yield efficient gains. This approach comprises of a two-dimensional allocation of control rights: vertical allocation between institutional investors and startup founders and horizontal allocation between institutional investors and traditional startup investors (namely, VCs).

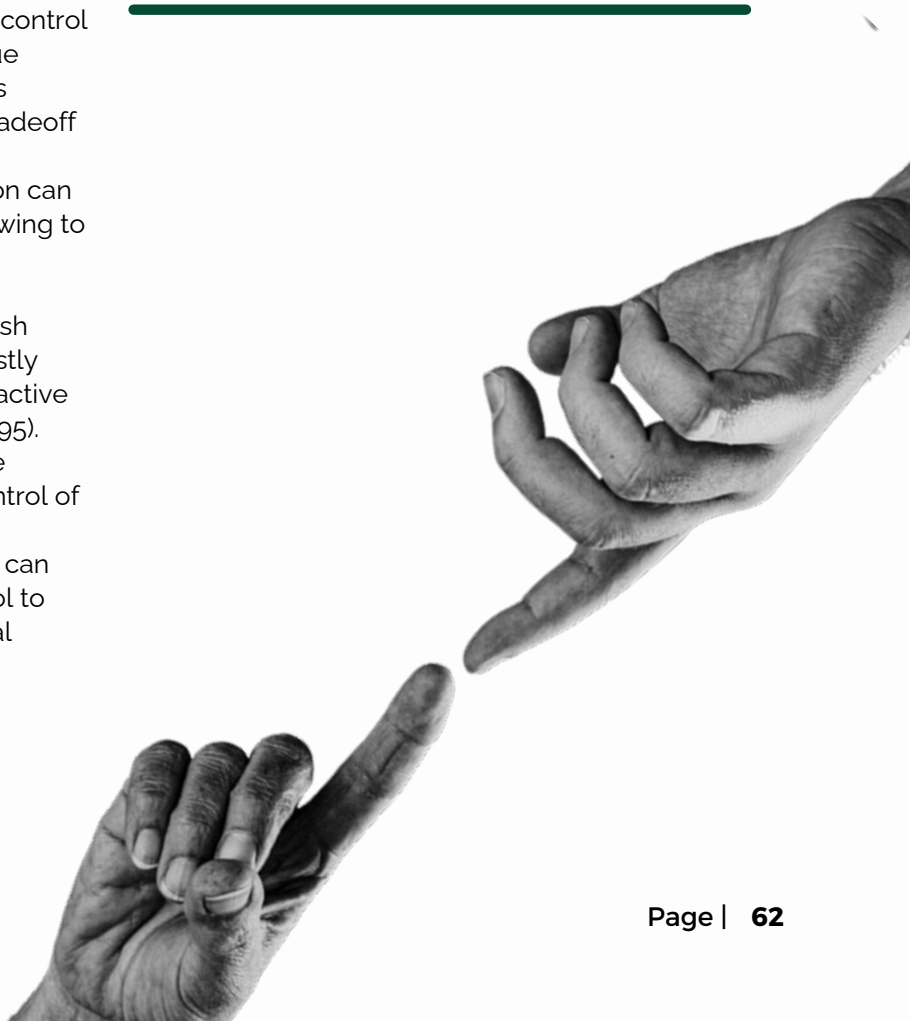
Vertically, institutional investors cede control rights to startup founders, whose visionary leadership and merits are synonymous with the companies they create (Hamdani & Kastiel, 2023). These investors intentionally enhance the control rights of founders in hopes that their unique virtues will generate above-market returns (Goshen & Hamdani, 2016). The inherent tradeoff between increased agency costs and the founders' pursuit of their idiosyncratic vision can benefit institutional investors, especially owing to startups' distinctive characteristics.

Horizontally, institutional investors relinquish control to traditional startup investors, mostly VCs, which are more knowledgeable and active in monitoring and engagement (Lerner, 1995). Institutional investors, relatively new to the private domain, enhance the relational control of VCs, allowing them to exert influence with greater efficiency. This strategic approach can optimize firm value by relinquishing control to more diligent monitors, mitigating potential managerial agency costs.

We argue that this two-dimensional approach can align with institutional investors' fiduciary duties towards their beneficiaries. Vertical allocation to founders encourages creativity and innovation, which can facilitate the attainment of mutual goals and increase firm value. Similarly, horizontal allocation to traditional startup investors delegates control to more experienced, knowledgeable players who can potentially add value and yield efficient returns.

Understanding this allocation of control rights approach can assist policymakers in delineating the fiduciary responsibilities of institutional investors in their capacity as startup investors. In establishing these duties, policymakers must consider the unique characteristics of the startup ecosystem and the identity of the involved players. Our analysis, we believe, justifies a more flexible approach to governance by institutional investors. Traditional stewardship expectations may not be entirely compatible with the dynamic and innovative nature of startups.

By Danielle A. Chaim (Bar-Ilan University) and Asaf Eckstein (Hebrew University of Jerusalem)



The era of chameleon capital

Narine Lalafaryan, University of Cambridge

Would you like 'debt' that looks a lot like 'equity'?

Or would you prefer 'equity' that looks a lot like 'debt'?

Would you like both? There is no set menu. Welcome to the era of chameleon capital.

Over the past sixteen years the corporate finance markets have been undergoing a dynamic redesigning. First, such an evolution and ongoing remodelling of corporate finance markets is due to the significant rise of private capital (private credit, private equity, venture capital). The gradual and continuous migration from public to private markets has also been prompted by banking regulation that was introduced in the aftermath of the global financial crisis of 2007-2008 (e.g., The Dodd-Frank Act 2010, Basel III regulations). The low-interest rate environment over the past two decades further played a role in the growth of private capital.

Second, the 2023 banking crisis and the macroeconomic environment post-COVID 19 further stress the significance of debt capital and its dynamic relationship with equity capital, in general, but especially in private companies. This dynamic between 'equity' and 'debt' is even more nuanced in the context of distressed investments or special capital solutions. With the significant rise of corporate debt levels, there is a lot of scope for private credit investment, including for rescue financing and capital solutions financing.

Third, on the one hand, there has been increased competition not only between banks and private credit funds ('the dual-track process'), but also between banks, private credit funds, and institutional investors (e.g., sovereign wealth funds) in providing corporate financing ('the triple-track process'). On the other hand, banks have started partnering with private credit funds in providing financing.

The liquidity issues have also impacted on how private equity and private credit firms work together to provide corporate financing.

Finally, because of the changes in the corporate finance markets post-GFC ...

> "... modern debt investment in the private capital domain looks a lot like equity, and, where necessary, modern equity may also be designed to look akin to debt."

The financing instruments in the private capital domain are blurred. Sophisticated modern investors, such as private credit funds, negotiate bespoke protection and governance measures, including by negotiating for equity upside and board observer rights (or even board representation), or for debt-like or equity-like modern hybrid investments or parallel investments (e.g., HoldCo payment-in-kind, debt-like pref equity, debt investment with warrants, debt investment and holding golden shares). An example of such a modern influence mechanism relied on by private credit funds is a debt investment combined with holding golden shares. Golden shares are issued on Day 1 of the investment, yet the rights attached to these golden shares are activated upon insolvency, giving these investors (i.e., the holders of golden shares) the rights, for instance, to replace the board. This enables such investors to keep their debt investment in the firm and simultaneously to have equity control. One reason why some investors might prefer debt and golden shares, as opposed to debt converting to equity, is because equity comes behind debt.

However, golden shares have no economic rights attached to them; they are control instruments. A further new development causing further blurring in 'equity' and 'debt' – but this time in the types of investors – is the rise in hybrid funds.

For years in the private capital industry opportunities did not always match the capital that the funds had raised. Such a mismatch was magnified during COVID, as the investment opportunities presented at this time were limited and often did not match the capital that the funds had raised from their investors. COVID has caused the surge in hybrid funds, commonly also called multi-strategy funds or pod-shops, interested in special opportunities or capital solutions, solving the mismatch issue. With the arrival of multi-strategy funds, there has been further blurring between 'equity' and 'debt', where the types of investors also started to blur; there is more crossover, and there is a rise in investors that are investing both in 'equity' and 'debt'. The objective of these hybrid funds is to maximise yield for their investors.

Operating in a market where information asymmetry is the game, these sophisticated investors bargain for modern hybrid and parallel investments, crafting bespoke and complex investments with long term interests and objectives in mind ('chameleons'). In light of these developments, in my new working paper, 'Chameleon Capital',[1] I aim to offer two contributions. First, based on qualitative interviews with legal practitioners in private credit, distressed investments, and leveraged finance, I investigate how in commercial practice (i.e., law in action, as opposed to law in books) the traditional distinctions between 'equity' and 'debt' investment have been blurring over the years in the private capital domain. Building on this evolution, from the corporate law perspective, I aim to show that the conventional division between 'equity' and 'debt' investment is only relevant in the context of collective proceedings.

For a single investor, or a small group of associated/affiliated investors, such as private credit firms and private equity firms, the distinction between 'equity' and 'debt' has become further blurred. Yet, the legal characterisation of what is 'equity' and what is 'debt' in law is very important, including in the context of restructuring of these arrangements

Second, I examine the implications of blurring from the corporate law perspective. Why is the blurring of 'equity' and 'debt' important for corporate law and why especially now? The blurring in commercial reality between 'equity' and debt' is relevant when it comes to the incentives, behaviour, and accountability of directors in the context of directors' duties. The distinction between 'equity' and 'debt' shines a microscope on corporate law because of the different levels of protection that corporate law offers to a firm's capital providers: shareholders and debtholders.

Additionally, the blurring between 'equity' and 'debt' is important when analysing a controlling investor's duty (typically a controlling shareholder's duty) and other issues, such as shadow directorship, shareholders' agreement, the reflective loss principle, legal capital rules, wrongful trading, misfeasance, and others. Moreover, over the past years, there have been various important developments, impacting the corporate law framework worldwide with regards to the treatment of 'equity' and 'debt'.[2]

I take a comparative approach and study the implications of the evolution of corporate finance, and the treatment of 'equity' and 'debt' in English corporate law, comparing and contrasting it with Delaware corporate law. While this project concentrates on English law and Delaware law, the issues highlighted above are also relevant for other legal systems. Why? The private capital industry is global, with funds operating and investing internationally.

The blurring of 'equity' and 'debt' in commercial practice (i.e., the mismatch between law in action and law in books) has important implications for corporate law, including, for instance, its influence on the fight for corporate control.

Corporate finance influences corporate control. By exploring the blurring between 'equity' and 'debt' in the private capital domain, the paper highlights interesting questions about the extent to which legal characterisation in corporate law still plays a residuary role.

By Narine Lalafaryan (University of Cambridge)

Unraveling the Web: How big Tech uses SPACs to skirt antitrust laws

Anat Alon-Beck, Case Western Reserve University
John Livingstone, Case Western Reserve University
Moran Ofir, Reichman University
Miriam Schwartz-Ziv, Hebrew University of Jerusalem

In recent years, Big Tech companies have faced growing scrutiny over their market power and influence. Despite this, they continue to expand, often using creative strategies to bypass regulatory roadblocks. One such strategy involves the use of Special Purpose Acquisition Companies (SPACs), which have gained popularity as a faster and less scrutinized path to going public. In our paper "Unraveling the Web: Big Tech Directors, SPACs, and Antitrust Evasion Tactic" we explore how Big Tech firms exploit SPACs to evade antitrust laws and maintain monopolistic control, acquiring startups and technologies while avoiding the regulatory scrutiny that traditional mergers would entail.

Understanding SPACs and Their Appeal

A SPAC is essentially a shell company created to raise capital through an initial public offering (IPO) for the purpose of acquiring a privately held business (the "target"). These entities do not have specific business operations or acquisition targets when they go public. The SPAC's board has two years to find a target company to acquire; if they fail, they must return the raised capital to investors. This timeline creates an inherent pressure to finalize deals quickly. Our research indicates a significant increase in SPAC formations since 2020, followed by a decline after 2022, possibly due to a growing number of unsuccessful deSPAC transactions (when a SPAC merges with a target company to bring it public).

Exploiting Regulatory Loopholes

Typically, mergers between large companies in the US are subject to antitrust review under the Hart-Scott-Rodino (HSR) Act, which requires federal regulators, such as the Department of Justice (DOJ) or the Federal Trade Commission (FTC), to assess whether the merger would substantially lessen competition. However, in the case of SPAC transactions, the HSR review occurs between the SPAC and the target company, not the investors behind the SPAC. This oversight allows Big Tech firms to invest in SPACs and acquire influence over target companies through board seats or voting rights, without triggering the regulatory red flags that a direct merger would.

We found that Big Tech companies are willing to pay a premium for SPACs because of these regulatory advantages. The average Private Investment in Public Equity (PIPE) ratio to valuation on the eve of a deSPAC transaction shows a 12.6% premium, indicating that Big Tech sees substantial value in avoiding antitrust scrutiny. However, this premium quickly evaporates; the stock prices of these companies often fall post-deSPAC, with an average transaction price reflecting a 6.2% discount immediately after the deal. This rapid decline suggests that the market does not value the companies as highly as the PIPE premium would imply, but Big Tech gains other benefits, such as technological access and competitive advantages.

The Case of Comcast and BuzzFeed

To illustrate these dynamics, we examine the deSPAC transaction involving Comcast and BuzzFeed.

Comcast, through its subsidiary NBCUniversal, was a significant investor in BuzzFeed, investing between $200 and $400 million. Additionally, the SPAC responsible for taking BuzzFeed public, 890 5th Avenue Partners, had board members with close ties to both NBCUniversal and BuzzFeed. This overlap created potential conflicts of interest, yet the HSR review for the transaction only assessed the SPAC and BuzzFeed, excluding Comcast's involvement entirely. Had Comcast sought to merge with BuzzFeed directly, the deal would likely have triggered a more comprehensive antitrust review.

Following the deSPAC, 98.2% of SPAC shareholders voted in favor of the transaction. However, the real motivation behind this overwhelming support became evident shortly afterward, as 94.4% of the shares were redeemed. The high redemption rate suggests that shareholders did not believe in the merger's value, instead opting to take their money back. BuzzFeed's subsequent market performance confirmed this skepticism, with its market capitalization dropping by over 90%.

The Role of Interlocking Directorates

Our research delves deeper into the influence Big Tech companies wield over SPACs by mapping out networks of interlocking directorates—situations where the same individuals serve on the boards of multiple companies. We found that directors often have connections through shared educational backgrounds, previous employment, or other board memberships, creating a dense web of relationships across different companies. This network extends beyond individual SPAC-target relationships and includes what we term "sister SPACs," where the same Big Tech firm has invested in multiple SPACs that operate in related industries.

A case in point is Google's investments in various SPACs, where interconnected directors were frequently found. Such interlocks pose significant risks, as they create conflicts of interest that could influence corporate decision-making in ways that favor the interests of Big Tech over competitive market dynamics.

Implications and Policy Recommendations

Our findings underscore the need for regulatory reform to address these emerging antitrust evasion tactics. The current legal framework, largely based on century-old legislation, is ill-equipped to handle the complexities of modern corporate structures, particularly in the tech sector. Policymakers should consider updating antitrust laws to scrutinize SPAC transactions more thoroughly, especially when large, influential investors are involved.

Additionally, transparency requirements could be strengthened to ensure that investors and regulators have a clearer view of interlocking directorates and potential conflicts of interest. Introducing more stringent HSR review criteria for SPAC transactions that involve significant investments from dominant industry players would be another step toward leveling the competitive playing field.

"Big Tech's use of SPACs represents a sophisticated strategy to extend their market dominance under the radar of antitrust regulators."

By exploiting SPACs, these companies gain access to technologies and eliminate competition without the regulatory scrutiny typically associated with mergers. Addressing this issue is crucial for maintaining a fair and competitive marketplace, as well as for protecting the innovation ecosystem that drives technological progress.

By Anat Alon-Beck (Case Western Reserve University), John Livingstone (Case Western Reserve University), Moran Ofir (Reichman University), and Miriam Schwartz-Ziv (Hebrew University of Jerusalem)

Event | 15 - 16 November 2024 | Organised by:

The Berkeley Center for Law and Business - ECGI

The symposium sparked meaningful discussions on emerging trends in corporate governance and sustainable business practices. Scholars shared their research projects on how businesses adapt to increasing demands for ethical and responsible decision-making in a rapidly changing global landscape.

This special blog edition highlights the three prize-winning papers from the senior and junior scholars' categories, shedding light on the intricate challenges of modern corporate law and governance. From the limitations of shareholder primacy in government-dominated industries to the tension between shareholder democracy in light of prescriptive ESG proposals, and the critical role of gatekeepers in green certification. These papers explore the pressing complexities of today's corporate governance landscape and advance academic inquiries that shape the dialogue about the future of corporate governance and ESG practices in a global context.

Green Gatekeepers

Luca Enriques, Bocconi University and ECGI
Alessandro Romano, Bocconi University
Andrew Tuch, Washington University in St Louis School of Law and ECGI

In an era of pervasive green claims, where products are labeled "recycled" or "carbon neutral" and investments branded as "ESG," the accuracy of such assertions often remains opaque to consumers and investors. "Green Gatekeepers" examines the vital role of third-party certifiers in addressing this information asymmetry. These intermediaries set and verify green standards, seeking to ensure that environmental claims reflect reality, not misleading marketing.

A great deal is at stake in the work of green gatekeepers. From firms' perspectives, there is money to be made from environmental claims: firms have powerful incentives to trumpet the green credentials of their products and operations.

But if firms market inaccurate credentials, consumers and investors—unable to verify them—may be misled. Environmental qualities, as credence attributes, are difficult to observe, even ex post. Worse, ...

"... without accurate green certifications, the promise of demand-side climate change mitigation strategies—such as altering lifestyles and consumption patterns—may be squandered."

Green gatekeepers may thus have an outsized role in driving the climate transition.

In "Green Gatekeepers," we address twin questions. First, do green gatekeepers have the right incentives to issue accurate certifications? Second, if not, how should policymakers respond?

We ground our analysis in a close study of five categories of prominent green gatekeepers and a hand-coded database of over 450 gatekeepers across 25 industries—the largest of its kind. Our in-depth investigation focuses on carbon offsets, gas sourcing, appliance efficiency, net-zero certifications, and other areas where gatekeepers like Verra, Gold Standard, Project Canary, MIQ, and SBTi provide third-party certifications.

As to green gatekeepers' incentives, we contrast green gatekeepers with traditional gatekeepers in financial markets, arguing that green gatekeepers likely face weaker reputational constraints than their traditional counterparts, including underwriters and auditors. First, green certifications may 'work' even when inaccurate; their certifications provide users with 'wiggle room' to feel that they are behaving morally, even when they are acting selfishly, and might also generate a sense of warm glow. In other words, users may derive utility from green certifications, so to speak, no-questions-asked.

The second reason for green gatekeepers' relatively weak incentives is that green-conscious consumers often face limited private costs from (unknowingly) relying on false certifications, diminishing incentives to second-guess certifications. For instance, one's flight is no less comfortable because the purchased carbon offsets fall well short of offsetting the flight's emissions. Third, green gatekeepers often deal with information characterized by a higher degree of complexity and uncertainty than that processed by traditional information intermediaries. Consider, for example, the allocation of GHG emissions across value chains in assessing net-zero targets or the determination of counterfactuals in verifying carbon offsets.

We appreciate that NGOs, scientists, and media might fill the gap. However, they, too, we argue, face evidential difficulties as well as "voice" and resource constraints in the green setting, compromising their value in enforcing reputational discipline on green gatekeepers. If green gatekeepers face weaker reputational constraints, might they make important organizational choices to signal their intention to issue accurate certifications? Our evidence suggests that few do. While many green gatekeepers adopt a non-profit form, most do not even disclose the standards they follow or the content of their audits.

Our analysis situates green gatekeepers within a larger regulatory framework that includes the firms whose claims they certify. As 'collateral' regulation, gatekeeper regulation is premised on the insufficiency of direct regulation—namely, of both firms and their managers—in deterring inaccurate claims. Accordingly, we assess the force of regulation by the Federal Trade Commission (FTC) and its Green Guides, state equivalents, and common law in curbing false green claims to consumers. Similarly, we examine the likely deterrent effect of federal securities law on false green claims to investors.

Whether aimed at consumers or investors, greenwashing appears inadequately deterred. To be sure, this conclusion is less robust for claims affecting both groups, as when a consumer suit reveals harm to investors, who bring their own suit for securities fraud, piggybacking on the consumer suit. But, where claims affect only one group or the other, firm liability may well be inadequate.

To address under-deterrence, policymakers might increase the severity and/or likelihood of sanctions on firms for greenwashing. However, barring a major shift by the FTC or reform to federal securities law, this seems unlikely. Moreover, as the severity and likelihood of sanctions increase, firms face an increased risk of asset insufficiency, which dulls the deterrent force of sanctions; managerial agency costs have a similar effect. In short, direct regulation seems insufficient to deter false green claims, a premise we accept as we consider our second question: how best to regulate green gatekeepers.

We propose a framework for the regulation of green gatekeepers. Other things equal, the appropriate policy mix should be a function of (1) the significance of private costs for users relying on inaccurate certifications and (2) the verifiability of green certifications by policymakers and courts, which is mainly a function of the complexity of the methodologies underlying green certifications. Applying these factors, we suggest a specific policy mix for different types of green gatekeepers. We consider the suitability of ex-ante regulation, ex-post liability, regulatory licenses, and other interventions such as mandated disclosures.

"Green Gatekeepers" engages in several scholarly debates. It extends the literature on gatekeeper control strategies, which has yet to explore their application in the environmental context. The article also contributes to scholarship in environmental law by recognizing the gatekeeping role of third-party certifiers, drawing comparisons with traditional gatekeepers, and applying economic analysis. Additionally, it bridges the divide reflected in scholarship between consumer and investor protection, emphasizing the role of green gatekeepers in promoting both.

Of course, the breadth of our analysis lends itself to general conclusions. There may be circumstances, for instance, where the strength of reputational constraints or firm regulation adequately ensures effective green gatekeeping. Whether this holds in specific settings, however, is an empirical question requiring case-by-case assessment. "Green Gatekeepers" therefore suggests an agenda for future research, which we hope will advance the role of green gatekeepers in ensuring the accuracy of green claims, thereby protecting consumers and investors, supporting demand-side mitigation strategies, and even helping blunt the impact of climate change.

By Luca Enriques (Bocconi University and ECGI), Alessandro Romano (Bocconi University), and Andrew Tuch (Washington University in St Louis School of Law and ECGI)

The Rise (and Fall?) of Prescriptive ESG Proposals

A review of *'Expanding Shareholder Voice: The Impact of SEC Guidance on Environmental and Social Proposals,'* by Kenneth Khoo (National University of Singapore) and Roberto Tallarita (Harvard Law School)

What does shareholder democracy look like? It typically includes corporate annual meetings, a venue where big-money investors and, occasionally, regular folks with a share or two under their belt, get to vote on how companies are run. It's the closest thing to a town hall for capitalism. But not all votes are created equal, especially when it comes to the thorny and divisive domain of ESG—environmental, social, and governance proposals.

For a while, ESG voting looked like it was hitting its stride. Shareholders were flexing their moral muscles, pushing companies to decarbonize, pay their employees more fairly, and do right by society. Support for ESG proposals climbed steadily, doubling from 2010 to 2021, as the world started to take climate change, social inequality, and corporate responsibility more seriously.
But in 2022, something weird happened: support for ESG proposals nosedived. By 2023, it was in freefall. This isn't just some minor fluctuation—it's a dramatic U-turn. What happened? Did investors suddenly stop caring about the planet and people? Not quite. The culprit seems to be something a little more mundane: a change in U.S. securities regulation.

Enter the SEC's 2021 Guidance

In their recent paper, Expanding Shareholder Voice: The Impact of SEC Guidance on Environmental and Social Proposals, which won a prize at the Berkeley-ECGI Corporate Governance Forum, Kenneth Khoo and Roberto Tallarita explore the consequences of a 2021 rule change by the Securities and Exchange Commission (SEC). This guidance allowed shareholders to submit ESG proposals that are, let's say, a bit bossy.

Instead of just asking companies to "consider doing better," these proposals could demand specific actions, detailed targets, and strict timelines. These are commonly described as "prescriptive" proposals.

Before the SEC's rule change, companies could often keep these prescriptive proposals off the ballot by invoking the "ordinary business exclusion." They'd argue that proposals dictating how they run their business were about ordinary business—and therefore not shareholder material. But the 2021 guidance threw that argument out the window. Suddenly, shareholders could demand specifics on the environmental and social policies which these shareholders would advocate for, and companies had to put those demands to a vote.

More Demands, Fewer Votes

You can probably guess what happened next. The floodgates opened, and although the number of proposals increased only modestly, their content became significantly more detailed and specific, with textual changes reflecting a marked rise in prescriptiveness. Shareholders began asking companies to adopt strict carbon emissions targets, phase out fossil fuels, or implement other sweeping reforms. These proposals are ambitious, but they're also expensive, complex, and sometimes not so great for the bottom line.

Unsurprisingly, most investors weren't thrilled about the costs. Shareholder support for these prescriptive proposals plummeted.

According to Khoo and Tallarita, the decline in support for ESG proposals after 2021 can be directly linked to this prescriptiveness. While non-prescriptive ESG proposals still attracted some goodwill, their bossier cousins saw vote tallies dwindle to single digits.

Voting With Your Ideology (and Wallet)

But not all investors are created equal, and their reasons for supporting—or rejecting—prescriptive proposals are far from uniform. Khoo and Tallarita used machine learning to dig into the data, classifying proposals and tracking voting patterns across different types of institutional investors.

They found that investors vote along ideological lines. Funds with a strong ESG focus —the kind that post "green" and "sustainable" all over their marketing materials—are more likely to support prescriptive proposals. But even they aren't going all in; there's a limit to how much they're willing to sacrifice returns for the sake of the planet. On the other hand, more financially conservative investors (think classic money managers who like dividends and low costs) overwhelmingly rejected these proposals. Even the "Big Three" passive index fund managers—BlackRock, Vanguard, and State Street—tended to align with the average shareholder's cautious stance.

So, ideology matters, but money talks louder. When prescriptive ESG proposals start looking like a tax on returns, most investors hit the brakes.

The Great ESG Tug-of-War

This dynamic exposes the central tension in ESG investing: the tug-of-war between idealism and pragmatism. Investors like the idea of doing good, but they don't like paying too much for it. Meanwhile, companies are caught in the middle. On one side, they face activist shareholders demanding ambitious reforms. On the other, they've got profit-minded shareholders ready to punish them if those reforms dent the bottom line.

The SEC's 2021 guidance may have amplified this tension. By enabling more prescriptive proposals, it gave ESG activists a louder voice. But the backlash from investors suggests that most shareholders prefer ESG-lite—the kind of feel-good policies that don't cost too much and let them sleep well at night.

If there's a lesson here for ESG proponents, it's that ambition needs to be tempered with strategy. Prescriptive proposals are a bold move, but they're also risky. Investors might support vague aspirations to "be better," but they balk at mandates that look expensive or impractical.

On the regulatory side, the SEC faces a tricky balancing act. Its 2021 guidance was a win for shareholder democracy, empowering investors to hold companies accountable. But democracy can be messy, and ...

"... an expansion of shareholder voice can make it more challenging for managers to discern what shareholders truly want, especially when demands vary widely."

The Future of ESG Voting

What's next for ESG proposals? The decline in support for prescriptive proposals doesn't necessarily mean the end of the road. Companies and shareholders alike are learning to navigate this new terrain. Activists may pivot to crafting proposals that are ambitious but not overly prescriptive, aiming to win broader support. Meanwhile, companies might use these votes as a barometer for how far they can push ESG initiatives without alienating investors.

As for the SEC, its 2021 Guidance has introduced a significant shift, giving shareholders a greater say in corporate strategy than ever before. The challenge now lies in navigating this expanded shareholder voice — finding common ground between idealism and pragmatism, between doing good and doing well.

Private profits, public business: When shareholder primacy doesn't work

A review of '*Private Profits and Public Business*,' by Aneil Kovvali (Indiana University Maurer School of Law) and Joshua Macey (Yale Law School).

Let's talk (again) about shareholder primacy - the classic idea that corporations exist to maximize shareholder value. Shareholders, being the residual claimants, are thought to care about efficiency, innovation, and all the other good things that drive societal wealth because they only get paid after everyone else. It's a neat theory, and markets love neat theories.

But Aneil Kovvali and Joshua Macey, in their forthcoming paper Private Profits and Public Business which won a prize at the Berkeley-ECGI Corporate Governance forum recently, point out that this neatness often unravels when you bring in the government. Specifically, in industries like utilities, defense, finance, and pharmaceuticals, where Uncle Sam is not just a referee but also the stadium owner, the rulemaker, and sometimes the only fan in the stands.

Their argument boils down to this: in government-dominated markets, the incentives that supposedly make shareholder primacy work—like the alignment of shareholder profits with societal value—just don't hold up. And when they don't hold up, bad things happen. Utilities overcharge ratepayers. Defense contractors pass along cost overruns. Banks gamble with public money, knowing they'll get bailed out. It's not pretty.

The Shareholder Primacy Fairy Tale

The shareholder primacy model relies on two big assumptions. First, shareholders internalize the upsides and downsides of corporate performance. If a company innovates and creates value, shareholders win big. If it screws up, they're the first to lose.

That's supposed to make them care about long-term success.

Second, non-shareholders—employees, customers, the government—can take care of themselves. Workers negotiate wages, customers shop around for better prices, and regulators keep things in check. This division of responsibility lets corporations focus laser-like on shareholder returns, with the side benefit of (supposedly) making the world a better place.

Kovvali and Macey argue that these assumptions fall apart in government-dominated industries. Shareholders don't face the same risks, and non-shareholders can't always protect their interests. When a firm's profits are underwritten by taxpayers, regulated by public agencies, or tied to essential services, the idea that shareholders bear all the residual risks becomes a myth.

The Holdup Problem

Take utilities. Electricity and water companies operate as regulated monopolies because nobody wants two sets of wires or pipes running through their neighborhood. Regulators cap utility profits to prevent gouging, but utilities still need to make big investments—building power plants, maintaining grids, etc. So, the government guarantees them a return on investment. Sounds fair, right?

Except this creates what the authors call a "holdup problem." Once a utility starts building, the government can't just walk away if costs spiral.

If Georgia Power racks up $17 billion in cost overruns on a nuclear reactor, what's the regulator going to do? Abandon the project after pouring billions into it? Of course not. Regulators cave, and shareholders walk away richer, while ratepayers foot the bill.

This isn't just a utilities problem. Defense contractors are notorious for ballooning budgets. Banks operating under the "too big to fail" doctrine can take outsized risks, knowing that taxpayers will clean up the mess. In all these cases, shareholder primacy leads to perverse outcomes: profits get privatized while losses are socialized.

Governance in Government-Dominated Markets

So, what's the fix? Kovvali and Macey suggest that in these industries, shareholder primacy needs to take a backseat to a more inclusive approach to corporate governance. Instead of relying on external mechanisms like contracts and regulation, the government should participate directly in corporate decision-making.

Imagine a world where the Department of Defense has a seat on Lockheed Martin's board, or where utility regulators weigh in on executive pay and merger approvals. These aren't far-fetched ideas; some of this authority already exists. The Federal Reserve, for example, can fire bank executives under certain circumstances. The problem is, regulators rarely use these powers.

The authors propose a range of interventions: expanding fiduciary duties to include non-shareholder interests, requiring government approval for major corporate decisions, or even giving public stakeholders board representation. These measures, they argue, would align corporate behavior with public goals, mitigating the holdup problem and reducing waste.

Trade-Offs and Skepticism

Of course, there are trade-offs. Giving the government more say in corporate governance could scare off investors or lead to bureaucratic inefficiency.

And let's not pretend that regulators always get it right—see: the FAA and Boeing, or Fannie Mae and Freddie Mac. There's also the risk of regulatory capture, where firms cozy up to their overseers and turn them into cheerleaders instead of watchdogs.

But the authors make a compelling case that the current system isn't working. The standard playbook of regulation and contract is ill-equipped to handle the complexities of industries where private firms deliver public goods. In these contexts, the authors argue, the trade-offs of more direct government involvement may be worth it.

A New Corporate Purpose?

The broader implication of the paper is that corporate governance doesn't have to be one-size-fits-all. In traditional markets, where competition keeps firms honest and contracts are enforceable, shareholder primacy might work fine.

> "But in government-dominated industries, where firms rely on public subsidies, guarantees, or demand, a different governance model is needed."

This isn't about nationalizing industries or turning corporations into arms of the state. It's about recognizing that in certain contexts, the rules of the game need to change. Firms that depend on the public shouldn't operate as if they're accountable only to their shareholders. They should be accountable to the public too.

Kovvali and Macey's paper raises a provocative question: what do we owe each other in a system where private firms deliver public goods?

Event | 15 - 16 November 2024 | Organised by:

The Universidad CEU San Pablo – ECGI

The conference explored cutting-edge research on fintech, bonds, climate finance, ownership, banks, private equity, boards, misconduct, and more. This edition opens with two Best Paper award–winning articles. The first examines how prosocial investors assess future corporate misconduct risks, highlighting trade-offs between ethics and financial returns. The second analyses the development of sustainable debt markets, identifying inefficiencies in green and sustainability-linked bonds and advocating for smarter hybrid designs.

The edition then turns to private equity perspectives. One article examines the impact of private equity ownership in European football, highlighting tensions between financial returns and on-field performance. Another explores venture capital's role in climate-tech startups as a catalyst for innovation and systemic change. The final article considers the evolving regulatory landscape for private equity, noting that while increased oversight may enhance transparency and curb opportunistic behaviour by general partners.

Corporate Misconduct and Prosocial Investing

Stefano Pegoraro, University of Notre Dame
Antonino Emanuele Rizzo, Nova School of Business and Economics
Rafael Zambrana, University of Notre Dame

Corporate misconduct, which can lead to legal risks such as regulatory fines and lawsuits, has long been a contentious issue in corporate governance, finance, and accounting. In our recent study, "Corporate Misconduct and the Capital Allocation of Prosocial Investors," we examine how institutional investors with prosocial mandates navigate these challenges. Our paper investigates whether these investors' portfolio decisions are shaped by their clients' ethical preferences and forward-looking insights into corporate misconduct. We focus on institutional investors explicitly catering to prosocial clients. These funds—characterized by their socially responsible or ESG-focused mandates—respond not only to public information but also utilize proprietary data to evaluate firms' future misconduct risks.

Prosocial Investors' Capital Allocation and Corporate Misconduct

We introduce a novel firm-level metric called "prosocial overweight," which measures the extent to which prosocial funds' holdings differ from those of their conventional peers.

This metric captures the collective judgment of prosocial investors, offering a lens to evaluate their preferences and expectations regarding corporate behavior.

Our study employs a revealed-preference methodology rather than relying on third-party ESG ratings, which often suffer from inconsistencies. By analyzing the actual portfolio decisions of prosocial funds, we provide a direct measure of perceived corporate values and compliance. This approach not only validates the commitment of prosocial investors to ethical investing but also highlights their ability to generate proprietary insights that extend beyond publicly available information.

Central to our analysis is the use of comprehensive datasets on regulatory violations and civil lawsuits. To measure corporate misconduct, we utilize data from Good Jobs First's Violation Tracker, which includes penalties exceeding $5,000 assessed by U.S. federal and local agencies. This dataset encompasses a wide range of violations, from environmental breaches to financial misconduct. Additionally, we leverage a novel dataset from Lequity, an ESG rating firm, which tracks civil lawsuits filed in state and federal courts. Unlike other ESG data providers, Lequity identifies all defendants in a lawsuit and covers a broader range of legal disputes. Together, these sources provide an unprecedented view into corporate behavior, enabling us to capture both regulatory violations and controversies involving stakeholders. By analyzing these datasets, we establish a robust measure of firms' legal and ethical compliance.

Empirical evidence reveals that prosocial funds avoid exposure to future regulatory fines and lawsuits through the firms they select. This suggests that ...

"... prosocial investors possess proprietary insights into firms' compliance and ethical practices."

However, this advantage comes at the cost of lower risk-adjusted returns, particularly for riskier stocks.

Key Findings

1. **Sensitivity to Legal Risk** - Prosocial funds exhibit greater sensitivity to corporate legal risks compared to conventional funds. When exposed to companies with past regulatory violations or lawsuits, these funds experience significant outflows—a response driven by their clients' strong aversion to misconduct. To mitigate these risks, prosocial funds actively reduce their holdings in firms with higher probabilities of future misconduct.

2. P**redictive Power of Trades** - The trading behavior of prosocial funds exhibits predictive power. By adjusting their portfolios, these funds respond not only to past legal infractions but also anticipate future violations and lawsuits. Specifically, an increase in prosocial overweight predicts a reduction in the likelihood of regulatory fines or lawsuits in the following year. This highlights the ability of prosocial funds to incorporate forward-looking information into their investment decisions.

3. F**inancial Trade-offs** - While prosocial funds effectively align their portfolios with clients' ethical values, this alignment entails financial costs. Firms with greater increases in prosocial overweight often deliver lower risk-adjusted returns. This trade-off is especially pronounced for stocks characterized by high idiosyncratic volatility and ESG-rating dispersion, where the same reduction in expected legal risk is associated with a steep decline in financial performance.

Implications for Corporate Governance

The research offers important insights for both investors and corporate managers. For investors, it emphasizes the value of prosocial mandates in directing capital toward firms with stronger compliance records and ethical practices. However, it also underscores the inherent trade-offs, calling for careful consideration of social objectives alongside financial performance.

For corporate managers, the study provides a compelling case for prioritizing legal and ethical compliance. Firms that proactively align with societal norms are more likely to attract capital from the growing pool of prosocial investors, potentially lowering their cost of capital over time. Conversely, a poor compliance record can result in divestments and reputational damage.

These findings contribute to broader debates in corporate governance, particularly regarding the role of institutional investors in promoting accountability and ethical behavior. While prior research has often focused on the financial aspects of ESG investing, this study shifts attention to its social dimensions. It also raises critical questions about the limits of prosocial investing: Can it effectively deter corporate misconduct? And at what cost to financial performance?

As prosocial investing continues to expand, its impact on capital allocation and corporate behavior is becoming increasingly significant. This study explores how prosocial preferences shape investment strategies, highlighting both the investment activity and the trade-offs involved in aligning portfolios with societal values. For investors, policymakers, and academics, the research provides valuable insights into the evolving landscape of ethical investing and its implications for corporate governance.

By Stefano Pegoraro (University of Notre Dame - Department of Finance), Antonino Emanuele Rizzo (Nova School of Business and Economics), Rafael Zambrana (University of Notre Dame - Mendoza College of Business)

Cracking the Green Code: Designing Smarter Sustainable Debt

Adelina Barbalau, University of Alberta
Federica Zeni, World Bank

The Green Financing Challenge

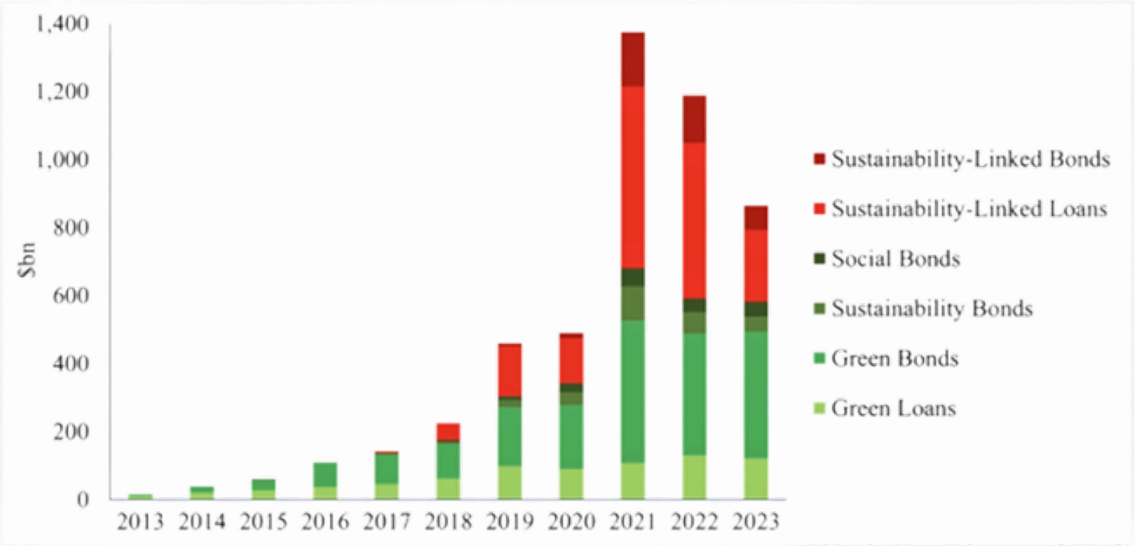
Financial markets are playing an increasingly important role in the fight against climate change. Despite the rising interest rate environment contributing to a recent slowdown, the sustainable debt market has grown exponentially over the past decade, surpassing $7.5 trillion as of 2023 or 5 percent of the global bond market[1]. This growth has been marked by an increase in the types of debt securities on the market, as well as heightened concerns regarding greenwashing and the limited environmental impact of these securities[2]. A recent paper, The Optimal Design of Green Debt by Adelina Barbalau and Federica Zeni, develops a theoretical framework for understanding how to structure debt contracts to curb greenwashing while maximizing environmental outcomes.

Understanding the Sustainable Debt Landscape
Despite the proliferation of securities in the sustainable debt market, a distinction can be made between two underlying contract designs:

- project-based designs, such as green bonds (GBs), which focus on specifying tangible projects that the proceeds are going to be allocated to, without targeting specific environmental outcomes

- outcome-based designs, such as sustainability-linked bonds (SLBs), which do not impose restrictions on the use of proceeds but focus on outcomes by linking the cost of debt to the achievement of environmental targets

Figure 1 Sustainable Debt Market



Source: authors' elaborations from Bloomberg fixed income.

The fact that GBs focus on actions (i.e., implementation of green project) rather than outcomes (i.e., carbon reductions) does not ensure nor does it incentivize the achievement of environmental goals. However, the fact that SLBs focus on green outcomes which cannot be measured precisely and are prone to manipulation, along with their lack of transparency regarding the use of proceeds, raises a distinct set of challenges.

Designing Green Debt Optimally

The paper "Optimal Design of Green Debt" takes a closer look at the development of the sustainable debt market to uncover what are the trade-offs and inefficiencies involved in issuing GBs or SLBs and, importantly, how securities aimed at financing the provision of green outcomes should be optimally designed. The authors consider a setup in which green outcomes can be obtained through the implementation of tangible green projects (e.g., solar panels) and/or intangible effort-based strategies (e.g., reducing energy consumption) and which allows for greenwashing, defined as the possibility to manipulate reported outcomes. They incorporate these features into a principal-agent problem in which an investor (principal) with pro-environmental preferences provides debt financing to a profit-maximizing firm (agent). The model delivers the following main results:

1. When greenwashing is not possible

If green outcomes are precisely measurable, an outcome-based instrument (like SLBs) is ideal. These instruments incentivize firms to pursue both tangible projects (e.g., solar panels) and effort-based strategies (e.g., energy efficiency), achieving efficient outcomes.

2. When greenwashing is very likely

If firms can easily manipulate reported green outcomes, the optimal contract takes the form of a project-based instrument (like GBs). Since reported outcomes cannot be trusted, the only reliable solution is funding tangible projects with environmental potential.

3. When greenwashing is possible but costly

When manipulation is possible at a cost, the optimal contract is a hybrid combining both project- and outcome-based features. Specifically, it includes a payoff component that depends on the environmental outcomes achieved, and a payoff component that depends on the implementation of green projects, i.e. the use of proceeds. Whereas the role of the outcome-dependent payoff is to incentivize effort-based strategies while controlling for manipulation, the role of the project- dependent payoff is to ensure that proceeds are allocated to the right projects.

Empirical Relevance and Market Implications

In practice, the theoretically optimal hybrid contract—combining pay-for-performance with dedicated use-of-proceeds—is rarely observed in the market. However, several issuances align with this design. For instance, the Austrian utility company Verbund issued a green and sustainability-linked bond in 2021 that integrates periodic reporting on performance targets with updates on projects funded by the proceeds (Verbund, 2012). Importantly, ICMA recently released guidelines for the issuance of Sustainability-Linked Loan financing Bonds - hybrid instruments that combine use-of-proceeds features with sustainability targets - signaling a market shift toward hybrid structures that reflect the optimal theoretical design.

The limited adoption of hybrid contracts can be attributed to the complexity and costs of contracting on multiple dimensions, as well as the associated monitoring and reporting requirements, making simpler instruments like GBs and SLBs the dominant options. The paper formally characterizes the inefficiencies of these two contracts, pins down the sources of such inefficiencies, and rationalizes issuance patterns across industries. For instance, through the lens of the model, financial institutions primarily issue GBs because the green outcomes they can deliver, e.g., Scope 3 emission reductions, are highly imprecise and prone to manipulation. Utilities, on the other hand, favor GBs due to their access to tangible projects and limited scope to improve their environmental performance through effort-based strategies.

Policy Implications

"The effectiveness of financial market solutions for combating climate change depends on well-designed contracts that align incentives, foster accountability, and curb manipulation."

The findings highlight that when greenwashing is possible, the security designs prevalent on the market (GBs, SLBS) are likely to be inefficient, and a hybrid design that combines transparency about use of proceeds with accountability to outcomes is best. Improvements in measurement systems, green lending policies as well as the development of more rigorous reporting and verification standards play a crucial role in ensuring the integrity and growth of the market. Policymakers, investors, and firms must ultimately work together to ensure that sustainable finance lives up to its promise of driving meaningful environmental change.

By Adelina Barbalau (University of Alberta) and Federica Zeni (World Bank)

Scoring Profits? The Impact of Private Equity Investments on Soccer Clubs

Kristina Lalova, Michigan State University – Eli Broad College of Business

In 'Scoring Profits? The Impact of Private Equity Investments on Soccer Clubs', I examine the interplay between private equity ownership and performance outcomes. The interplay between private equity (PE) ownership and performance outcomes in soccer clubs raises fundamental questions about the nature of these organizations: Are soccer clubs profit-maximizing entities akin to traditional firms, or do they embody characteristics of non-profit organizations, prioritizing community and social outcomes? This paper investigates how PE investments impact financial value and social value, particularly whether financial outcomes come at the expense of team dynamics and team performance.

According to a recent analysis by a PitchBook senior reporter, over 20% and nearly 30% of the European football clubs in the main leagues are backed by private equity investors from the United States. Beginning with 2019, this specific sport has seen a rise in not only private equity financing, but involvement also primarily by firms and funds located in the United States. This increase in private wealth investments is a result of a rise in popularity for soccer in the U.S., as well as an expansion in funds created in devotion to sports.

The European football market, a multibillion-dollar industry, presents high exit multiples and has consistently outperformed traditional public indices in terms of growth. In 2022, over six billion dollars were invested in the industry, comprising both majority and minority stakes, which created a substantial pool of capital for clubs to leverage. U.S. private equity firms, experienced in sports investment and management, quickly emerged as crucial investors. These firms not only provided much needed funding but also offered strategic partnerships and management expertise.

The paper examines 28 private equity male clubs and 68 non-private-equity male clubs and 15 private equity female clubs and 52 non-private-equity female clubs (and their players). The majority of the deals in the sample are buyout and growth capital deals, even though there are co-investment deals in the sample. In addition to identifying the month and the year that private equity invests in football clubs, I also identify the season in which the investment takes place. I use a staggered difference-in-differences model to isolate the causal long-run effect of private equity investments on individual players' performance and team match performance, players' salaries, and clubs' financials and the causal short-run effect of private equity investments on chairman, management, and squad changes.

However, this financial growth is accompanied by declines in on-field performance, especially in away games and more so in female teams, where key performance metrics, such as goals, points per game, and overall possession diminish post-investment. For example, becoming a PE-owned club results in a decrease in away goals for male teams. A PE investment reduces away goals by 0.186 goals per match. This accounts for approximately 18% of the pre-treatment mean and represents a moderate economic impact, equivalent to 0.17 of variability.

For female teams, this decline is even more dramatic. A PE investment reduces away goals by 0.813 goals per match. This represents a substantial reduction of approximately 87% of the pre-treatment mean and corresponds to 0.68 of variability, indicating a strong economic impact. This highlights a much greater disruption in female teams' away performance compared to male teams. This suggests that clubs under PE ownership might struggle with away games, possibly due to changes in team dynamics, tactics, or travel-related factors.

The interaction and coordination between players significantly influence team performance. Player co-appearances in matches reflect these interactions as teammates develop chemistry and understanding through shared playing time. Measuring degree centrality (frequency of interactions), closeness centrality (efficiency of interactions), and betweenness centrality (role of bridge players) relies on mapping these co-appearances to quantify players' roles within the team network. In addition, as the paper shows, PE investments bring squad, management, and chairman changes which potentially further disrupts team dynamics. Player appearances highlight how these changes affect core players' positions in the network and continuity and consistency in team dynamics. By linking co-appearance data to network metrics, I can assess how well-connected the team remains and correlate it with performance outcomes in home and away games.

I document that degree centrality, betweenness centrality, and closeness centrality among players decline following a PE deal, which correlates with and has a direct and negative impact on home and away match performance. These metrics reflect the interconnectedness and collaboration among players.

"Disruptions stemming from managerial and squad turnover – a hallmark of PE restructuring – undermine team cohesion, which is especially critical during high-pressure away games."

Based on the analysis of PE investments in European football, the paper reveals significant insights into their multifaceted impact. While PE investments are highly effective in enhancing financial outcomes (consistent with the profit-maximizing objectives of PE firms), I show this comes at the expense of on-field performance, which is a key social value for fans, players, and the broader football community. The shift toward profit-driven priorities risks alienating fans and stakeholders who value on-field success and team loyalty over financial metrics. As PE's influence in European football grows, these trade-offs will continue to shape the debate around the role of private equity in sports.

By Kristina Lalova (Michigan State University – Eli Broad College of Business)

Catalysts for Climate Solutions: Corporate Responses to Venture Capital Financing of Climate-Tech Startups

Shirley Lu, Harvard Business School
George Serafeim, Harvard Business School
Simon Xu, Harvard Business School

As the global community grapples with the escalating climate crisis, the need for innovative climate solutions has never been more urgent. Products and services that enable a transition to a low-carbon economy are essential, and climate-tech startups often lead the way. These startups bring groundbreaking technologies to market, addressing the critical challenges of decarbonization, energy storage, and industrial efficiency. Yet, an important question arises: How do established corporations—incumbent firms—respond to these innovative newcomers?

Our research focuses on this dynamic, exploring whether venture capital (VC) financing of climate-tech startups influences corporate strategies in significant ways. We find that ...

"VC investment plays a transformative role, serving as a signal of the commercial potential of climate technologies and prompting established firms to increase their focus on climate solutions."

How Venture Capital Shapes Corporate Strategy

Venture capitalists are renowned for their ability to identify and nurture promising innovations. Their investments often reflect not only confidence in a startup's potential but also broader market demand for the technology it offers. In this way, VC financing serves as a powerful market signal. For incumbent firms operating in similar markets, these signals can influence strategic decisions, prompting them to adjust their product offerings and invest in climate technologies.

Using large language models (LLMs), we quantified how firms incorporate climate-related products and services into their strategies. By analyzing U.S. public firms' annual 10-K filings, we developed a Climate Solutions (CS) measure that measures a firm's engagement in climate solutions.

Our findings show that incumbent firms in product markets similar to those of VC-backed startups significantly increased their CS measure following VC investment rounds. This effect was particularly strong when the startups exhibited promising commercial prospects, such as larger investment sizes, higher valuations, and revenue generation.

Factors Amplifying the Impact

The strength of this VC signal depends on several factors. For instance, deals with more significant media coverage and those involving new investors tended to draw greater attention from incumbents. Visibility matters, as it amplifies the perceived importance of the startup and its technology.

Incumbents with a pre-existing focus on climate solutions responded more strongly to VC signals. These firms already possessed complementary assets, such as technical expertise and market presence, which positioned them to capitalize on the growing market for climate technologies. In contrast, firms without prior experience in climate solutions exhibited a weaker response, possibly due to organizational inertia or a lack of necessary capabilities.

The type of VC investor also played a role. Startups backed by high-performing VCs with a track record of success and financial motivation sent stronger signals, leading to more pronounced responses from incumbents. Conversely, investments by impact-focused VCs, which prioritize environmental goals over financial returns, generated weaker responses. This distinction underscores the role of VC investments as a market signal.

From Signals to Action

The implications of these signals extend beyond strategic intent—they translate into tangible actions. Incumbents that increased their focus on climate solutions boosted their investments in research and development, capital expenditures, and product innovation. These firms demonstrated a willingness to allocate resources toward advancing their climate-related offerings, signaling a strategic commitment to future growth in the climate-tech space.

Stock Market Validation

Stock market reactions further validate the role of VC signals in shaping corporate strategies. We found that shareholders of incumbent firms operating in the same industry as VC-backed startups and already have existing engagements in climate solutions reacted positively to news of VC investments. This indicates that market participants view these signals as indicators of new opportunities rather than competitive threats.

Implications for Policymakers and Investors

The ripple effects of VC investments carry important implications for policymakers and investors. For policymakers, fostering a vibrant VC ecosystem for climate-tech startups could accelerate the transition to a low-carbon economy. Policy tools such as tax incentives, research grants, and regulatory support for climate innovation can encourage VC investments and amplify their spillover impact on incumbent firms.

Investors, on the other hand, should consider the broader influence of their capital. VC investments in climate-tech startups are not merely bets on the startups themselves—they have the potential to reshape entire industries. By signaling market demand and technological viability, these investments catalyze systemic change, encouraging established firms to innovate and compete in the climate solutions space.

A Catalyst for Systemic Change

Ultimately, our research highlights the catalytic role of climate-tech startups and their VC investors in driving corporate change. By validating the commercial potential of climate solutions, VC investments incentivize incumbents to align their strategies with the demands of a sustainable future.

This dynamic underscores the importance of collaboration across the innovation ecosystem. Startups, investors, policymakers, and incumbents all have a role to play in advancing climate solutions.

Together, these stakeholders can create a virtuous cycle of innovation, investment, and adoption that accelerates progress toward a low-carbon economy.

As we face the growing challenges of climate change, fostering such catalytic effects will be essential. Venture capital has proven to be more than a funding mechanism—it is a driver of systemic transformation, encouraging industries to embrace the technologies and solutions that will define our sustainable future.

By Shirley Lu (Harvard Business School), George Serafeim (Harvard Business School), and Simon Xu (Harvard Business School)

Spreading Sunshine in Private Equity: Financial Intermediation and Regulatory Oversight

Yingxiang Li, City University of Hong Kong

Should regulatory oversight play a role when market forces can potentially discipline conflicts of interest faced by private equity (PE) fund managers? PE fund managers, or general partners (GPs), play an important role in managing trillions of dollars of PE investments on behalf of investors such as pension funds, endowments, and insurance companies, collectively known as limited partners (LPs). However, the opaqueness of PE funds has received growing attention from investors and regulators. One of the concerns revolves around PE fees, compensation paid to GPs, since these fees are often perceived as excessive and opaque. Although such compensation can attract scarce managerial talent and reward strong performance, the outsized fees also reflect inherent agency conflicts in the delegated asset management, especially if these fees are difficult for investors to assess.

The Promise and Limits of Market Discipline

While various forms of market discipline, discussed below, act as the first line of defense in mitigating conflicts of interest faced by GPs, these market forces may fail to sufficiently align incentives due to pervasive information frictions in PE markets featured with a lack of market pricing and limited disclosure.

- Compensation contracts: Key components of the compensation include management fees and carried interest, which incentivize GPs to act in the best interest of LPs. However, both limited partners (LPs) and general partners (GPs) possess some pricing power due to information and search frictions in the market. As a result, the compensation contract may also be part of the agency problem. The complexity of PE fee structures, compounded by PE funds' limited transparency, creates challenges for LPs to evaluate and oversee fees, potentially leading to rent extraction and inefficient contracting.

- Future fundraising: Beyond direct compensation from existing LPs, GPs are motivated by future fundraising opportunities based on their past performance. Unlike publicly traded stocks that have market prices, the assets within PE funds are typically valued quarterly based on interim assessments from GPs. These valuations are often outdated and may not capture the latest information. Consequently, the absence of mark-to-market valuations can result in inadequate market discipline and inefficient fund selection by LPs. Additionally, inflated interim valuations during fundraising periods can mislead investors and exacerbate these challenges.

- Ex-post monitoring: LPs can attempt to motivate GPs through post-investment monitoring. However, this approach can be prohibitively expensive due to GPs' limited disclosure and LPs' coordination challenges. While LPs can voice concerns through advisory committees if GPs make poor investment choices, their influence is significantly weaker compared to the board of directors, who can actively participate in corporate decision-making. Furthermore, if LPs were to interfere directly in the fund's daily operations, they would risk losing their limited liability status.

- The closed-end structure and illiquidity of PE funds also restrict LPs' ability to govern through exits of existing fund investments, unlike investors in mutual funds or public companies.

Evolving Regulatory Landscape of PE Funds

Despite the potential limits of market discipline, most PE fund advisers in the US historically received minimal regulatory oversight, since they could avoid SEC registrations under an exemption provided by the Investment Advisers Act of 1940. This exemption applied to advisers with fewer than 15 clients, treating each fund as one client regardless of the number of investors within a fund. However, the Dodd-Frank Act removed this exemption in 2012, replacing it with much narrower exemptions based primarily on advisers' size and investment strategies rather than on potential agency conflicts. These adjustments reflect regulators' concerns about systemic risks in private funds following the 2008 financial crisis. Based on regulatory filings, the paper documents that many advisers including large GPs had to register for the first time, becoming subject to examinations, regulations, and disclosure requirements.

Subsequent SEC examinations of newly registered GPs revealed widespread compliance deficiencies, especially in the PE fee arena, including misallocated expenses, hidden fees, and manipulated valuation of portfolio companies. If these payments were merely another type of compensation aimed at maximizing investor value, it is puzzling why they would be structured in such opaque ways.

Conscious of the agency conflicts in PE funds, the SEC recently implemented comprehensive reforms regarding PE fees. These proposed rules mandate, among other things, quarterly reports detailing fees, new auditing and bookkeeping requirements, and a prohibition on charging certain fees and expenses. Although these changes aim to increase transparency, they primarily apply to registered fund advisers. Additionally, GPs and other interest groups have challenged the SEC, alleging regulatory overreach, resulting in some of the SEC's oversight rules being overturned by a US court in 2024.

Main Findings

Conceptually, the Dodd-Frank Act substantially expanded the regulatory oversight of PE funds in 2012, enhancing market transparency and limiting GPs' opportunistic behaviors. This paper finds that the enhanced regulatory oversight increases LP inventors' PE market participation and reduces their incentives to bypass intermediation. Overall, better investor protection increases capital supply to PE markets.

Moreover, the paper shows that, when bypassing the intermediation, investors tend to finance more mature, larger, and less innovative companies. This contrasts to investing through PE funds, because pension funds, endowments and insurers typically lack the expertise to invest in private companies and the diversification provided by PE funds which can pool large amount of capital for PE investments.

"By facilitating intermediation, regulatory oversight of PE funds mitigates the potential capital misallocation resulting from the disintermediation of PE markets."

Although these benefits are significant, it is crucial to recognize that regulatory intervention brings ongoing compliance and disclosure costs for PE fund advisers, most of which are likely to be passed on to investors. This could also distort GPs' fundraising incentives and create opportunity costs for the SEC due to its limited resources. Consequently, the findings of this paper can contribute to the ongoing discussions regarding the costs and benefits of regulation for

PE funds, which will have important implications for various institutional investors, their beneficiaries, and the broader economy.

By Yingxiang Li (City University of Hong Kong)

Event | 14 March 2025 | Organised by:

The John L. Weinberg Center for Corporate Governance - The Department of Finance at the Lerner College of Business and Economics at the University of Delaware - ECGI

The symposium and competition date back decades and have evolved in various forms, with the past five years focusing on empirical academic finance research in corporate governance. Since its inception, the competition has received more than 1,000 papers, with an average of around 100 submissions annually in recent years. Many submissions and winning papers have become highly influential. Since 2015, the top five papers alone have accumulated over 1,500 citations, with nearly a third exceeding 100 citations.

At the Weinberg Center, we view Delaware not just as a leading state of incorporation, but as a premier forum for advancing corporate governance scholarship. This year's symposium featured papers covering timely and complex governance topics, including the evolving role of proxy advisors and customisation in shareholder voting; tensions between shareholder democracy and political responses in public goods provision; the influence of climate disasters on investor activism; potential trade-offs between diversity and operational flexibility; and a reassessment of index funds' role in corporate oversight.

Custom Proxy Advice and the Architecture of Shareholder Voice

A review of *"Custom Proxy Voting Advice"* by Edwin Hu (University of Virginia), Nadya Malenko (Boston College, NBER, FTG, CEPR, and ECGI) and Jonathon Zytnick (Georgetown University).

Here's how proxy voting could work: Asset managers carefully consider thousands of proposals across thousands of companies, evaluate the merits of each, and cast their votes in a way that reflects both fiduciary duty and broader stewardship principles. The sheer scale of this task suggests that many asset managers may seek ways to simplify their decision-making process.

In practice, they rely on proxy advisors. These firms—like ISS or Glass Lewis—supply voting recommendations that streamline the voting process. Critics argue this makes institutional investors passive, outsourcing their influence to third-party advisors with their own views. But the paper Custom Proxy Voting Advice by Edwin Hu, Nadya Malenko, and Jonathon Zytnick, recently awarded the 2025 John L. Weinberg/IRRCi Research Paper Prize, shows that this common narrative is too simplistic.

As the authors discussed in a blog post on the Harvard Law School Forum, we now know that proxy advice today is not a one-size-fits-all service. Around 80% of funds in the sample receive customised proxy recommendations. These differ from benchmark advice in over 20% of ballots. The process is straightforward: before the proxy season, a fund communicates its ideological preferences—say, stricter views on ESG or a more lenient stance on director overboarding. The proxy advisor encodes those views into a policy engine. Then, as votes roll in, the fund can accept the customised recommendation or manually override it.

In an ECGI interview with Tom Gosling, Prof. Malenko elaborates on how this system works in practice. Some investors opt for bespoke custom policies; others subscribe to ready-made thematic options like "climate" or "governance-first." The key point is that these aren't passive defaults—they are expressions of strategy. What's more, the researchers track when and how funds vote differently from the advice they are provided by analysing voting timestamps. If a fund casts its vote on a different date than its auto-submission setting, that's a manual intervention—a signal of attention.

The theoretical framework underpinning the paper is where things get particularly interesting. The authors model proxy voting as a two-stage process. First, a fund decides whether to invest in customisation. This requires upfront costs—time, money, and effort—but yields voting advice aligned with its worldview. Second, it receives recommendations and decides whether to investigate specific items further. This structure introduces two key mechanisms: substitution and complementarity.

In non-controversial cases, customisation acts as a substitute—removing the need for further scrutiny. But in high-stakes or contentious cases, it frees up cognitive and organisational bandwidth. This is where the complementarity kicks in: funds that customise are actually more likely to pay attention when it counts. They use proxy advisors not as crutches, but as intelligent filters.

This insight flips much of the regulatory narrative on its head. Rather than seeing auto-submission as disengagement, this paper shows that it may facilitate more effective stewardship. When done right, customisation doesn't replace accountability—it enables it.

The empirical findings are robust. The majority of investors customise their policies while still devoting scrutiny to key votes. This undermines the stereotype that proxy advisors impose uniform ideologies and that funds are blindly following proxy advice. Instead, they function as vote engineers—building the infrastructure through which institutional investors can express diverse priorities at scale.

Among the paper's most valuable contributions is its recognition of attention as a scarce resource. Stewardship isn't just about conviction; it's about capacity. And customisation, it turns out, is a rational way of allocating that capacity. Investors who customise are better able to prioritise high-salience decisions without drowning in routine ones.

For policymakers, the implications are clear. Banning pre-filled ballots or discouraging auto-submission may sound like a win for active oversight, but could actually backfire. These measures might erode the customisation infrastructure that allows investors to reflect their values. And when investors default back to generic benchmarks, true diversity in corporate governance outcomes may shrink, not grow.

Ultimately, Custom Proxy Voting Advice helps reframe how we think about proxy advisors—not as ideological monoliths, but as scalable enablers of institutional differentiation. It is this quiet shift—from advice to infrastructure, from standardisation to expression—that marks a deeper evolution in shareholder governance.

When Democracies Collide

A review of *"Voting on Public Goods: Citizens vs Shareholders"* by Robin Döttling (Erasmus University Rotterdam), Doron Levit (University of Washington, CEPR, and ECGI), Nadya Malenko (Boston College, NBER, FTG, CEPR, and ECGI), Magdalena Rola-Janicka (Imperial College Business School, FTG, and CEPR).

In a recent article for ProMarket, the authors of Voting on Public Goods: Citizens vs Shareholders offered a timely and compelling overview of their prize-winning research. Their argument was clear and disconcerting: while shareholder democracy can help overcome public policy shortcomings such as inadequate climate policies, it can also trigger a political backlash that might undermine some of the goals it seeks to advance. In a world of politicised ESG investing, this insight has immediate resonance.

The ProMarket article laid out three central takeaways. First, it argued that when regulation is weak or constrained, shareholder democracy can provide a useful substitute as pro-social shareholders prompt companies to target socially beneficial goals next to financial profits. Second, it explained that shareholder pressure for socially responsible corporate behaviour can crowd out political support, prompting a backlash that reduces public subsidies for those same initiatives. Third, it noted that ESG backlash is not merely rhetorical or symbolic; it may be a rational political response to perceived overreach by investors, especially when their preferences differ from those of the broader public.

For those engaged in the deeper currents of corporate governance theory, the paper delivers something equally valuable: a structured framework for understanding what happens when two democratic systems – one-person-one-vote and one-share-one-vote – collide in the provision of public goods. The results are both elegant and unsettling.

Presented at the 2025 Corporate Governance Symposium where it was awarded the John L. Weinberg/IRRCi Research Paper Prize, the paper by Robin Döttling, Doron Levit, Nadya Malenko, and Magdalena Rola-Janicka builds a rigorous model of how shareholder preferences interact with political decisions when it comes to public good provision. Their contribution is not just to highlight the rising influence of investors on ESG issues, but to ask: what happens when shareholders become too influential?

The answer, as their model shows, is that shareholder democracy may substitute for public policy when the state is constrained or inefficient. But it also risks distorting outcomes away from the preferences of the median citizen. This is because shareholder voting power, tied to share ownership, is inherently skewed toward the wealthy, and their preferences regarding social outcomes may diverge from those of the general population.

This misalignment – the authors call it the "preference representation problem" – is particularly acute when shareholder influence is amplified by high levels of diversification and delegation to asset managers. Shareholders with small stakes in many companies (so-called "universal owners") internalise fewer of the costs associated with corporate public good provision, and may therefore vote for more ambitious ESG initiatives. But these same initiatives can provoke a political backlash, as the model endogenously predicts. The political system, sensitive to the preferences of the median voter, reacts by scaling back subsidies or imposing new frictions – a dynamic that mirrors the real-world rise of anti-ESG legislation in parts of the United States.

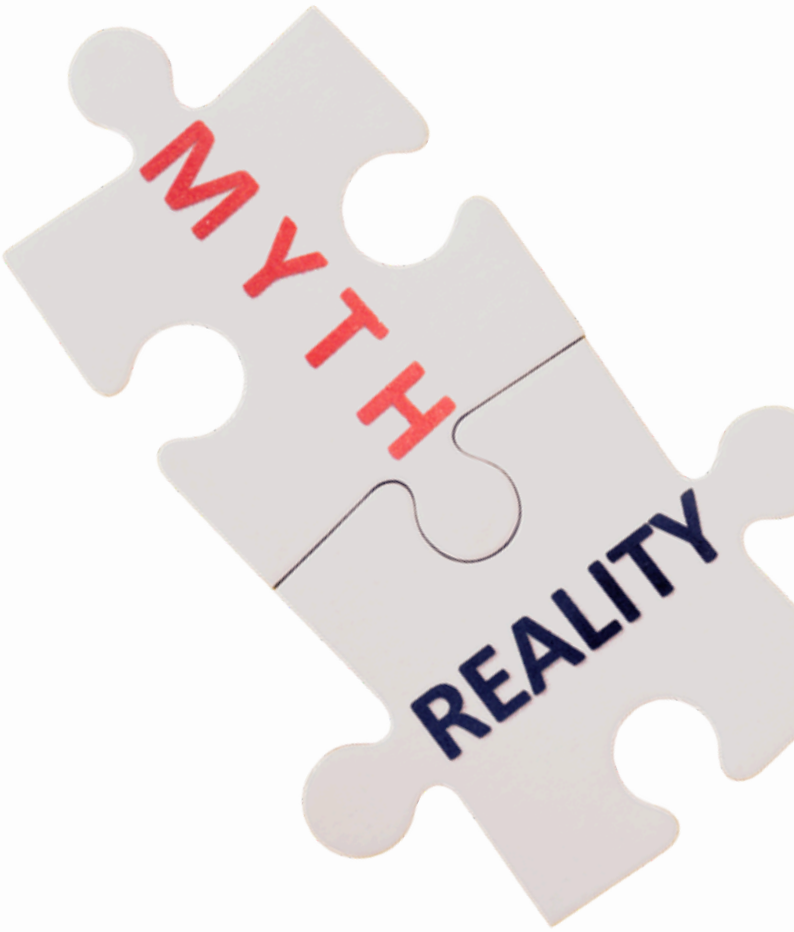
In this sense, the paper offers a powerful theoretical explanation for what many observers have sensed intuitively: that the growing assertiveness of institutional investors on climate and social issues can provoke regulatory pushback. Crucially, the model clarifies when such backlash is simply a substitution for imperfect public policy – and when it becomes counterproductive.

Beyond these core results, the paper explores several extensions that are likely to be of special interest to corporate governance experts. It challenges the assumption that pass-through voting always enhances representation: when fund managers aggregate the preferences of small shareholders, they can actually amplify the voice of less wealthy investors. Disaggregating those votes may lead to less, not more, democratic alignment. The model also introduces the possibility of greenwashing: shareholders deriving a "warm glow" from wasteful or symbolic ESG activity, which can further reduce welfare and fuel backlash.

What emerges is a nuanced view of shareholder democracy. It is not always good, nor always bad. It is context-dependent, shaped by the distribution of wealth and preferences in the population, and by the institutional mechanisms through which shareholder influence is exercised. In some cases, it can efficiently fill the gaps left by dysfunctional regulation. In others, it can lead to outcomes that neither maximise welfare nor reflect democratic consensus.

For corporate governance experts, the implications are far-reaching. The paper invites fresh thinking about the role of institutional investors, the design of voting systems (including pass-through voting), and the limits of firm-level ESG initiatives in delivering broad societal outcomes. It also reminds us that even the most well-intentioned interventions in the corporate sphere do not exist in a vacuum: they interact with politics, and politics pushes back.

The richness of the paper lies not only in its core results but in the breadth of its implications. It offers a theoretical foundation, real-world relevance, and thoughtful extensions that speak to current debates across economics, finance, law, and public policy. It is therefore no surprise that the paper was recognised with the 2025 John L. Weinberg/IRRCi Research Paper Prize.



How Climate Shocks Turn Investors into Climate Activists

Matthew Gustafson, Pennsylvania State University
Ai He, University of South Carolina
Ugur Lel, University of Georgia and ECGI
Zhongling Qin, Auburn University

Climate risk is one of the greatest challenges facing the world today and investors are taking notice, but a full understanding of how investors exert influence remains elusive. In our recent paper, we propose a new time-varying portfolio level driver of investors' ESG attention and engagement, conjecturing that ...

"... investors' exposure to climate disasters via one portfolio firm impacts the way investors engage on climate-related issues at other (non-disaster hit) firms in their portfolios."

To test this hypothesis, we collect extensive data on large climate disasters and institutional investors' holdings from 2003 to 2019. We then measure investors' portfolio exposure to climate disasters, accounting for disaster-hit firms' geographic footprints and investors' attention to these hit firms via portfolio weights. Importantly, we benchmark investors' portfolio exposure to climate disasters by overweighting geographic areas that experienced worse disasters than that of the 1990s. Overall, we can intuitively interpret our main measure as the percentage of investors' portfolio value exposed to a worse climate event year than would have been expected from the 1990s.

We next investigate our conjecture by testing if investors' portfolio exposure to climate disasters predicts how they engage and eventually affect firms' policies. We begin by using shareholder climate proposal votes as a setting to understand the extent to which investors react to their portfolios' climate disaster exposure through shareholder activism. We find that investors with portfolios hit by disasters in the previous year vote more for climate-related shareholder proposals on the other firms they own. This is in comparison to their own voting behavior at different times and the voting patterns of other investors on the same proposals. More importantly, we study whether our findings are influenced by cases in which Institutional Shareholder Services (ISS) recommends against a proposal and find that the increased likelihood of supporting climate proposals is concentrated in cases where ISS recommended against them. This suggests that disaster exposure makes investors more active voters--- following proxy advisors' recommendations normally correlates with a low-cost and passive approach to voting.

Our findings have important economic implications: a one standard deviation increase in disaster exposure in the previous two quarters predicts a 6-percentage point (or approximately 30%) increase in the probability of supporting a climate proposal. Given that climate and ESG-related proposals normally receive very low support from institutional investors – the approval rate has remained below 30% in the past 10 years – our finding indicates that portfolio climate exposure affects institutional investors and changes their voting decisions.

The sensitivity of investors' voting behavior to climate disasters in their portfolio is driven primarily by large and value-relevant disasters, disasters hitting portfolio firms' headquarters are also more predictive of a shift toward voting support for climate proposals at other portfolio firms. These affected climate proposals also tend to target "brown" firms that emit large amounts of CO2, like Exxon Mobil, and relate to policies like the promotion of greenhouse gas (GHG) targets. We find little evidence, however, that the effect varies depending on investor type. Thus, even the most impactful votes from the largest institutions, such as Blackrock or Vanguard, are affected.

Surprisingly, we do not find similar effects for non-climate-related environmental proposals or social-oriented proposals. Collectively, the above voting evidence supports the contention that investors, by responding with support for more aggressive climate policy targeting brown firms, become more concerned about future climate risks when they experience climate disasters in their portfolio.

While the immediate impact on voting is a particularly powerful set of evidence, it remains the (revealed) tip of the iceberg for all the direct or background avenues of investor engagement in firms. To dig into these routes, we move from the tests at the investor level to the firm level by considering whether the aggregate disaster exposure of a firm's investor base affects corporate outcomes. Specifically, we exploit the heterogeneous impact of our proposed time-varying exogeneous investor-level portfolio shock to climate disasters for differential levels of institution ownership in firms.

Armed with this spillover measure, we then studied the impact of investors' climate disaster exposure on long-run environmental policy. Our findings indicate that firms adopt specific governance mechanisms, such as linking their executive pay policies to GHG emission reductions and providing their boards with explicit responsibility for climate change in the two-year period following climate shocks to their institutional investors.

Concurrently, firm-level GHG emissions and energy usage cumulatively decline, suggesting that changes in these governance mechanisms incentivize firms to shrink their carbon footprints.

Overall, our study contributes to a large literature on how and when shareholders gather the information they use in their voting and engagement decisions. Specifically, we introduce portfolio exposure to climate disasters as a high-frequency, time-varying, investor-level determinant of active support for climate proposals, and more broadly for firms' ES discussion and policies. Our work is particularly important in the current context of increasing awareness and action against climate change. Our paper also contributes to the growing literature on climate finance and the role institutional investors may play in addressing the challenges posed by climate change. In particular, our conclusions speak to the debate on whether institutional investors should exit (divestment and boycott) or voice (engagement) when aiming to make impactful, sustainable investments. We show that, when exposed to climate disaster events in their portfolios, institutional shareholders improve corporate sustainability performance through engagement and voting.

By Matthew Gustafson (Pennsylvania State University), Ai He (University of South Carolina), Ugur Lel (University of Georgia and ECGI), Zhongling Qin (Auburn University)

A Hidden Cost of Corporate Diversity and Inclusion

Hoa Briscoe-Tran, University of Alberta

Lately, diversity and inclusion (D&I) have become buzzwords, capturing the attention of investors, policymakers, and the general public alike. And why not? Promoting D&I could support social justice, align with ethical goals, and, frankly, many consider it surely the right thing to do. But as firms rush to embrace these values – even as recent political backlash has made them more cautious – a crucial question emerges: Could prioritizing diversity and inclusion be limiting companies' ability to quickly adapt to changes?

Intuitively, a diverse workforce should offer a broad spectrum of perspectives and creative solutions, potentially making a firm more agile in responding to risks and opportunities. However, there's also a real possibility that investing heavily in D&I practices could slow things down. Communication can get trickier, and integrating diverse backgrounds effectively might require considerable time and resources.

To get a clearer picture, we need accurate, reliable measures of D&I practices, which, until recently, have been pretty scarce. In 2020, Glassdoor provided a breakthrough by allowing employees to anonymously rate their employers' D&I efforts. Hoa Briscoe-Tran, a finance professor at the University of Alberta, extended these ratings back to 2008 in his paper by analyzing written employee reviews on Glassdoor with Google's powerful BERT language model. In doing so, he created a comprehensive D&I rating system covering over 10 million employee reviews.

Interestingly – and somewhat controversially – Briscoe-Tran finds that firms with higher D&I scores tend to be less flexible. He measures flexibility by looking at how consistently firms can maintain their operating cost margins over time.

To understand this intuitively, imagine a flexible firm as one that smoothly adjusts its costs relative to revenues, keeping this ratio stable even as economic conditions fluctuate. On the other hand, a less flexible firm struggles to adapt swiftly, resulting in larger swings in its cost margins. These fluctuations indicate inefficiencies or delays in responding to market changes, reflecting lower overall agility.

It turns out that highly rated D&I firms often experience wider fluctuations in these margins, suggesting they're slower to adapt to economic changes. This was particularly clear after a 2013 court ruling that suddenly increased employer accountability for workplace harassment. Companies impacted by this ruling improved their D&I ratings but also became noticeably less flexible.

Why might this happen? Briscoe-Tran identifies two potential culprits. First, diverse and inclusive hiring and firing practices can complicate workforce management decisions, leading to delays. Second – and perhaps more significantly – maintaining communication across diverse groups can slow decision-making, impacting efficiency.

The COVID-19 crisis of 2020 provided a stark test case. When the pandemic hit, companies had to quickly adjust their operations. Briscoe-Tran's analysis reveals that ...

"... firms strong on D&I suffered greater losses in operating efficiency compared to less diverse firms."

Notably, their challenges were more related to efficiency issues rather than workforce size adjustments.

Here's the bottom line: Yes, diversity and inclusion are essential for ethical and social reasons. However, there's some trade-off – firms emphasizing D&I practices might sacrifice some operational agility, especially during major economic shocks.

How about equity, as in the buzz term Diversity, Equity, and Inclusion (DEI) we have heard so much about in the news? While Briscoe-Tran's measurement approach (the Glassdoor rating) captures diversity and inclusion – but not equity – it's reasonable to expect a similar trade-off might apply. That is, if firms care about equity – fair access and support tailored to individual needs – on top of diversity and inclusion, they will have to sacrifice even more flexibility. Put simply, the more criteria one wants to satisfy, the more operating frictions there might be.

Does this mean firms should reconsider investing in D&I or DEI? Perhaps not. But they should approach these issues with their eyes wide open, understanding the potential downsides, and actively managing these challenges. After all, true leadership is not about avoiding trade-offs but recognizing and navigating them wisely. Briscoe-Tran's work offers crucial insights that can help business leaders make better-informed decisions in today's ever-evolving corporate landscape.

By Hoa Briscoe-Tran (Alberta School of Business, the University of Alberta)

Index Funds Get a Bad Rap – Why That's Wrong

Todd Gormley, Washington University in St. Louis and ECGI
Hwanki Brian Kim, Baylor University

Index funds have revolutionized investing. Once a niche strategy, indexing now dominates Wall Street, with giants like Vanguard, BlackRock, and State Street—the "Big Three"—holding significant stakes in most large U.S. corporations. Understandably, that's made a lot of people nervous.

A big question looms over this new reality: Do index funds actually monitor the companies they own? A highly cited study by Heath, Macciocchi, Michaely, and Ringgenberg (2022)—let's just call them HMMR—says no. Their conclusion is alarming: as index ownership rises, firm performance weakens, managers get paid more regardless of results, and corporate governance takes a hit.

But here's the thing: they got it wrong.

In our new paper, we revisit the data and methods HMMR used and find that the scary headlines don't hold up. Their study made a few key mistakes—mistakes that, once corrected, make the picture look very different.

So what went wrong?

HMMR use a popular strategy in finance research: comparing companies that just barely make it into one index (e.g., the Russell 2000) versus those that just barely stay in another (e.g., the Russell 1000). This index cutoff creates a natural experiment. Stocks on either side are pretty similar, except for one big thing: the ones that fall into the Russell 2000 get snapped up by more index funds. HMMR used these "index switchers" to estimate the effects of index fund ownership on firm outcomes.

But here's the catch: their analysis introduces a fundamental mismatch.

HMMR tried to estimate how moving between these two indexes affects firm behavior by lumping all the "switchers" and "stayers" into one giant statistical model. Unfortunately, this introduced apples-to-oranges comparisons between firms that were in different indexes to begin with. The result? They were attributing performance differences to index funds when they were really due to the companies being fundamentally different from the start.

Fixing the framework

We took their data and their code and made just one simple fix: we made sure the companies being compared were truly similar at the outset. When we did that, the big, scary effects of index fund ownership vanished.

Managers didn't suddenly start slacking off when index funds bought more shares. Pay-for-performance incentives didn't deteriorate. Corporate governance didn't weaken. And firm performance—measured by metrics like return on assets and Tobin's Q—didn't decline.

If anything, we found signs of better alignment between pay and performance.

More Than a Single Fix

We didn't stop at that one correction. We also addressed other methodological oversights that further skewed HMMR's results.

First, we account for whether a company's index status changed again after the initial switch. HMMR's model didn't, meaning some "treated" firms may not have remained treated at all. Second, we control for firm size—a major driver of index assignments as well as executive pay, governance structure, and performance. Ignoring this factor makes it hard to isolate the impact of index ownership. Lastly, we implement a combined, corrected approach that leverages both types of index switches in one unified analysis. This not only boosts statistical power, but also helps researchers avoid cherry-picking results across subsamples.

None of these adjustments are exotic. They're small, standard improvements that strengthen the reliability of any empirical study. But together, they paint a clearer picture—and that picture doesn't look anything like the one HMMR drew.

Not all investors are created equal

One of HMMR's central claims is that index funds displace active mutual funds, which presumably monitor companies more closely. If true, that might explain a decline in oversight. But we show that's not what's happening.

Instead, the rise in index fund ownership tends to come at the expense of smaller, more fragmented institutional investors—the kind that own tiny stakes and have little incentive or ability to monitor. In contrast, the Big Three tend to hold larger stakes, which means they have more to lose if a company underperforms—and more leverage to push for change.

That's a big deal. It means the shift toward index ownership isn't necessarily a move toward passivity. It might actually be a consolidation of influence in the hands of players with the most skin in the game.

Why this matters

The broader debate about index funds is often painted in black and white. Either they're saviors of low-cost investing, or they're silent enablers of corporate mismanagement. The truth is more complicated.

Our research shows that when you use the right tools and make the right comparisons, the data tell a very different story than the one HMMR presented.

"Index funds aren't dragging down governance or firm value. If anything, they're holding steady—or even helping."

To be clear, this doesn't mean index funds are perfect stewards. Real concerns remain about the concentration of ownership and how these firms exercise their influence. But if we're going to shape policy or public opinion around these issues, we should do so based on sound evidence—not shaky comparisons. We owe it to the public, and to the markets, to get the evidence right.

Bottom line: The narrative that index funds are passive passengers doesn't hold up. They may be low-cost, but that doesn't mean they're low impact.

By Todd Gormley (Washington University in St. Louis, NBER, and ECGI) and Hwanki Brian Kim (Baylor University)

The Evolution of ESG Disclosure: More Words, Less Meaning?

Yan Lin, University of Macau
Rui Shen, The Chinese University of Hong Kong, Shenzhen
Jasmine Wang, University of Virginia
Y. Julia Yu, University of Virginia

In the business world, Environmental, Social, and Governance (ESG) issues have evolved from being a niche concern to a mainstream obsession. As investors increasingly demand transparency on how companies impact the environment and society, companies have responded with a flood of ESG disclosures in their annual reports. But what exactly is being disclosed? And, more importantly, is it useful?

Our recent study delves into these questions by analysing over 210,000 annual reports from 24,271 public firms across 30 countries, spanning two decades from 2001 to 2020. Using a natural language processing technique called word embedding, we created an ESG dictionary to track trends in how companies communicate their environmental and social (E&S) impacts. The results might make you rethink how much faith to put in those glossy sustainability sections.

The Rise of ESG Disclosure: A Good Thing?

The first thing we noticed is that companies are definitely talking more about ESG. The length of E&S disclosures in annual reports has grown dramatically—by more than six times since 2001. By 2020, the median company was dedicating over 1,700 words to discuss their environmental and social practices, up from just a few hundred words two decades ago, which might suggest more transparency.

However, the bulk of this increase comes from what we affectionately call "boilerplate" language—generic, often recycled phrases that sound good but say little.

Think of the kind of corporate-speak that can be summed up as "We care about the planet and our people," but without any concrete details. In fact, the use of boilerplate language in E&S sections has tripled over our study period, from 3.6% to over 12.5%. It fills space, but does it mean anything?

Specificity Declines as Disclosure Increases

You might argue that more disclosure, even if generic, is still a step in the right direction. After all, companies are acknowledging the importance of ESG, which could push them to act more responsibly. But what we show is that as the volume of disclosure has increased, its specificity has decreased.

Specificity is important because it indicates how much a company is willing to share about its actual practices and impacts. Specific disclosures provide concrete data—think "Our carbon emissions reduced by 5% this year" rather than "We are committed to reducing our environmental footprint." Unfortunately, our study found that the proportion of specific information in E&S disclosures has slightly dropped over the years, suggesting that while companies are saying more, they're not necessarily saying more that's meaningful.

The Role of Voluntary Frameworks and Mandates

To see what's driving these trends, we looked at the role that voluntary ESG reporting frameworks (like the Global Reporting Initiative) and mandatory disclosure regulations have played.

Interestingly, voluntary frameworks seem to improve the quality of disclosures—companies that adopt these frameworks tend to use less boilerplate language and provide more specific, sticky (i.e., consistent year-over-year) disclosures, although we recognize the possibility that these voluntary adopters might be firms that were hoping to get better at ESG disclosure.

On the flip side, when ESG disclosure becomes mandatory, the quality tends to drop. This makes sense if you think about it: companies that are forced to disclose might do so grudgingly, sticking to the minimum required and recycling old content.

The Changing Landscape of ESG Topics

Another interesting trend is the shift in focus within ESG topics. Early in our study period, companies talked a lot about issues like product quality and customer service under the social disclosure umbrella. But as we moved into the 2010s, discussions about human capital (think workforce diversity and employee well-being) and climate change started to dominate. Words like "greenhouse gas" and "carbon" have become increasingly frequent in recent years, reflecting the growing concern over climate change.

Meanwhile, some topics have faded into the background. Mentions of product quality, for example, have decreased significantly, which might be a sign that companies feel the pressure to focus on what's currently trending in the public discourse.

Global Trends: Who's Leading, Who's Lagging?

Finally, we ranked countries by the average length of E&S disclosure over time. Unsurprisingly, developed countries in Europe often rank near the top, while many Asian countries started lower but have climbed the rankings significantly. For example, firms in China, Hong Kong, and Japan have seen some of the most dramatic increases in disclosure length, reflecting growing awareness and regulatory pressure in these regions.

But as with the global trend, keep in mind that longer disclosures don't necessarily mean better disclosures.

Overall, at least on the surface, ...

"... the explosion of ESG disclosure in annual reports might seem like a victory for transparency and accountability."

But dig a little deeper, and it becomes clear that more disclosure isn't always better disclosure. The rise in boilerplate language and the decline in specificity suggest that much of this newfound transparency might be more about checking boxes than providing investors and stakeholders with the information they need.

As regulators and standard-setters continue to push for greater ESG disclosure, it's crucial to focus not just on the quantity of information, but on its quality. Otherwise, we risk drowning in a sea of words that say a lot but mean very little.

By Yan Lin (University of Macau), Rui Shen (The Chinese University of Hong Kong, Shenzhen - School of Management and Economics; Shenzhen Finance Institute), Jasmine Wang (University of Virginia), and Y. Julia Yu (University of Virginia)

Changing the DNA of our corporate sector one step at a time: Integrated Value

Dirk Schoenmaker, Rotterdam School of Management, Erasmus University Rotterdam

As the world grapples with the escalating impacts of climate change, the race to achieve net zero emissions by 2050 has become the defining challenge of our time. While governments are setting ambitious targets, business holds the key to driving this transition forward.

"To effectively meet global net zero goals, the corporate sector must evolve from traditional models to integrated value models—an approach that merges financial decision-making with environmental and social imperatives."

Integrated value models offer the promise of aligning capital with sustainability objectives by embedding environmental, social, and governance (ESG) factors into the very foundation of a company's operations. By factoring in the true costs of carbon emissions, resource depletion, and societal impacts, these models can accelerate the flow of capital into low-carbon solutions, creating the economic conditions necessary to decarbonise industries, scale innovation, and ensure that net zero is not just a target but a reality.

Achieving net zero will require a vast reallocation of capital. According to estimates from the International Energy Agency (IEA), the world must invest nearly $4 trillion annually in clean energy infrastructure by 2030 to remain on track for net zero. Yet, global investments in fossil fuels continue to dwarf those in renewable energy, signalling that the corporate sector is still misaligned with climate goals.

Part of the problem lies in how financial value is traditionally measured. Investment decisions have long been based on short-term profitability metrics, with little consideration for long-term environmental risks. This narrow focus on financial returns has led to the chronic undervaluation of green technologies, infrastructure resilience, and sustainable innovations, even though these areas are critical for the global transition to net zero.

Integrated value models can change this by expanding the scope of what capital markets value, embedding sustainability metrics into financial analysis, and shifting investment flows toward sectors and projects that contribute to the net zero transition.

At the heart of integrated models is the concept of integrated value, which goes beyond traditional financial metrics to include environmental and social capital. They are assets and liabilities that can materially affect a firm's future cash flows. For example, the carbon emissions a company generates today might not show up on the balance sheet until carbon pricing policies make them expensive. But by then, it can be too late to adjust the strategy.

Inditex, the parent company of Zara, provides a prime example. The company excels at maximising financial value by turning out trendy clothing in record time. Yet, when you factor in environmental capital—such as the massive carbon emissions and waste generated by its fast fashion model—the valuation picture changes. Inditex has responded to some of these concerns by introducing sustainability initiatives, including a commitment to reduce its emissions and improve transparency in its supply chain. However, the company's targets—particularly in addressing its Scope 3 emissions, which account for over 98% of its total carbon footprint—remain limited. While Inditex aims for a 90% reduction in its direct (Scope 1 and 2) emissions by 2030, its more distant target for Scope 3 (20% by 2050) suggests that the company is not yet fully addressing the environmental impact of its outsourced production.

Integrated value recognises that long-term profitability depends on sustainable business practices and the responsible use of natural and social resources. A new open textbook Corporate Finance for Long-Term Value offers a guide to corporate finance for modern companies that want to create integrated value. Drawing on recent literature on sustainable companies, it starts by analysing the Sustainable Development Goals as a strategy for the transition to a sustainable economy. Next, it translates the general concept of sustainability into core corporate finance methods, such as net present value, company valuation, cost of capital, capital structure and M&A.

Current corporate finance textbooks are primarily based on the shareholder model, designed to maximise financial value. This book instead adopts the integrated model, which argues that companies have to serve the interests of their current and future stakeholders. Accordingly, companies move from simply maximising financial value to optimising integrated value, which combines financial, social and environmental value. Applying this new paradigm of integrated value is the truly innovative feature of this textbook.

Written for undergraduate and graduate students of Finance, Economics, and Business Administration, this textbook provides a fresh analysis of corporate finance. Combining theory, empirical data and examples from actual companies, it reveals the sustainability challenges for corporate investment and shows how finance can be used to steer funds to sustainable companies and projects and thus accelerate the transition to a sustainable economy.

By Dirk Schoenmaker (Rotterdam School of Management, Erasmus University Rotterdam)

Book Review: "Unjust Debts: How Our Bankruptcy System Makes America More Unequal" by Melissa B. Jacoby

Anat Admati, Stanford University and ECGI

My local utility, Pacific Gas and Electric (PG&E), filed for Chapter 11 bankruptcy in early 2019 to preempt lawsuits related to multiple wildfires involving its aged equipment. Shortly after it emerged from bankruptcy in July 2020, a 2017-fire victim who had previously sued PG&E for damages and became an "unsecured creditor" in the bankruptcy told me about the opaque court process and the outcomes it produced. I was flabbergasted. Tens of thousands of victims seeking to recover from the devastation of the fires ended up with claims against a trust that owned 25% of PG&E shares, inefficiently bearing non-diversifiable risks. Other creditors, including insurance companies, and all lawyers, were paid in cash. The hedge funds that controlled PG&E through bankruptcy and played key roles in the process dumped their shares quickly and moved on. The process and outcome seemed disturbingly flawed.[1]

"Unjust Debt" refers to injustices produced by US bankruptcy law and to Jacoby's suggestion that bankruptcy returns to its original "just debt" intent to apply just to contractual (debt) promises. Prevailing narratives hold that bankruptcy can "reduce suffering and promote innovation" (p.4), but instead its application is uneven and often problematic.

"Powerful parties transformed bankruptcy into "a legal Swiss army knife" that undermines civil justice and can rob people of their legal rights without consent even when debtors' obligations are due to bad behavior."

The first two chapters describe personal bankruptcy, explaining how Chapter 7, which provides immediate debt relief (with key exceptions such as student debt and fines), and Chapter 13, where relief is conditional on successful completion of a court-supervised repayment plan, work. An individual in bankruptcy has little control over the process, or privacy. About two thirds of Chapter 13 filers -- disproportionately Black -- never receive any relief. A 2005 law made personal bankruptcy less debtor friendly, causing delays in filing that further benefit lenders.[2] Differential outcomes "pile on" existing inequality.[3]

The remaining chapters, drawing stark and thought-provoking contrasts, focus on what Jacoby refers to as "fake people," also known as "legal persons," entities like corporations, nonprofits and municipalities that are separate from all "real people" (humans) and created entirely by law. "The system perceives lawyers and their clients' financial problems in profoundly different ways, depending on whether their clients are real or fake people" (p. 64). Unlike humans, "enterprises that can persuade a majority of their creditors and a court to support their Chapter 11 plans can cancel almost everything, even debts arising from willful or malicious injury or fraud" (p. 67).

Chapter 11 bankruptcy allows managers of bankrupt corporations to continue controlling information and decisions, does not require government-appointed trustees, and provides final relief from obligations, sometimes also releasing third parties not in bankruptcy from liability, upon the approval of a plan rather than after debtors fulfil promises they made in the plan. Those involved in the process, including judges, have no duty or true incentives to promote societal objectives like deterring corporate misconduct. Does it always make sense to allow companies that persistently engage in pollution, wage theft, reckless endangerment or fraud to get a fresh start (and possibly thrive later) and never pay fully for the harm they caused?

The book discusses (Chapter 4) the history of municipal bankruptcies and key examples, particularly Detroit. Cities in bankruptcy may be able to reduce prior obligations to victims of civil rights violations such as police brutality, where remedies may not be only monetary.

Similar issues arose in the bankruptcy of gunmaker Remmington in 2020, discussed in chapter 5 ("My Money, My Rules"). Families of Sandy Hook school shooting suing Remmington wanted information about its marketing of deadly weapons to prevent future harm.

This chapter explains the history of Chapter 11 bankruptcy and how it enables corporations to insulate themselves from obligations. One approach, used by Remmington in 2020, is proposing a quick and "essential" sale of the company that requires certain liabilities be cancelled.

Chapters 5 and 6 cover more examples of the use of bankruptcy for non-contractual liabilities, starting with asbestos in the 1980s and including Bikram Yoga, Weinstein Company, and Purdue Pharma. In the Purdue case, after this book went to print the Supreme Court blocked the bankruptcy plan that provided permanent releases from all litigation to Sackler family owners, some bearing significant responsibility to the massive opioid crisis but only considered third parties in the corporate bankruptcy of Purdue.

Explaining accessibly the cynical use of bankruptcy as "litigation tool" to evade accountability and deprive people of legal rights (as in the PG&E case, not discussed in the book) is the most significant contribution of this important book. A common trick illustrated in the case of Boy Scouts of America, which filed for bankruptcy to deal with a pervasive sexual harassment scandal, is to include as many victims as possible in a bankruptcy "class," each getting equal voting right. Victims with strong cases that would have succeeded in civil courts might be outvoted by others who would have been unable to get any compensation elsewhere. A broader problem (for all laws), seen in Purdue's case, is the ability to remove money out of reach of legal jurisdictions.

Basic corporate finance textbooks calculate the tax "shield" corporations gain by borrowing. They rarely ask why tax laws reward excessive use of debt funding by corporations that makes bankruptcies more likely, and they entirely ignore the use of corporate bankruptcy as "shield" from non-debt liabilities. Law schools teach future lawyers how to use all tools and shape laws to benefit corporate clients.

Economists seem remarkably blind to the fact that firms are separate legal ("fake") persons, and the significant impact this separateness can have on economic outcomes.

In reviewing Steven Shavel's Foundations of Economic Analysis of Law, Posner (2006) lamented that "the 'law' that Shavell analyzes is an abstract or stylized—a simplified— version of actual law; it is law minus detail and texture, law trimmed to fit the economic model." Unjust Debt explains the detail, texture and political economy of US bankruptcy law in a highly readable form, and illustrates how they matter. It also shows that the power to shape laws and enforcement, including through deceptive narratives, matters greatly too.[4]

This book offers new research directions for economists related to bankruptcy and much beyond. Studying the detail, texture, implementation and political economy of laws as they apply to real people and to "fake" people, also across jurisdictions, is important. Such explorations can help address distortions in the system and improve outcomes.

By Anat R. Admati (Stanford University and ECGI)

Tiktok's Identity Crisis: Corporate Personality in a De-Globalizing World

Dan Puchniak, Singapore Management University, Yong Pung How School of Law, and ECGI
Curtis J. Milhaupt, Stanford Law School and ECGI

TikTok's travails under the Trump and Biden Administrations are typically portrayed as a clash between national security interests and First Amendment protections. This tension is the focus of TikTok's suit against the U.S. Government over a 2024 law that subjects the video platform to a ban in the United States unless it is divested from Chinese control by January 19, 2025.

But TikTok's problems in the United States expose another serious tension: between longstanding legal doctrines of corporate identity and separate personality, on one hand, and increasing concerns over Beijing's use of erstwhile private commercial firms as instruments of state influence, on the other. The divest-or-ban legislation illustrates that corporate law's answers to the question of corporate identity and separateness are not definitive in a de-globalizing world.

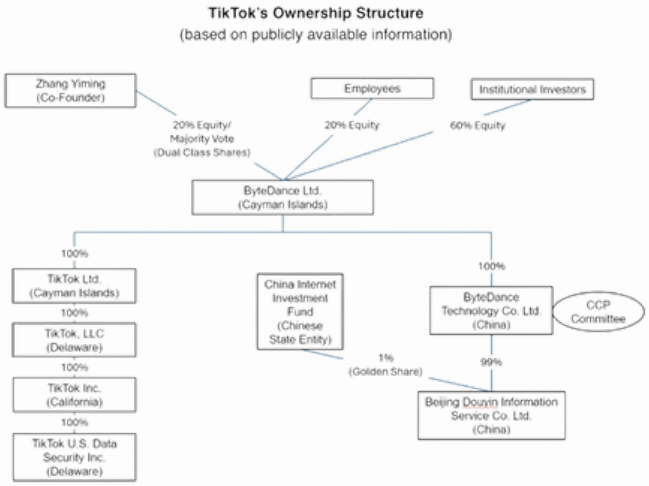
Corporate Identity and Personality

What determines the identity of a corporation? Corporate law has straightforward answers. Under the internal affairs doctrine followed in the United States, the identity of a corporation is determined by its jurisdiction of incorporation. In the traditional test followed in continental Europe, the real seat doctrine asks where a company's "center of management and control" resides – focusing on the place where day-to-day management decisions are made.

An important corollary of these principles is the doctrine of separate corporate personality – barring unusual circumstances, a corporation is deemed to have a separate existence from that of its shareholders, including its corporate parent.

These doctrines have withstood the test of time, suggesting that despite the inevitable weaknesses of any bright line test, they provide workable choice-of-law rules with which to resolve internal governance issues and to establish the basis by which assets are partitioned between a corporation and its investors.

But corporate law's standard identity and personality tests are proving far less helpful in addressing the national security challenges posed by corporate activity in a global – but rapidly de-globalizing – world, particularly one in which data is the coin of the realm.
Consider TikTok's identity crisis.
Open configuration options



TikTok, the short video streaming platform with 170 million U.S. users, is operated by TikTok Inc., a California Corporation with headquarters in Culver City, California. The parent of TikTok Inc. (via an intermediary LLC), overseeing TikTok's global operations, is TikTok Ltd., which is incorporated in the Cayman Islands. Its parent, ByteDance Ltd., is also incorporated in the Cayman Islands. ByteDance Ltd. is controlled by one of its co-founders, Zhang Yiming, via dual class shares reportedly giving him majority voting control, notwithstanding his 20% equity stake. Sixty percent of the equity is held by global institutional investors, including Sequoia and KKR. Employees hold the remaining 20% of the equity. While ByteDance Ltd.'s headquarters are in Beijing, a majority of its board members are non-Chinese nationals, including multiple representatives of its U.S.-based institutional investors. None of its directors reside in China.

Neither TikTok Ltd. nor TikTok Inc. operates in China, and none of their senior executives are Chinese nationals. The company's executives operate out of Singapore and Los Angeles. Data generated by the platform's users is stored in the United States, Singapore, and Malaysia. A subsidiary of TikTok Inc., Delaware incorporated TTUSDS, was created to limit ByteDance's access to the data of TikTok's U.S. users and to monitor security of the platform.

Thus far, nothing about TikTok is Chinese, apart from the nationality of the (human) controlling shareholder of its ultimate parent company, which is immaterial under corporate law's standard personality tests. From this perspective, it is plainly inaccurate to call the TikTok entities or the video platform they operate "Chinese."

But here's where the question of corporate identity gets complicated in a world rife with geopolitical tensions between the United States and China – and a Chinese political economy that increasingly blurs the boundary between commercial enterprises and instruments of the party-state.

ByteDance Ltd., at the top of the TikTok ownership chain, also wholly owns ByteDance Technology Co., Ltd., a China-incorporated company in charge of the group's Chinese domestic operations. This corporate sibling of TikTok maintains an internal Chinese Communist Party (CCP) committee, as long required by China's Company Law (see Article 18). This feature of Chinese corporate law – requiring an organization representing a political party within the corporation – has no counterpart anywhere in the world, not even in Russian state-owned enterprises. Exactly what the internal CCP committee of ByteDance, or any other Chinese firm, does is a matter of speculation, because neither the Company Law nor any other regulation explicitly specifies the role of such committees – although Article 33 of the Chinese Communist Party Constitution provides that in private companies, the Party committee "shall implement the Party's principles and policies."

Most Chinese companies, ByteDance included, say little publicly about the membership or function of their internal CCP committees. While it is unlikely that these committees routinely intervene in corporate strategy or operations, they are plainly a channel of potential political influence in Chinese commercial enterprises, ensuring that management remains friendly toward the Party and government. And research shows that some private firms cede substantive governance roles to these committees. The very existence of these committees raises fundamental questions about whether corporate law's standard personality tests are appropriate for Chinese companies where the question of Beijing's influence is concerned.

ByteDance Technology Ltd.'s wholly owned subsidiary is Beijing Douyin Information Services Co., Ltd., which operates Douyin, a short video streaming platform for the Chinese market. (TikTok is not allowed in China and Douyin does not contain most of the videos available on TikTok.) Douyin is ByteDance's crown jewel, generating the bulk of its China revenues, which account for roughly 80% of ByteDance's total revenues. Via an intermediary, a state investment organ called China Internet Investment Fund (CIIF) holds a 1% stake in Beijing Douyin. This is a golden (or "special management") share, giving a representative of China's Cyberspace Administration a board seat and editorial influence over Douyin's content.

Similar special management shares have been taken by organs of the Chinese state in many data-rich companies, particularly ones that provide content subject to China's strict censorship regime.

The TikTok and Douyin platforms are designed for different markets and operated by legally separate entities. Yet it is hard for Western policy makers to ignore their common lineage and the reality that TikTok's corporate siblings are connected to the Chinese party-state via share ownership, board representation, and an internal organization representing the CCP.

An additional concern is China's National Intelligence Law, which provides in Article 7 that all Chinese "organizations and citizens shall support, assist and cooperate with national intelligence efforts…" While the law likely does not apply to a foreign incorporated subsidiary ultimately controlled by a Chinese citizen, such as TikTok Inc., it is unrealistic to expect that Zhang Yiming or other senior Chinese corporate leaders of ByteDance could resist government or CCP orders to influence the TikTok algorithm to the detriment of U.S. national security interests, or to seek access to the data generated by its American users for Chinese intelligence purposes.

The reality is that TikTok's relationship with China and its susceptibility to Chinese party-state influence operate through channels that venerable doctrines on corporate identity and separate personality do not fully recognize. As a result, it is not surprising that policymakers in the United States and Europe have viewed TikTok's Western persona with a great deal of skepticism. They see TikTok as a potential instrument of malign Chinese state influence – a conclusion that led the U.S. Congress in 2024 to pass The Protecting Americans from Foreign Adversary Controlled Applications Act (Public Law 118-50, Division H; the "Applications Act"). The Applications Act requires the TikTok platform to be divested from "foreign adversary control" by January 19, 2025 (subject to a 90-day extension by the President) or effectively be banned from operation in the United States.

The policymakers' concerns over TikTok are seemingly at odds with the law's standard tests of corporate identity and separate personality: the legislation is not seeking to pierce the corporate veil by treating TikTok as the alter ego of ByteDance and its controlling shareholder. Rather, the law effectively treats TikTok as the alter ego of the Chinese government and CCP. Whether justified or an overreaction, this approach reflects a more wholistic view of China's "hybrid commercial threat" in the global economy than one framed entirely by standard corporate law and governance metrics. The D.C. Circuit Court of Appeals (at p. 27) explicitly notes that the U.S. government was not asking the Court to apply standard exceptions to fundamental principles of corporate separateness, but to recognize the "risk of a foreign adversary exploiting [the] corporate form."

Corporate Identity and National Security

The TikTok episode exposes a new reality: Contrary to widespread predictions that globalization would lead to the statelessness of large corporations, weaponized interdependence has heightened the salience of questions about corporate identity and control, as well as informal channels of state influence over commercial enterprises.

"TikTok's identity crisis reveals the limitations of standard corporate law doctrines in satisfying policymakers focused on national security and geopolitical rivalry."

The Applications Act, requiring divestiture of applications under the control of a "foreign adversary" (statutorily defined as China, Russia, North Korea and Iran), illustrates how fundamental corporate law principles can be sidestepped by approaches that effectively disregard established doctrines of corporate identity and separate personality, in view of perceived national security imperatives.

Broader tests of corporate identity may be necessary in these circumstances because more than ever, state influence over commercial actors operates through control over capital and data flows, market access, supply chain vulnerabilities, and other forms of geo-economic leverage. Yet, if blunt tests of "adversary control" over a corporation such as that used in the Applications Act (see Section 2(g)(1)) are to be avoided in favor of more surgical approaches to corporate identity that facilitate continued global economic interaction, more nuanced frameworks for determining corporate identity and de facto state influence/allegiance may need to be developed. This is a tall order.

Until the current de-risking and friendshoring trends are reversed, we can expect more episodes that expose the limitations of traditional corporate identity and personality tests in a de-globalizing world.

By Curtis J. Milhaupt (Stanford Law School and ECGI) and Dan W. Puchniak (Yong Pung How School of Law and ECGI)

Automated Bail-In: Enhancing TLAC Instruments with a Penny Stock Trigger

Urs Lendermann, Deutsche Bundesbank University of Applied Sciences

Background: Evolution of Bank Resolution Mechanisms

The 2023 banking turmoil exposed significant flaws in the resolution framework for global systemically important banks (G-SIBs), as highlighted in the "Christmas Report" of the Parliamentary Investigation Commission on the Management of the Authorities — Credit Suisse (CS) Emergency Merger (December 2024).This merger reignited concerns regarding regulatory capital requirements for UBS, especially given its "too big to save" status and the Swiss Government's limited negotiating power compared to host countries where the bank operates. While discussions on the quantity of capital remain critical, equal attention should be given to capital quality. Additional Tier 1 (AT1) instruments face increasing scrutiny, with the Netherlands considering reforms and Australia already implementing changes. This blog contribution proposes enhancements to the Total Loss-Absorbing Capacity (TLAC) standard to improve its automatic loss absorbency.

After the Global Financial Crisis (GFC), policymakers and the financial industry needed a credible solution to the "too big to fail" (TBTF) problem that minimized resistance from banks and political fallout. Representatives of CS successfully lobbied for the bail-in mechanism, avoiding more radical solutions such as breaking up banks, separating business lines, imposing stringent equity capital requirements, or capping bank size.

The bail-in concept gained traction based on its promise as an effective resolution tool, making alternative proposals seem obsolete.

Regulatory discussions then shifted toward balancing risk tolerance, credit supply, and the cost of regulatory capital. The debate involves multiple stakeholders: G-SIBs seeking low financing costs, debt investors demanding risk-adjusted pricing, competitors pushing for a level playing field, and taxpayers seeking compensation for implicit state guarantees. Regulators, however, remain uncertain whether reducing banks' funding cost advantages should outweigh concerns about profitability and the market for regulatory capital.

TLAC and Its Shortcomings

To complement the bail-in mechanism, the TLAC standard was introduced as a buffer to absorb losses. However, TLAC requirements led to the issuance of opaque bail-in bonds, which are marketed as loss-absorbing instruments to regulators but as debt instruments to investors. These instruments continue to benefit from lower funding costs compared to regulatory capital, with minimal reduction in implicit state guarantees.

The bail-in mechanism ultimately became a euphemism for public bailouts. The discretionary nature of bail-in trigger events and the blurred distinction between recovery and resolution create pre-insolvency uncertainty, leading to delays in regulatory action. Existing triggers, such as those for AT1 instruments, are difficult to assess and often too late to be effective. The discretion involved in identifying resolution triggers introduces time inconsistency—politicians may delay activating resolution mechanisms due to short-term costs, undermining financial stability.

Legal scholar Katharina Pistor's Legal Theory of Finance supports this observation, noting that the legal enforcement of financial contracts is often suspended during crises to protect systemic stability. However, it is paradoxical for a crisis management framework to be abandoned precisely when it is most needed. It follows, that the bail-in mechanism only benefits the industry as long as it remains unused.

A Market-Driven, Automatic Loss Absorption Mechanism

To address these flaws, this article proposes a streamlined approach: TLAC-eligible instruments should be structured as mandatory contingent convertible (CoCo) bonds with a penny stock trigger (USD 5 or higher). This solution builds on ideas from Flannery, Pennacchi, Vermaelen and Wolff, and Sundaresan and Wang. The proposed trigger is simple, contractual, and transparent, ensuring compliance with solvency requirements for Emergency Liquidity Assistance (ELA).

One concern about activating TLAC instruments is the potential for market destabilization. Critics argue that a share price-based triggers could initiate a "death spiral," but this concern might be overstated. Converting TLAC debt into equity at a predetermined share price threshold would simply flood the bank with equity capital, stabilizing its balance sheet. The proposed mechanism ensures automatic recapitalization, reducing reliance on government intervention.

Aligning Management Incentives with Stability

Linking TLAC conversion to a share price threshold incentivizes bank management to maintain strong stock valuations. While short-term measures like dividend payouts and share buybacks could artificially boost stock prices, they remain regulated and monitored. More importantly, the risk of losing control due to forced TLAC conversion aligns management incentives with long-term financial stability.

Preventing Opportunistic Behaviors

An automatic TLAC trigger prevents creditors and potential acquirers from exploiting regulatory delays or negotiating preferential outcomes during crises. By eliminating discretionary interventions, the framework discourages holdout strategies and reduces legal disputes. Markets would price risks upfront, fostering discipline among banks and their stakeholders.

International Crisis Management Challenges

Cross-border resolution is complicated by fragmented capital and funding structures. In case of CS, capital at the solo-entity level was insufficient due to internal funding structures resembling a carry trade and involving double leverage through intermediate holding companies. CS parent bank in Switzerland raised funds at low costs and downstreamed them to foreign subsidiaries, where local regulations restricted their recoverability. Ringfencing issues make a Single Point of Entry (SPE) resolution strategy unrealistic. Given that a bank's assets are often located abroad, a Multiple Point of Entry (MPE) strategy is the only feasible option, requiring a horizontal holding structure.

The proposed automatic conversion mechanism reduces reliance on prolonged negotiations, enabling smoother coordination among international crisis management groups.

Emergency Liquidity Assistance (ELA) and Market Confidence

The CS crisis underscored how fragile market confidence can lead to liquidity crises and bank runs. Public announcements of ELA can exacerbate panic, as market participants may interpret them as signs of distress. The proposed automatic TLAC conversion mechanism stabilizes a bank's balance sheet before liquidity issues escalate, while ensuring that solvency criteria are met for coordinated liquidity support among central banks.

"The proposed automatic TLAC conversion mechanism stabilizes a bank's balance sheet before liquidity issues escalate, while ensuring that solvency criteria are met for coordinated liquidity support among central banks."

Transparency and Regulatory Adjustments

To enhance transparency, TLAC-eligible liabilities should be ranked equally with Tier 2 capital instruments and include clear subordination language and Basel II Pillar 3 disclosures at the solo-entity level. The distinction between going-concern (Tier 1) and gone-concern (Tier 2 and TLAC) capital appears artificial unless G-SIBs can demonstrate orderly resolution. TLAC triggers should not be treated as events of default or trigger early termination rights. Instead, Basel III standards for Tier 1 capital—where discretionary payments do not constitute a default—should be extended to TLAC instruments. This adjustment would curb speculative behaviors like shorting bank stocks to trigger TLAC instruments to gain Credit Default Swap (CDS) payouts.

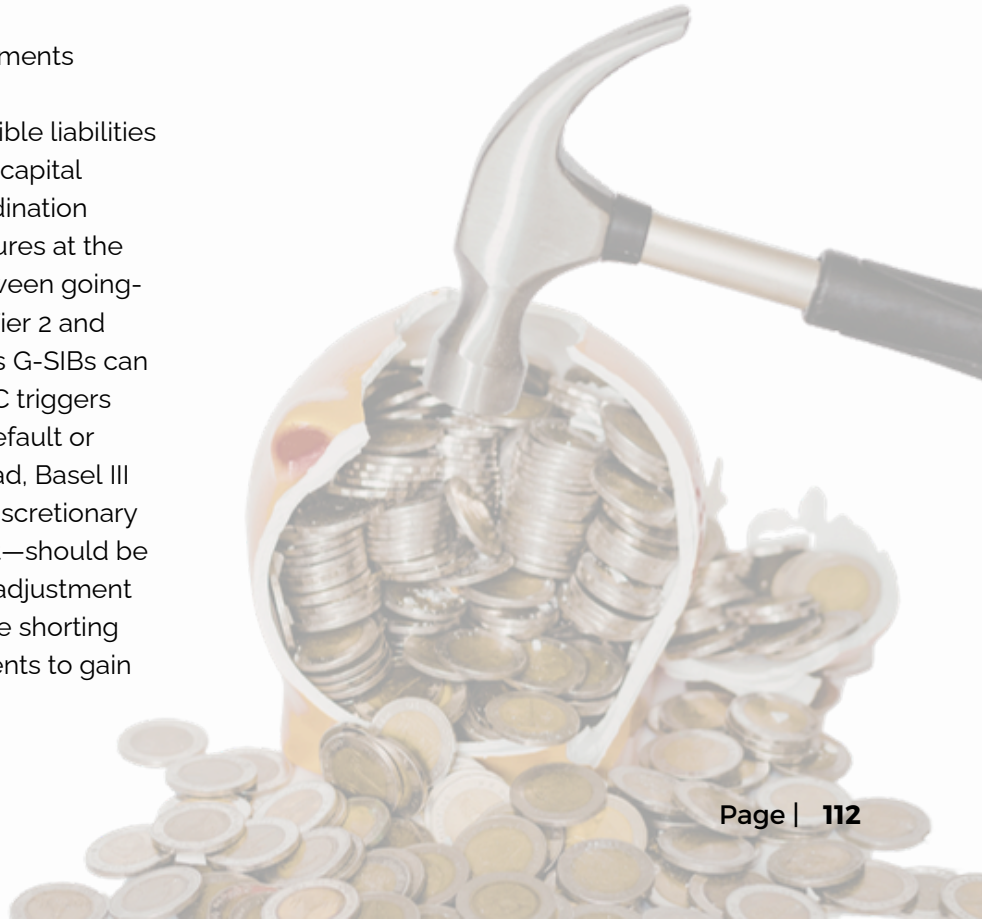
Regulatory disparities in tax treatment should also be addressed to maintain an international level playing field.

A Market-Driven Solution Without Public Intervention

This proposal does not involve central banks, regulators, or resolution authorities. There is no need for statutory amendments, debates over intervention appropriateness, or concerns about state liability. The automatic TLAC conversion mechanism operates purely within the market framework, enhancing loss absorption without requiring formal resolution proceedings.

Lessons from the CS collapse highlight the need for a more effective TLAC framework. If TLAC cannot be entirely backed by equity, incorporating equity-like mechanisms through automatic triggers is the best alternative.
For further analysis on bail-in regulations and an in-depth discussion of this proposal, see my recent article in the Journal of Banking Regulation.

By Urs Benedikt Lendermann (Deutsche Bundesbank University of Applied Sciences)



Lessons from Ecuador's Corporate Revolution

Paúl Noboa-Velasco, Universidad San Francisco de Quito

Latin American companies are commonly shaped by a concentrated ownership structure, where one or a few shareholders hold significant control. While this pattern may create strong incentives for oversight, it also opens the door to shareholder exploitation. Unlike managerial agency problems, where directors act against dispersed shareholders, in Latin America, it's often the controlling shareholders who use their power to benefit themselves, at the expense of minority shareholders. This context requires tailored regulatory strategies.

"Ecuador's recent corporate reforms offer important solutions to protect non-controlling shareholders and promote accountability in corporate governance."

Regulating Related-Party Transactions

Not all related-party transactions are harmful, but without regulation, they can enable unjustified self-dealing. Therefore, Ecuador has taken steps to ensure they are properly monitored. Now, any transaction involving a conflict of interest must only be approved by disinterested shareholders. The law also includes "indirect" related-party transactions involving relatives or companies in which controlling shareholders or directors have significant influence. And importantly, when there's a legal dispute, it's the beneficiaries of the deal who must prove it was fair. That shift in the burden of proof is a game changer in the region.

Minority Voting Rights

Ecuador has granted minority shareholders greater influence in critical corporate decisions. Key matters—such as mergers or the reinvestment of profits—now require supermajority approval. Also, changes to the rights of specific share classes must also be approved by all the holders of those shares, giving non-controlling shareholders a say in protecting their interests.

Appointment Rights for Non-Controlling Shareholders

Independent directors in Latin America are often closely aligned with controlling shareholders. To address this, Ecuador allows minority shareholders to appoint at least one independent director. Additionally, a dual voting system gives minority shareholders veto power over appointments made by controlling shareholders. This enhances genuine representation and strengthens oversight mechanisms.

Tools for Corporate Accountability: Derivative and Direct Actions

For corporate litigation to be meaningful, it must be accessible. Ecuador allows any shareholder—regardless of their ownership percentage—to bring a derivative claim against directors for breaches of the duty of care, and a direct action for breaches of the duty of loyalty. These rights have been extended to allow derivative actions against controlling shareholders in specific cases, such as abuse of voting rights or unlawful related-party transactions. And again, the burden of proof can shift to whoever holds the evidence to sustain or dismiss the claim, which levels the playing field in court.

Holding De Facto and Shadow Directors Accountable

In many Latin American companies, it's not the legally appointed directors who run the company's operations. Often, decisions come from behind the curtain—from controlling shareholders or advisors who act as de facto or shadow directors. Ecuador now recognizes these figures under the law. If someone interferes in corporate management without being formally appointed, that person can be held liable as if he was a formally appointed director. That includes responsibility for damages and the possibility of being sued through a derivative action.

Abusive Voting Practices Are Finally Regulated

The new legislation defines and penalizes abusive voting behaviors, distinguishing between majority abuse, minority abuse, and deadlock abuse. Whether it's diluting shares unfairly, blocking necessary resolutions without cause, or exploiting a voting deadlock, bad-faith voting can now result in annulled resolutions, damage payments, or other legal consequences.

Making Corporate Litigation Accessible—but Not Abusive

Previously, a 25% ownership threshold was required to challenge corporate resolutions in Ecuador. That requirement has been eliminated. Now, any shareholder can bring a claim within a year of a resolution being passed. This extended timeframe allows for adequate evidence gathering. Also, to avoid frivolous litigation, courts may penalize shareholders who file baseless claims. Provisional measures, such as injunctions, are subject to strict criteria to prevent undue disruption of business operations.

Remedies Against Shareholder Oppression

Oppression involves more than isolated acts; it refers to sustained patterns that marginalize minority shareholders. Ecuadorian law now provides remedies in such cases. Courts can annul oppressive decisions, require controlling shareholders to change their behavior, or force the company to buy out minority stakes at a fair value. These remedies are especially relevant in cases involving unfair capital increases or voting structure manipulations.

Regulating Litigation Costs and D&O Insurance

Running a company involves risk, but directors and controlling shareholders shouldn't be personally liable for litigation costs if they act in good faith. Ecuador now allows companies to cover legal expenses or provide Directors & Officers (D&O) insurance, subject to strict conditions. For instance, coverage must be linked to official corporate duties, not personal disputes. These protections must be approved by disinterested shareholders after a financial assessment confirms the company can afford them. Importantly, reimbursement only applies if the court finds the defendant acted properly. This ensures protection for good-faith actors, without shielding wrongdoing.

A Model for the Region?

The recent Ecuadorian reforms, which will ensure greater transparency and accountability in corporate decision-making, are a reference for modernizing corporate governance across the region. Also, from a practical standpoint, implementing a combination of ex-ante and ex-post mechanisms would help mitigate the main agency problem that Latin American companies deal with during their existence. By adopting these measures, the region can move towards a more balanced corporate governance framework, which would, in the end, encourage investment and innovation in our companies.

By Paúl Noboa-Velasco (Universidad San Francisco de Quito and Ibero-American Institute for Law and Finance)

CONTACT

Kateryna Varava
Project Manager
European Corporate Governance Institute (ECGI)
blog@ecgi.org
www.ecgi.global

European Corporate Governance Institute (ECGI)
c/o Royal Academies of Belgium
Palace of the Academies
Rue Ducale 1 Hertogsstraat
1000 Brussels
Belgium

www.ecgi.global/blog