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Debtholder Stewardship

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Debtholder stewardship refers to the involvement of corporate creditors in a firm's governance framework with the aim of improving corporate decision-making. This article develops the theory of debtholder stewardship by identifying the mechanisms of debtholder influence, assessing their effectiveness in modern capital markets, and outlining the implications of this analysis for investor stewardship and regulatory efforts to support it. The impetus of this study is the expansion of the UK Stewardship Code across a broader range of asset classes, stewardship activities, and topics. The code has moved away from the traditional focus on shareholders by adding investors in other assets to the list of the stewards of corporate activities. Also, the revised concept of stewardship covers broader topics, including environmental, social, and governance (ESG) factors. But our understanding of debtholder stewardship, especially on sustainability matters, is inadequate. This article explains whether corporate creditors, both public and private, can promote responsible business practices through the stewardship of borrowers.

INTRODUCTION

According to the UK Stewardship Code's revised and updated stewardship guidelines, stewardship goes beyond listed shares and applies to different classes of assets, no matter how capital is invested.[1] The code is a soft law tool comprising a set of 'apply and explain' principles for asset owners (like pension funds and insurance companies) and asset managers (firms providing investment management services), collectively institutional investors.[2] Accordingly, corporate debtholders that have chosen voluntarily to become signatories to the code and follow its recommendations are now expected to systematically integrate stewardship into investment decision-making, that is in the assessments to buy,

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1 Financial Reporting Council, *The UK Stewardship Code 2020* (London: FRC, 2020) (Stewardship Code 2020) 7.

2 *ibid*, 4.

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hold, or exit investments.[3] Also, similar to shareholders, institutional debtholders are encouraged to actively exercise their rights[4] and engage with issuers to maintain or enhance the value of debt instruments.[5]

The code thus marks a major change in the concept of stewardship by expanding the traditional and exclusive focus of stewardship codes on shareholders to a broader range of assets, including corporate debt.[6] Debt has been the leading source for financing corporate activities.[7] Accordingly, debtholders have a powerful role in corporate governance which has long been recognised in the literature.[8] More recently, a growing number of studies envision a potential role for debtholders in monitoring and influencing corporate decisions beyond the borrower's financial health and credit risk, especially on environmental, including climate change, social, and governance (ESG) matters.[9] The Stewardship Code aims to harness this potential.[10]

However, unlike shareholder stewardship, stewardship by debtholders, due to its novelty, is more uncertain. Institutional shareholders have developed comprehensive strategies for monitoring, voting, and engagement. Different service providers like proxy advisors, investment consultants, and research and data providers have further reinforced the infrastructure for shareholder stewardship. Shareholder stewardship has also been studied extensively by scholars.[11] But stewardship in other asset classes, including debt, is an emerging field of which there is little knowledge. It is, for instance, unclear how precisely corporate creditors, both public and private, can be active stewards and whether the strategies of debtholder stewardship can be effective in improving the overall quality of stewardship.

This article aims to fill this gap by advancing the theory of debtholder stewardship that places stewardship over ESG matters at its core. The article identifies and assesses the effectiveness of the mechanisms of debtholder influence in modern capital markets and shows how the involvement of corporate debtholders can enhance investor stewardship. The analysis also leads to several important normative implications for regulatory efforts to build effective stewardship frameworks, including a stronger integration of private lenders within this framework. Although most conclusions, especially on the role of debtholder stewardship tools, apply regardless of specific stewardship topics, the analysis focuses primarily on debtholders as ESG stewards because this is where

3 *ibid*, Principle 7 (Principles for Asset Owners and Asset Managers).
4 *ibid*, Principle 12 (Principles for Asset Owners and Asset Managers).
5 *ibid*, Principle 9 (Principles for Asset Owners and Asset Managers).
6 *ibid*, 7.
7 Figure 1 below.
8 n 19 below.
9 nn 31-35 below.
10 The Stewardship Code 2020 recognises this reality by noting that there has been significant growth in assets other than listed equity since the first publication of the code, thereby justifying the extension of the stewardship principl for institutional investors to a broader range of asset classes (Stewardship Code 2020, n 1 above, 4).
11 Two recent edited book collections point to the massive interest in the topic and its extensive coverage (D. Katelouzou and D.W. Puchniak (eds), *Global Shareholder Stewardship* (Cambridge: Cambridge University Press, 2022); H. Kaur, C. Xi, C. Van der Elst, and A. Lafarre (eds), *Cambridge Handbook of Shareholder Engagement and Voting* (Cambridge: Cambridge University Press, 2022)).

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the Stewardship Code 2020 can add value. Debtholders have traditionally been investing, lending, and monitoring borrowers based on careful firm-specific analysis of financial health. The expanded concept of stewardship makes little, if any, difference in this regard. The code's novel aspect is rather the ESG focus that requires better understanding in terms of potential value added by debtholder stewardship.[12]

The article identifies a series of important limitations to the existing two channels through which debtholders could act as active stewards. These must be addressed if debtholder stewardship is to fulfil its potential or, at least, the role which the Stewardship Code 2020 foresees. The first stewardship tool is the integration by creditors of their stewardship preferences in investment decisions on public debt markets or in loan underwriting criteria on private markets (collectively, stewardship integration). The analysis shows that stewardship integration is a promising tool for promoting ESG goals by debtholders but this promise can be fulfilled only if regulators and market participants manage to address three key challenges: the current lack of standardised and credible reporting frameworks, especially on environmental and social factors, the inaccurate pricing of ESG risks, and the distortive effect of the tool on business organisation decisions.

The second channel of debtholder stewardship is the exercise of debtholder rights and private engagement with corporate borrowers (voting and engagement). This study identifies major problems with the use of this tool by debtholders for stewardship purposes which means that debtholders can rely on 'voice' in more limited circumstances than shareholders. On public debt markets, the limits of the tool are associated with the narrow reach of the rights of bondholders and the intermediated relationships between bondholders and debt issuers; private lenders have stronger rights but their incentives to engage on matters not directly linked to credit risk are unclear.

This article concludes that the creditors of financially healthy firms *can* largely rely on stewardship integration as a stewardship tool. One key implication of this conclusion is that the growing concerns about the negative impact of stewardship integration on voice are less significant in debt markets compared to equity markets. When socially and environmentally responsible shareholders exit firms, they may be replaced by less responsible investors who reinforce poor management practices. By contrast, debtholders can safely exit without causing negative side effects for voting and engagement after debt placement because debtholders have limited scope for using voice during normal times anyway.

12 The expansion of stewardship beyond equity is not the only major difference of the new concept of stewardship from its earlier versions. The new code also takes a broader perspective on the tools available to active stewards and embraces more explicitly the need to integrate ESG factors in stewardship activities. In addition to operating performance and corporate governance matters, the updated concept of stewardship covers other topics, including material ESG factors relevant for individual firms and broader market (Stewardship Code 2020, n 1 above, 4 (for stewardship generally), Principle 7 (Principles for Asset Owners and Asset Managers) (for investment decision-making)). This change is excellently captured by Professor Paul Davies in describing the new concept of stewardship as moving 'from saving the company to saving the planet' (P.L. Davies, 'The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?' in Katelouzou and Puchniak (eds), *ibid*, 44).

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This means that debtholders can apply divestment as a stewardship tool more freely than shareholders. As such, debtholder stewardship complements shareholder stewardship by broadening the list of effective tools and thus improves the overall quality of investor stewardship.

This article makes important contributions to the theory of debtholder stewardship by identifying the toolkit available to debtholder stewards, defining the effectiveness of those tools for the purposes of stewardship, and showing the value added by debtholder stewardship. The study has practical relevance for the development of stewardship as well by helping advancing stewardship in fixed-income assets to close the gap with shareholder stewardship. The article also offers important normative implications. Most importantly, it identifies the necessary steps that regulators need to take to assist in developing debtholder stewardship and flags the risks of debtholder stewardship that require careful attention and regulatory intervention.

The rest of this article is structured as follows. First, the article introduces the conceptual framework by explaining the reasons why debtholders have interest in stewardship, especially on sustainability matters – as opposed to the traditional debtholder attention to a company's financial health. This section also outlines the two tools available to debtholder stewards, as envisioned in the Stewardship Code 2020. The next two sections proceed to analyse in turn the tools of debtholder stewardship – stewardship integration and voting and engagement. The last section highlights the implications of the study and proposes suggestions for action. Brief conclusions follow.

THE CONCEPTUAL FRAMEWORK OF DEBTHOLDER STEWARDSHIP

Debtholders attracted little attention during the early policy efforts to develop the stewardship pillar of corporate governance. The main target of the first generation of stewardship guidelines introduced in the UK after the 2008 financial crisis were institutional shareholders.[13] But in the best tradition of being the main innovator in building effective corporate governance and stewardship frameworks, the UK has embarked on an effort to broaden the scope of stewardship beyond equity investments. Bondholders, as recognised by the experts of the Financial Reporting Council (FRC), the regulatory body responsible for designing the UK corporate governance and stewardship codes, and the Financial Conduct Authority, the UK's financial regulator, have a role to play in stewardship.[14]

13 Financial Reporting Council, *The UK Stewardship Code* (London: FRC, 2012) 2 (explaining that the Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies). For the classification of the different versions of UK stewardship codes into first- and second-generation codes, see Davies, *ibid*, 44.

14 Financial Reporting Council and Financial Conduct Authority, *Building a Regulatory Framework for Effective Stewardship* Discussion Paper DP19/1 (London: FRC/FCA, 2019) para 4.21.

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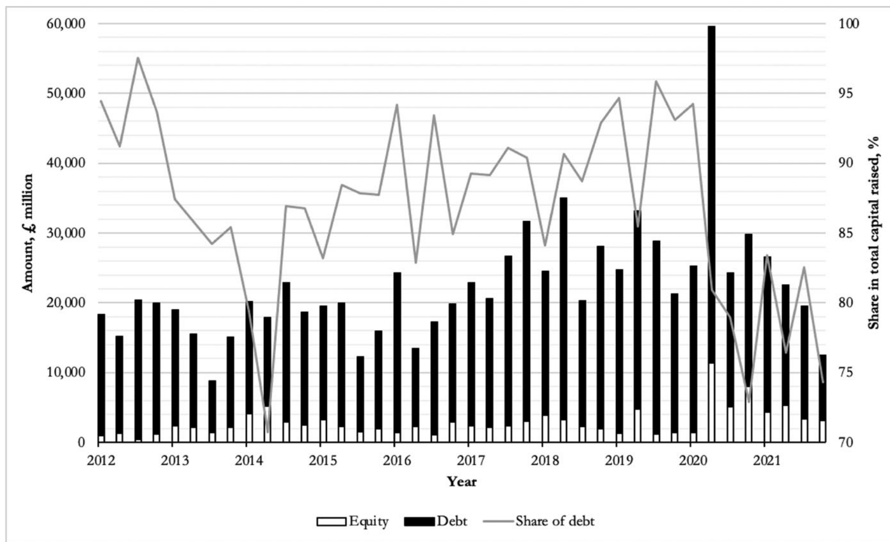

Figure 1: Capital Raised by Non-Financial Companies on UK Capital Markets
Source: Bank of England.
Notes: The figure includes data on equity and debt capital raised by non-financial companies both in local and foreign currencies on public capital markets in the UK, including the London Stock Exchange. Equity capital comprises ordinary and preference shares; debt covers commercial papers (short-term debt instruments issued with maturities of up to and including one year) and bonds (issued under longer maturity terms).

The expansion of the scope of investor stewardship is an attempt to add institutional debtholders to the list of investor stewards.[15] The substantial role of debt in financing businesses, as well as concerns that companies may replace equity with debt to avoid being disciplined in markets where only shareholders are encouraged to be active stewards, are strong grounds for justifying this decision. Almost 87 per cent of capital raised by non-financial companies on UK capital markets over the last 10 years was through the issuance of bonds and short-term debt instruments, according to the Bank of England (Figure 1). In addition to bonds issued on capital markets (also called 'public debt'), companies also use bank loans, debt financing provided by private equity funds, and private debt placements via notes or debentures (collectively referred to as 'private debt').[16] Private debt is, in fact, the largest external source of funding for listed firms, according to some estimates.[17] But in addition to merely scaling up investor stewardship on matters where different types of investors have shared visions, debtholders can also fill the gaps in investor stewardship in markets and in firms where outside equity investors are less powerful.[18]

15 *ibid*, paras 4.22-4.23.
16 G.G. Triantis and R.J. Daniels, 'The Role of Debt in Interactive Corporate Governance' (1995) 83 California L Rev 1073, 1083.
17 F. Tung, 'Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance' (2009) 57 UCLA L Rev 115, 121; C.K. Whitehead, 'The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance' (2009) 34 J Corporation L 641, 642.
18 D. Dharmapala and V.S. Khanna, 'Controlling Externalities: Ownership Structure and Cross-Firm Externalities' (2021) European Corporate Governance Institute, Law Working Paper No

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Legal scholars have long challenged the traditional account of corporate governance, which focuses exclusively on mechanisms that shareholders use to discipline managers, as incomplete and have recognised the powerful role of debtholders in influencing corporate decision-making.[19] Broad and strong debt covenants included in loan and other debt contracts provide debtholders with significant power to influence corporate managers even before debt issuers enter financial distress. According to Professors Douglas Baird and Robert Rasmussen, the control influential debtholders exercise over corporate decision-making is 'the missing lever of corporate governance'.[20] These scholars view creditor control as a complementary mechanism to more traditional means of dealing with managerial agency problems which all together form a firm's corporate governance framework.[21] Importantly, the intensity of governance influence varies across debt types: public bondholders, while not enjoying the same level of control as banks and private debtholders, still have power to influence corporate governance.[22] The governance role of bondholders is further supported by activist hedge funds holding corporate bonds.[23]

Although debtholders target primarily the borrower's financial health and credit risk, evidence suggests that debtholder governance offers benefits even in firms outside the distress context.[24] The first question to address then is whether debtholders have any incentives for acting as stewards beyond a company's financial health and credit risk. These incentives are clearer on public capital markets where fixed-income instruments have become increasingly linked with the governance and performance of the issuers. Professor Steven Schwarcz explains that bondholders, due to weaker reliance on buy and hold strategies and more frequent trading in modern capital markets, increasingly view bonds as investments that have fluctuating market prices tied to the issuer's performance.[25] Thus, just like shareholders, bondholders have become more interested in improving business and operating performance and can use

603/2021, 13-15 at https://ssrn.com/abstract=3904316 (showing the limits of institutional equity investors in controlling externalities in countries with concentrated ownership structures and in firms with dominant controlling shareholders).

19 Triantis and Daniels, n 16 above, 1082-1088; G.G. Triantis, 'The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines' (1996) 16 Int'l Rev L & Econ 101, 104-108; G.G. Triantis, 'Debt Financing, Corporate Decision Making, and Security Design' (1996) 26 Canadian Bus L J 93, 100-102; D.G. Baird and R.K. Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 University of Pennsylvania L Rev 1209, 1211; Tung, n 17 above, 123-129; Y. Yadav, 'The Case for a Market in Debt Governance' (2014) 67 Vanderbilt L Rev 771, 782-788.

20 Baird and Rasmussen, *ibid*, 1211.

21 Triantis and Daniels, n 16 above, 1079; Baird and Rasmussen, *ibid*, 1242-1243.

22 Yadav, n 19 above, 786-788.

23 M. Kahan and E. Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights' (2009) 103 Northwestern University L Rev 281, 284-292.

24 Tung, n 17 above, 120, 128-129.

25 S.L. Schwarcz, 'Rethinking Corporate Governance for a Bondholder Financed, Systematically Risky World' (2017) 58 William & Mary L Rev 1335, 1344-1346 (explaining that under the traditional approach to bonds as creditor claims with a certain priority upon their maturity date, bondholders are agnostic to the issuer performance as long as the issuer remains solvent and generates cash flows enough to repay the debt and pay periodic interest because the expected returns of bondholders are capped by the agreed interest rate; but this changes where bonds are actively traded on a market and have fluctuating market prices).

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stewardship to influence borrowing companies for achieving positive financial outcomes.[26] Issuers are likely to address bondholder demands to reduce future borrowing costs. This strengthens the incentives of bondholders to engage with companies more regularly, rather than stepping up their efforts only when borrowing companies are facing financial difficulties.

But corporate bonds are less standard than equities with key differences in purpose, structure, maturity, and risk profile across bond issues, even when issued by one company. Different features of bond issues influence the incentives of their holders to act as stewards. Project-specific bonds where the proceeds are used to fund a pre-defined project – consider, for example, green bonds[27] – effectively restrict the scope of stewardship to the matters relevant for the funded project. This leaves bondholders with limited powers and incentives to demand broader improvements in the performance of the bond issuer.[28] Similarly, stewardship incentives differ across secured and unsecured bonds. The risks of secured bonds depend on the quality of the underlying assets. As such, the broader performance of the issuer is less relevant for bondholders. By contrast, unsecured bonds are more exposed to the performance of the issuer and thus create stronger incentives for broader stewardship.[29] Last, the duration of bonds can influence the stewardship time horizon of bondholders. Clearly, investors in short-term bonds have weaker incentives to focus on matters that may influence the issuer in the distant future.[30] At the other extreme are convertible bonds which come the closest to the equity in terms of the stewardship time horizon. As follows, unsecured general purpose long-term bonds more closely resemble equity investments regarding investor stewardship preferences. On the other hand, stewardship preferences may be different (weaker) for the holders of secured project-specific bonds, especially where the bond duration is short.

More recent scholarship offers mechanisms that link ESG factors with credit risk and corporate performance, thereby explaining the interest of institutional investors in ESG stewardship. From the bondholder perspective, ESG stewardship may be motivated by several factors. First, improved borrower ESG-profile may reduce credit risk. Indeed, there is a growing consensus among investors[31] and the expert community[32] that investor stewardship may be motivated by the need to reduce climate risks: the physical threat to the assets of portfolio firms or costs associated with the transition to greener economy. Second, ESG

26 Remarkably, this effect is likely to be driven by actively trading short-term oriented bondholders who have incentives to improve the issuer's performance before the bonds are due to capture gains by trading bonds on secondary debt markets. By contrast, if all bondholders were long-term buy-and-hold investors, debt investors would have little interest in the active stewardship of financially healthy issuers.

27 For the definition of green bonds, see n 70 below.

28 A. Hamilton Claxton, 'Four Lessons for Applying ESG in Fixed Income' *ESG Clarity* 6 May 2020 at https://esgclarity.com/ashley-hamilton-claxton-four-lessons-for-applying-esg-in-fixed-income/.

29 *ibid*.

30 *ibid*.

31 P. Krueger, Z. Sautner, and L. Starks, 'The Importance of Climate Risks for Institutional Investors' (2020) 33 Rev Fin Stud 1067, 1079-1080.

32 J. Stroebel and J. Wurgler, 'What Do You Think About Climate Finance?' (2021) 142 J Fin Econ 487, 489.

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stewardship offers benefits in terms of protecting investor portfolios against downside risks related to reputation, customer loyalty, or regulatory oversight. For example, investors may use stewardship as a tool to reduce the exposure of their portfolios to social risks and unfavourable regulatory changes.[33] Active ESG stewardship can also be a marketing tool for attracting and retaining capital from the growing base of environmentally and socially conscious clients.[34] Last, ESG stewardship helps diversified investors to address systematic risks, like climate change, that they cannot diversify away by investing in a broad portfolio.[35]

Although these arguments are often discussed in the context of the equity investments of diversified investors, they are relevant for debt investments in public capital markets as well. As explained earlier, active trading on bond markets links the financial and ESG performance of bond issuers with market prices.[36] The incentives of lenders to account for ESG factors during stewardship are less obvious on private debt markets because of the small impact those factors have on the near-term solvency of borrowers.[37]

The Stewardship Code 2020 builds on this logic to embed institutional debtholders on public capital markets within the corporate governance and stewardship frameworks of companies.[38] The second question thus is whether debtholders have the appropriate tools for acting as effective and active stewards.

The new code, unlike its predecessor, does not consider voting and engagement as the only potent mechanisms of stewardship; investment decisions are now part of stewardship as well.[39] In particular, the Stewardship Code 2020 defines stewardship as 'the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'[40] The responsible allocation and management of capital refer to the stage of investment decision-making.[41] Particularly, asset owners need to define how to allocate assets among investment products offered by different asset managers based on investment strategy, asset classes and types, geography, industry sectors, and other factors. Asset managers too need to make decisions on investing assets under their management based on the mandate of managed funds or on a discretionary basis. After investments are made, the oversight of capital involves monitoring and engagement with the issuers of securities (assets).[42] Monitoring through the

33 S. Gadinis and A. Miazad, 'Corporate Law and Social Risk' (2020) 73 Vanderbilt L Rev 1401, 1410.
34 M. Barzuza, Q. Curtis, and D.H. Webber, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance' (2020) 93 Southern California L Rev 1243, 1284–1286.
35 M. Condon, 'Externalities and the Common Owner' (2020) 95 Washington L Rev 1, 17; J.N. Gordon, 'Systematic Stewardship' (2022) 47 J Corp L 627, 629.
36 n 25 above.
37 But see S.E. Light and C.P. Skinner, 'Banks and Climate Governance' (2021) 121 Columbia L Rev 1895, 1916 (arguing that because banks need to have a 'social license' to operate, they have incentives to facilitate the transition of borrowers to climate-friendlier behaviour).
38 Private lenders, as explained below, are not targeted by the Stewardship Code 2020 (see n 214 below).
39 Davies, n 12 above, 47.
40 Stewardship Code 2020, n 1 above, 4.
41 *ibid*, 7.
42 *ibid*.

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period of holding assets not only supplies information for engagement, but also feeds back to the allocation and management of capital because asset owners and investment managers can review their investment decisions based on the results of monitoring and engagement by, for example, divesting certain assets and investing in others.

In line with this definition, institutional investors dealing with corporate debt securities can act as active stewards in two different ways. First, active stewardship involves investment decisions on allocating capital among various corporate fixed income instruments based on material factors such as pricing, investment risks, business performance, and ESG matters. Second, debtholders act as stewards by overseeing the issuers of fixed income instruments and engaging with them via the exercise of debtholder rights or through private meetings. The next two sections analyse in turn the effectiveness of these two tools for the purpose of debtholder stewardship.

DEBTHOLDER STEWARDSHIP VIA INVESTMENT DECISION-MAKING

Academic literature has traditionally considered exit as an engagement strategy because of its indirect influence on corporate decision-making via the pricing of capital. Albert Hirschman's famous framework on exit, voice, and loyalty clarifies the link between the divestment of corporate securities and corporate decision-making: the downward pressure on the prices of securities when many unhappy investors are selling encourages issuers to change their behaviour.[43] Peer effects can amplify this pressure further because more investors adjust their investment decisions and exit after observing that many other investors have already exited.[44] Thus, informed trading can encourage corporate managers to be responsive.[45] But even where investors do not divest their holdings, the prospect of exit may be enough for disciplining corporate managers. The threat

43 A.O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970) 22-25.

44 Mark Granovetter, 'Threshold Models of Collective Behavior' (1978) 83 American J Sociology 1420, 1424-1425 (showing that for explaining outcomes of collective actions, in addition to individual preferences of all actors, we need to know how these individual preferences interact).

45 A. Edmans, 'Blockholder Trading, Market Efficiency, and Managerial Myopia' (2009) 64 J Finance 2481, 2493-2495 (showing that outside blockholders can encourage managers to take actions contributing to the long-term growth of the firm through informed trading of the firm's shares, even if they cannot intervene in the firm's management directly); A. Edmans and G. Manso, 'Governance Through Trading Intervention: A Theory of Multiple Blockholders' (2011) 24 Rev Financial Studies 2395, 2406-2408 (showing that the presence of multiple outside blockholders, while weakening their incentives to intervene in the firm's management, strengthens the disciplining effect of share trading by blockholders on managers). Indeed, a recent empirical study of the effect of divestment on carbon-intensive firms shows that high divestment levels reduce share prices; furthermore, divested firms experiencing a share price decline subsequently reduce their carbon emissions compared to non-divested firms (M. Rohleder, M. Wilkens, and J. Zink, 'The Effects of Mutual Fund Decarbonization on Stock Prices and Carbon Emissions' (2022) 134 J Banking & Finance 106352, 6-11).

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of exit is a form of investor activism that can be used behind the scenes to affect managerial decisions.[46]

This view was not broadly shared beyond academia, however. The major drawback of exit as a stewardship strategy, as follows from Hirschman's classic framework, is the loss of investor rights to influence firms directly.[47] Furthermore, exit, unlike focused direct engagement, does not necessarily communicate clearly to corporate managers the reasons for investor divestments and, accordingly, what needs to be changed, thereby making exit a 'blunt instrument' at best.[48] The loss of direct engagement rights after exit and obscure signaling may explain why the earlier versions of the stewardship code focused almost exclusively on voice-based engagement strategies as the preferred version of stewardship.[49]

The Stewardship Code 2020 clearly gives more weight to stewardship integration by encouraging debtholders to systematically integrate stewardship, including material ESG factors, in investment decision-making.[50] Importantly, although debt instruments often do not have deep markets, the limited maturity of fixed-income instruments allows investors to use the exit option even where there are no prospective buyers by simply not extending new credit. This makes the divestment strategy available even in illiquid markets. But stewardship integration faces three important challenges. First and foremost, stewardship integration requires clearly defined stewardship goals and ability to rank investment products against those goals. Debt investors have traditionally made entry and exit decisions relying on the well-established trade-offs between financial return and risk. The less well-known and orderly characteristics of sustainable debt capital markets complicate stewardship integration. Second, integration of non-financial sustainability-linked characteristics into investment decision-making requires clear understanding of the risks of non-sustainable businesses and ability to accurately price those risks. Stewardship integration cannot become an effective tool for promoting more responsible corporate behaviour if markets continue mispricing ESG risks. Third, business practices and models not favoured by investors are expected to drift away from the public scrutiny of debt capital markets and concentrate elsewhere. Firms subject to the stewardship efforts of responsible bondholders may respond by divesting or spinning off business parts to private owners strategically to improve their standing. This may be good for individual firms and their investors, but from an economy-wide perspective the negative impact of industry on stakeholders remains unchanged.

These challenges undermine the credibility of sustainable investing as a stewardship tool and, accordingly, require regulatory intervention. Stewardship

46 A.R. Admati and P. Pfleiderer, 'The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice' (2009) 22 Rev Financial Studies 2645, 2657-2658 (showing that a credible threat of a large shareholder to exit if managers do not act in shareholders' interests is an effective disciplining tool encouraging managers to take actions that increase the value of the firm).

47 Hirschman, n 43 above, 36-37.

48 D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (London: HM Treasury, 2009) 69-70.

49 Davies, n 12 above, 46.

50 Stewardship Code 2020, n 1 above, Principle 7 (Principles for Asset Owners and Asset Managers).

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integration offers potential for change but can become an influential tool of stewardship in the long run only if the three concerns are addressed on time and effectively. The rest of this section explains each challenge in more detail.

Inconsistent and non-credible disclosure of non-financial information

The vital aspect of stewardship integration is certainty about the characteristics of assets.[51] Accurate information helps directing capital towards assets that meet the stewardship preferences of investors. By contrast, investors trading based on inaccurate or incomplete information cannot clearly distinguish assets by their quality. This uncertainty increases the risk of investments and lowers investor demand, thereby punishing the sellers of high-quality assets.[52] Consequently, investor stewardship loses its power as a driver of change in markets because all assets, regardless of their real characteristics, are treated similarly. Effective debtholder stewardship integration requires debtholder access to relevant information about assets. If sustainability is a stewardship priority, then classification protocols distinguishing sustainable from unsustainable investments are needed to guide investment decisions.

The rise of sustainability as part of stewardship is fueling demands for accurate classification and rating of capital market instruments based on their ESG credentials. Debt contracts typically impose detailed financial information reporting obligations on issuers, thereby allowing debtholders to monitor issuers and price debt instruments efficiently.[53] This disclosure is supported by commonly shared understanding of financial information based on widely accepted accounting standards across markets and countries. The same, however, cannot be said about various non-financial factors associated with sustainable debt capital markets. There are no established market-wide guidelines for ranking debt instruments based on sustainability criteria, such as green or social credentials of debt instruments and their issuers, resulting in poor correlations between the ratings offered by different service providers.[54] The lack of comparable and reliable data is a major concern for investors interested in ESG integration.[55]

51 S. Steuer and T. Tröger, 'The Role of Disclosure in Green Finance' (2022) 8 J Fin Reg 1, 31-32.

52 G.A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 Quarterly J Econ 488, 490-491.

53 n 111 below.

54 A.K. Chatterji, R. Durand, D.I. Levine, and S. Touboul, 'Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers' (2016) 37 Strategic Mgmt J 1597, 1602-1604; D. Avramov, S. Cheng, A. Lioui, and A. Tarelli, 'Sustainable Investing with ESG Rating Uncertainty' (2022) 145 J Fin Econ 642, 651; F. Berg, J.F. Kölbel, and R. Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings' (2022) Rev Finance 6, 7-9 (forthcoming). In particular, Florian Berg and his co-authors show that the correlation among the ESG ratings of six prominent agencies was on average 0.54; by comparison, credit ratings from major rating providers are correlated at 0.99 or at 99 per cent (*ibid*). See also 'ESG Investing: Poor Scores' *The Economist* 7 December 2019, 71-72. The strong correlation of credit ratings, of course, does not mean that they are flawless; but credit rating providers at least agree on what to measure and how.

55 A. Amel-Zadeh and G. Serafeim, 'Why and How Investors Use ESG Information: Evidence from a Global Survey' (2018) 74 Fin Analysts J 87, 92-93.

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Two factors complicate the supply of accurate ESG data. The first is the absence of a universally accepted definition of sustainability or of a sustainable business practice.[56] As a result, existing ratings underline one or a combination of different dimensions of sustainability, thereby making it difficult to compare and assess debt instruments and their issuers in terms of sustainability.[57] Second, there are also no standard non-financial corporate reporting requirements to supply complete and comparable data for sustainable investment ratings.[58] Compounding the problem, non-financial disclosures, unlike reporting on financial performance, are not audited independently, raising concerns over their reliability.[59] Voluntary sustainability reporting or uncoordinated private ordering through the design and inclusion of non-financial information disclosure obligations in individual debt contracts cannot fill this gap either.[60]

The absence of consistent and credible ratings of sustainable debt instruments weakens the effectiveness of entry and exit as a stewardship tool. Rating uncertainty makes sustainable investing riskier and hence lowers investor demand for sustainable assets.[61] This, in turn, increases the cost of capital for sustainable issuers that cannot credibly distinguish their products from others.[62] As a result, the capability of investors with ESG preferences to influence the performance of issuers becomes weaker.[63] The manifestation of this problem is the widespread and growing concern about 'greenwashing' – a marketing spin that leverages weaknesses in the disclosure and classification of environmentally friendly practices to mislead various stakeholders, including investors, through selective information disclosure.[64] Although the social aspect of ESG has so far received less attention than the environmental aspect, similar 'social washing'

56 B.L. Jacobs and B. Finney, 'Defining Sustainable Business – Beyond Greenwashing' (2019) 37 Virginia Environmental L J 89, 94-99.

57 Jacobs and Finney, *ibid*, 99-100; L. LoPucki, 'Repurposing the Corporation Through Stakeholder Markets' (2022) 55 UC Davis L Rev 1445, 1463-1465.

58 LoPucki, *ibid*, 1460-1461. See also N. Hume and H. Sanderson, 'Polymetal Chief Calls for Common ESG Metrics' *Financial Times* 20 October 2020, 13 (contrasting inconsistent, inaccurate, and box ticking format of reporting on sustainable matters with common rules for reporting on financial performance under the International Financial Reporting Standards). At present, most data points for ESG ratings come from company voluntary disclosures or survey responses collected by rating firms (J. El-Hage, 'Fixing ESG: Are Mandatory ESG Disclosures the Solution to Misleading ESG Ratings?' (2021) 26 Fordham J Corp & Fin L 359, 363, 369).

59 V. Harper Ho, 'Modernizing ESG Disclosure' [2022] University Illinois L Rev 277, 289. See also A. Mooney, 'Face to Face with Frédéric Janbon: "Sustainable Investing Will be a Major Force"' *Financial Times* 27 July 2020 4 (FTfm) (quoting the CEO of BNP Paribas Asset Management, one of the leading asset managers in ESG investing, on the concerns over data availability and credibility for sustainable investing).

60 V. Harper Ho, 'Nonfinancial Risk Disclosure and the Costs of Private Ordering' (2018) 55 American Bus L J 407, 443-456; V. Harper Ho and S. Kim Park, 'ESG Disclosure in Comparative Perspective: Optimizing Private Ordering in Public Reporting' (2019) 41 University Pennsylvania J Int'l L 249, 266-269; Harper Ho, *ibid*, 288-290.

61 Avramov et al, n 54 above, 645-647, 653-654 (showing formally that ESG-sensitive investors are expected to lower their demand for assets with uncertain ESG profiles and offering evidence supporting this prediction).

62 *ibid*, 647.

63 *ibid*, 654.

64 M.A. Cherry, 'The Law and Economics of Corporate Social Responsibility and Greenwashing' (2013) 14 UC Davis Business L J 281, 282, 284-287 (defining and tracing the origins of greenwashing); E.L. Lane, 'Greenwashing 2.0' (2013) 38 Columbia J Environmental L 279, 303-304

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concerns arise when classifying and ranking debt instruments based on social factors.[65]

Poor corporate sustainability reporting is not the only barrier for stewardship integration. Another challenge is the absence of a sustainability reporting framework for investment funds and investment managers. Large asset owners, such as pension funds and insurance companies, typically do not invest directly but rather allocate their assets among different investment funds.[66] As such, asset owners lack legal means for direct engagement with investee companies and rely on investment fund managers for communicating their stewardship preferences across the investment chain. Essentially, stewardship by asset owners happens at the stage of selecting investment fund products and asset managers that will invest and engage with investee companies in line with the stewardship preferences of their clients.[67]

This setup of investment relationships stresses the importance of accurate information flows across the investment chain to facilitate informed selection of asset management services by investors. In transparent markets, asset managers are expected to offer products that meet the needs of asset owners. Effectively functioning reporting frameworks for investment funds and fund managers promote better allocation of assets among investment fund products by strengthening informed decision-making based on the fund's investment and engagement strategies. But where reporting frameworks do not work adequately and information transmission across the investment chain is broken, this apparatus of investment product selection falls apart.

There is an intensifying concern that funds marketed as sustainable often fail to meet sustainability criteria.[68] Greenwashing and social washing by investment fund managers can distort stewardship decisions of asset owners through the allocation of their assets, just like they weaken investor stewardship in direct relationships between investors and firms.[69] These practices become possible because cross-fund comparisons, due to the absence of an obligation for sustainable investment funds to report against the same indicators, are complicated.

(explaining the extension of greenwashing from business-to-consumer to business-to-business relationships).

65 C. Hodgson and B. Nauman, '"Social Washing" Warning Over Pandemic Crisis Bonds' *Financial Times* 30 June 2020, 11; A. Money and P. Nilsson, 'Boohoo Debacle Breeds Doubts on ESG Ratings' *Financial Times* 27 July 2020, 11.

66 S. Gomtsian, 'Article 3i: Transparency of Asset Managers' in H.S. Birkmose and K. Sergakis (eds), *The Shareholder Rights Directive II: A Commentary* (Cheltenham: Edward Elgar Publishing, 2021) 188, 201.

67 *ibid*, 188.

68 Recent empirical studies offer evidence of greenwashing in the asset management industry (R. Gibson Brandon, S. Glossner, P. Krueger, P. Matos, and T. Steffen, 'Do Responsible Investors Invest Responsibly?' ECGI Finance Working Paper No 712/2022 (September 2022) 19-21 at https://ssrn.com/abstract=3525530 (finding evidence of greenwashing among US institutional investors)). See also A. Mooney, 'On Guard Against Greenwashing' *Financial Times* 11 March 2021, 21 (reporting that popular ESG funds have been marketed as sustainable despite investments in the world's largest carbon emitters); 'Climate Finance: The Green Meme' *The Economist* 22 May 2021, 61, 62 (showing that the world's 20 biggest ESG funds have holdings in fossil-fuel companies, including in Saudi Aramco, and invest in gambling companies, alcohol and tobacco producers).

69 A.M. Pacces, 'Will the EU Taxonomy Regulation Foster Sustainable Corporate Governance?' (2021) 13 *Sustainability* 12316, 8.

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The lack of consensus on what makes an investment sustainable only complicates the matter further.

Bond markets are more advanced in this regard than capital markets in general. In particular, external certifiers, including major credit-rating agencies like S&P and Moody's as well as specialised firms like Sustainalytics (now part of Morningstar, Inc) and Cicero, have been issuing green bond certificates for debt raised to fund projects with positive environmental benefits.[70] But each service provider is using its own methodology for labelling purposes and also faces conflicts of interest that may weaken standards in pursuit of more clients.[71] Difficulties in comparing debt instruments weaken the link between stewardship integration and the allocation of capital among debt issuers. This underlines the clear need for regulatory intervention and supply of clarity on unified sustainable (ESG) metrics.[72]

Importantly, the full disclosure of ESG risks in fund portfolios relies on sustainability data supplied by issuers. Investment funds and managers can meet fund-level transparency requirements on sustainable investments only if corporate ESG reporting supplies fund managers with credible and consistent sustainability data.[73] In other words, the regulatory framework for the transparency of issuers is the building block of the entire framework of investment chain transparency. Yet, companies are not required to report ESG data in many countries, making it harder for asset managers to meet their own reporting obligations.[74]

The problem of mispricing risks

Stewardship integration works through the influence of investor stewardship priorities on asset prices. If many influential investors share and actively

70 J. Lee, 'Green Bonds Need the Right Filter' *Wall Street Journal* 1 July 2020, B16. The International Capital Markets Association (ICMA) defines green bonds as 'any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new or/and existing eligible green projects' (International Capital Markets Association, 'Green Bond Principles: Voluntary Process Guidelines for Issuing Green Bonds' (June 2021) 3 at https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf).

71 Many service providers label green bonds based on specific bond parameters and without giving full consideration to overall business practices of the issuer. This leads to situations where green bonds are issued by firms with poor environmental records (T. Stubbington and B. Nauman, 'ESG Credentials in Spotlight Over "Greenwashing" Fears' *Financial Times* 28 October 2020, 12).

72 Pacces, n 69 above, 10; Steuer and Tröger, n 51 above, 33-34.

73 Indeed, the European Fund and Asset Management Association (EFAMA) and BVI, the industry representative bodies, successfully lobbied to delay the implementation of sustainable investing disclosure rules until more necessary underlying data supplied by issuers becomes available (S. Riding, 'Asset Managers Lobby for ESG Rule Delay' *Financial Times* 1 September 202, 8; S. Riding, 'Brussels Bows to Industry Pressure on Anti-Greenwashing Rules Deadline' *Financial Times* 8 October 2020, 12). According to some estimates, of the 32 ESG data points that asset managers are required to report, only eight were available at the beginning of 2021 (S. Riding, 'EU Rules Aim to Cut Through Noise of Sustainable Investing' *Financial Times* 18 January 2021, 8).

74 F.N. Ochoa, 'European Funds Face Challenges with New Rules' *Wall Street Journal* 28 June 2021, R5.

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promote similar stewardship priorities, stewardship becomes a major factor in capital markets. The rise of sustainable finance is remarkable in this regard. Information on data usage and fund inflows indicate that the interest in assets that meet the ESG demands of investors is booming in Europe.[75] Thus, a broad range of institutional investors see themselves as the agents of change in promoting responsible business practices. But these important changes in capital markets come with the challenge of pricing risks accurately. Risk mispricing can undermine the credibility of the growing concept of sustainable finance.

ESG risks, although not new, can be hard to quantify as part of the credit risk of fixed-income instruments. One reason for this is disagreement over their scope. In other words, what constitutes an ESG risk and its importance is a matter of opinion. Indeed, the provocative speech by a former head of responsible investing of a major UK bank and financial services holding company at a Financial Times Moral Money event and the following debate show that there is not even an agreement among finance professionals that climate change is a financial risk that needs to be priced in assets.[76]

In addition to unclear scope, the lack of standard and credible ESG information complicates the accurate pricing of long-term ESG risks. For example, investors may struggle to obtain accurate information for assessing the exposure of a firm to climate risk.[77] Even if complete ESG data were available, market participants still need to learn how to use this information for assessing the financial risk to firms arising from climate, social, or other risks.[78] It is even unclear whether markets can develop universal ESG standards akin to standards for assessing financial performance.

Scope and measurement differences lead to substantial divergences in ESG ratings by different providers.[79] A recent study found that the biggest contributor to this divergence is the differences in measurements used by various ESG

75 Refinitiv, 'The Big Conversation, Episode 34: Now It's a Bubble' 24 June 2020, [00:19:35] at https://www.refinitiv.com/en/the-big-conversation/episode-34-now-its-a-bubble (showing that ESG data, long a niche product popular among media, have seen a tremendous increase in the interest from investment professionals since early 2020); P. Mathurin, 'Under the Hood: Sustainable Investing Comes of Age During Pandemic' *Financial Times* 6/7 February 2021, 14 (showing that self-proclaimed 'sustainable' funds increased assets under management by 50 per cent during 2020 and managed $1.7 trillion by the end of the year; remarkably, almost 70 per cent of those assets were concentrated in European funds). The interest in sustainable investing continues past 2020, including in bond funds (S. Johnson, 'European Sustainable Fund Inflows Surpass All Other ETFs For First Time' *Financial Times* 27 April 2021, 11 (reporting that sustainable investment funds attracted more funds in Europe in the first quarter of 2021 than all other ETFs combined; for comparison, in 2019, inflows into sustainable funds accounted for only about 15 per cent of total ETF inflows); Mooney, n 68 above (reporting expert predictions that assets in sustainable funds in Europe will grow more than three times to reach €7.6 trillion by 2025); A. Mooney, 'Fiery Five Months as Investors Pile $54bn Into ESG Bond Funds' *Financial Times* 26/27 June 2021, 17 (reporting that ESG bond funds accounted for about one-fifth of total sustainable fund assets in mid 2021)).

76 H. Agnew, S. Mundy, and S. Morris, 'HSBC Banker Attacks Climate "Hyperbole"' *Financial Times* 21 May 2022, 15; H. Agnew and A. Klasa, 'HSBC Contrarian's Climate Speech Stirs Debate' *Financial Times* 25 May 2022, 9.

77 S. Giglio, B. Kelly, and J. Stroebel, 'Climate Finance' (2021) 13 Annual Rev Fin Econ 15, 22.

78 A. Livsey, 'Obstacles Remain on Pathway to Global Sustainability Standards' *Financial Times: FT Special Report on Managing Climate Change* 1 November 2021, 2.

79 n 54 above.

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product providers (56 per cent).[80] Another 38 per cent of divergence comes from scope disagreements.[81] ESG rating agencies thus disagree both on what must be included in sustainability and how to measure risks associated with it. As a result, asset prices do not, at present, sufficiently reflect many ESG, including climate, risks. This is a widely shared consensus among experts, according to a recent large-scale survey of finance academics, professionals, and regulators.[82] Other studies offer corroborating evidence: empirical studies of equity[83] and syndicated loan[84] markets question the capability of markets to price accurately full climate risk at present. One review of recent empirical evidence reached a similar conclusion.[85]

Inability to price ESG factors and link them with credit risk weaken investor incentives to trade based on the issuer's ESG profile. For example, some institutional debtholders, such as insurance companies, are sensitive to credit rating changes because these changes may lead to higher capital requirements.[86] But if market participants cannot price ESG risks accurately, then those risks become irrelevant or, at best, ineffective as a tool for influencing corporate debtholder behaviour.

In response to the difficulties of identifying and pricing relevant ESG risks, creditors may refrain from financing entire industries that are perceived to be high risk. The intended effect of blacklisting certain borrowers is to encourage them to embrace change and invest in more sustainable business practices. But instead, higher cost of capital may slow down the pace of change in firms with less desirable business models. Higher costs of external financing, coupled with less cash generated internally because of investment and production cuts in existing business models, means that many firms will struggle with financing transition to more sustainable production.[87] These firms also have no incentives to change if they are blacklisted regardless of their efforts.[88] This, clearly, undermines the intended effect of entry and exit as a stewardship strategy for promoting responsible business practices and explains why many responsible investors give priority to direct engagement over investment decision-making.[89]

80 Berg et al, n 54 above, 21.
81 *ibid*.
82 Stroebel and Wurgler, n 32 above, 489, 491.
83 R. Faccini, R. Matin, and G. Skiadopoulos, 'Dissecting Climate Risks: Are They Reflected in Stock Prices?' (May 2022) 21 at https://ssrn.com/abstract=3795964 (showing that investors price the imminent transition risks from government intervention, but not the direct risks from climate change itself).
84 T. Ehlers, F. Packer, and K. de Greiff, 'The Pricing of Carbon Risk in Syndicated Loans: Which Risks are Priced and Why?' (2022) 136 J Banking & Finance 9-10 (finding that banks price only scope 1 direct carbon emissions of borrowers but ignore the overall carbon impact that includes also indirect emissions).
85 R. Tallarita, 'The Limits of Portfolio Primacy' (2023) 76 Vanderbilt L Rev 31-34 (forthcoming).
86 International Organisation of Securities Commissions, 'Corporate Bond Markets: Drivers of Liquidity During COVID-19 Induced Market Stresses' Discussion Paper (April 2022) 18 at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf.
87 'Climate Finance: It Is Not So Easy Being Green' *The Economist* 27 March 2021, 63.
88 A. Edmans, D. Levit, and J. Schneemeier, 'Socially Responsible Divestment' ECGI Finance Working Paper No 823/2022 (July 2022), 13-16 at https://ssrn.com/abstract=4093518.
89 In particular, institutional investors which signed for the initiative Climate Action 100+ (CA100+), a global investor engagement group, aim to change the practices of polluting firms

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The risk of shielding business parts from the public scrutiny of capital markets

Greenwashing has grabbed lot of attention.[90] Little discussed but certainly not less harmful is a related phenomenon called 'brown-spinning' – the practice of putting business parts with heavy negative externalities for environment or other stakeholders within legal structures that are beyond the reach of the scrutiny of public capital markets. As a result, investor efforts to fight climate change are likely to lead to significant reductions of carbon emissions by all publicly traded companies, but there will be no reductions in absolute emissions; to the contrary, carbon emissions globally may actually go up.[91] The logic behind this paradox is simple. Firms that are coming under increasing pressure from institutional investors face a choice: they can invest in upgrading business practices to meet investor demands or, instead, can divest business parts with the highest negative externalities to other investors – smaller private firms, private equity funds, commodities traders, or state oil and gas companies – which are less transparent, are beyond the public scrutiny of capital markets, whether equity or debt, and are willing to exploit lucrative business opportunities that are becoming available at low valuations given the growing list of assets on sale.[92] Although the first option may be optimal from the societal perspective, it is not granted because of high transition costs. The second option helps individual firms to meet the targets set by institutional investors at a lower cost and at a quicker pace, yet the overall negative impact of the business sector on society remains unchanged at best.

Sustainability-driven asset sales and restructurings in extractive industries by major publicly traded firms improve their sustainability profiles by shedding assets responsible for low ESG scores. But emissions or other negative footprints of those assets do not disappear because the new owners continue operating them. The problem of publicly traded firms is simply moved to other firms that are less exposed to pressure from institutional investors. To the contrary, the disposed assets, in the absence of credible monitoring mechanisms and investor pressure in privately held firms, may be operated less responsibly with negative footprint that is larger relative to the production levels. Because governance and stewardship recommendations apply to the activities of firms and investors in public capital markets, what is happening beyond the shield of privately held ownership does not matter for reporting purposes, neither for firms nor for their investors. Many may have selected the organisational form of a private firm

by investing in those firms and being vocal in advocating for change through setting decarbonisation targets, disclosing climate risks, and improving governance around those risks, *The Economist*, n 87 abo

90 n 64 above.

91 C. Taraporevala, 'Beware Risks of the Spin Behind Climate Change' *Financial Times* 14 May 2021, 14.

92 *ibid*. According to the Financial Times, the big oil and gas firms alone disposed of more than $28 billion in assets during the three years after 2018 and are planning to sell another $30 billion in the coming years. The total value of oil and gas assets up for sale across the entire industry stood at $140 billion in mid 2021 (A. Raval, 'The $140bn Asset Sale: Big Oil's Push to Net Zero' *Financial Times* 7 July 2021, 21).

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consciously to be insulated from public scrutiny. As a result, the environment, society, or other stakeholders are clearly not better off, and businesses are not overall more responsible for their impact.

Firms can also react to domestic sustainability-linked divestment campaigns by moving their activities with negative externalities to 'pollution havens' – parts of the world where various stakeholder interest protections and sustainable activism campaigns are relatively weaker.[93] Research shows that banks reduce lending to coal, oil and gas companies domestically but offer more financing abroad in response to active divestment campaigns and strong environmental policies[94] or carbon taxes[95] at home. Similarly, firms exploit cross-country differences in the design and enforcement of environmental rules for exporting their high-polluting business activities from countries with strict environmental policies to countries with relatively weaker policies.[96]

Brown-spinning is a clear and present risk for investor stewardship as a tool for promoting sustainable business practices and for dealing with global challenges. Ironically, behind this risk are the efforts of the most active and responsible stewards because their activities increase the cost of capital for certain business practices and create incentives for them to hide those business practices beyond the reach of investor stewards. Regulators around the world need to be aware of and address this risk to prevent the further marginalisation of investor stewardship. The most effective way to do this is by the adoption of common behavioural standards that apply to all firms, ideally across countries. Less effective but more feasible alternatives are discussed in the last section.

DEBTHOLDER STEWARDSHIP VIA EXERCISE OF RIGHTS AND ENGAGEMENT

According to the Stewardship Code 2020, the stewardship activities of debtholders include active exercise of rights arising from debt instruments.[97] The code states that asset owners investing in debt instruments via investment

93 S. Ambec, M.A. Cohen, S. Elgie, and P. Lanoie, 'The Porter Hypothesis at 20: Can Environmental Regulation Enhance Innovation and Competitiveness' (2013) 7 Rev Environmental Economics & Policy 2, 9; J. Surroca, J.A. Tribó, and S.A. Zahra, 'Stakeholder Pressure on MNEs and the Transfer of Socially Irresponsible Practices to Subsidiaries' (2013) 56 Academy Mgmt J 549, 551.

94 T.F. Cojoianu, F. Ascui, G.L. Clark, A.G.F. Hoepner, and D. Wójcik, 'Does the Fossil Fuel Divestment Movement Impact New Oil and Gas Fundraising?' (2021) 21 J Econ Geography 141, 157.

95 L. Laeven and A. Popov, 'Carbon Taxes and the Geography of Fossil Lending' CEPR Discussion Paper No DP16745 (November 2021), 15-16 at https://cepr.org/active/publications/discussion_papers/dp.php?dpno=16745.

96 I. Ben-David, Y. Jang, S. Kleimeier, and M. Viehs, 'Exporting Pollution: Where Do Multinational Firms Emit CO_2?' (2021) 36 *Economic Policy* 379, 395-400, 402-403 (finding that firms headquartered in countries with strong environmental protections emit less CO2 domestically relative to firms headquartered in countries with weaker protections, but also offering evidence of carbon export by firms from countries with strict environmental protections to countries with less strict regulations).

97 Stewardship Code 2020, n 1 above, Principle 12 (Principles for Asset Owners and Asset Managers).

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funds or discretionary arrangements with external investment managers should state the expectations they have set for investment managers that exercise rights on their behalf.[98] Investment managers (and also asset owners investing directly), in turn, should explain how they exercise debtholder rights.[99] More specifically, both asset owners and investment managers are expected to explain their approach to: (1) seeking amendments to terms and conditions in indentures and contracts; (2) seeking access to information provided in trust deeds; (3) impairment rights; and (4) reviewing prospectus and transaction documents.[100]

In addition to exercising their rights, debtholder stewardship includes engagement with issuers to maintain or enhance the value of their fixed income instruments.[101] Stewardship guidelines clarify that asset owners that are not holding debt directly and investment managers that delegate engagement should explain the expectations they have set for others that engage on their behalf and how; institutional investors that engage directly should explain how they have selected and prioritised engagement.[102] It is also best practice to explain the engagement methods used, such as meetings with the directors or managers of an issuer, writing letters to an issuer, or raising key issues through the issuer's advisers.[103]

This section shows that there are two key conceptual differences between direct engagement by debtholders and shareholders. Debtholder rights, unlike shareholder rights, are contractual in nature and do not provide debtholders with extensive grounds for monitoring and engaging over a broad range of matters unrelated to the borrower's credit risk.[104] Additionally, there are more layers of intermediaries between public debtholders and the managers of borrowing firms than between shareholders and corporate managers, complicating and increasing the costs of direct engagement by debtholders further. Debtholder engagement with management, consequently, is typically limited to a new issue 'roadshow'.[105] As such, it is unrealistic to place shareholder-like direct engagement expectations on bondholders. Debtholder stewardship via voting and engagement outside distress is then unlikely to fulfil the potential of promoting long-term value creation as envisioned by the Stewardship Code 2020.

Contractual nature and narrow scope of bondholder rights

Unlike shareholders, debtholders have neither statutory voting rights, nor can they generally rely on directors' duties to restrain managerial behaviour. Outside distress situations, debtholders can only use contractual rights agreed with

98 *ibid*.
99 *ibid*.
100 *ibid*.
101 *ibid*, Principle 9.
102 *ibid*.
103 *ibid*.
104 Credit risk is a lender's exposure to the possibility that a borrower will fail to perform its obligations under a loan or other fixed income instrument, particularly will not be able to repay the principal and make periodic interest payments (Whitehead, n 17 above, 642).
105 E. Carr, 'ESG Playbook for Bond Investors Needs a Rewrite' *Financial Times* 8 April 2022, 14.

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borrowers to influence corporate decisions.[106] Typically, debtholders cannot make claims beyond those contractual rights.[107] As such, the breadth and the outcomes of debtholder rights are heavily determined by bargaining dynamics between creditors and borrowers.[108] Where bargaining dynamics – due to changing market conditions, lending practices, or other context-specific bargaining factors – favour the borrower, debtholder rights tend to be narrowly defined or cannot be realistically used to their full extent for stewardship purposes.

Debtholder rights take the form of various debt covenants included in debt documents: maintenance financial covenants set ratios for the borrower's financial performance and, by being tested on a periodic basis, serve as an early warning mechanism; incurrence covenants restrict the borrower's freedom of action, for example, on raising new higher-ranked debt, without debtholder approval.[109] Typical debt covenants deal with the agency costs of debt – conflicting interests between a borrowing firm's creditors on one side and its shareholders and managers on the other.[110] The major focus of these covenants is on protecting debtholders from the borrower's deteriorating financial health or credit risk during the fixed term of the debt.[111] Accordingly, debtholder rights are triggered when a borrowing firm is facing financial difficulties

106 Tung, n 17 above, 118-119.

107 Debtholders in many countries are, in addition to contractual rights, protected by special duties to consider creditor interests, but those duties arise only where the company is insolvent or is facing financial distress, like being on the verge of insolvency (for example Companies Act 2006, s 172(3)). See also A. Keay, 'Directors' Duties and Creditors' Interests' (2014) 130 LQR 443; A.N. Licht, 'My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency' (2021) 98 Washington University L Rev 1731. Additionally, the statutory regime of fraudulent and wrongful trading of the Insolvency Act 1986 protects the creditors of UK companies (Insolvency Act 1986, ss 213 and 214).

108 J. McClane, 'Reconsidering Creditor Governance in a Time of Financial Alchemy' (2020) 2020 Columbia Business L Rev 192, 195, 199.

109 Although most of the literature on borrower covenants is based on US debt contract models, debt contracts governed by English law have broadly similar structures (D.B. Citron, 'The Incidence of Accounting-Based Covenants in UK Public Debt Contracts: An Empirical Analysis' (1995) 25 *Accounting & Business Research* 139, 144-145; J. Day and P. Taylor, 'The Role of Debt Contracts in UK Corporate Governance' (1998) 2 J Management & Governance 171, 181-182; L. Moir and S. Sudarsanam, 'Determinants of Financial Covenants and Pricing of Debt in Private Debt Contracts: the UK Evidence' (2007) 37 *Accounting & Business Research* 151, 156, 158-159; L. Gullifer and G. Penn, 'The Boundaries of a Borrower's Freedom to Act: Negative Covenants in Loan Agreements' in P.S. Davies and M. Raczynska (eds), *Contents of Commercial Contracts: Terms Affecting Freedoms* (Oxford: Hart Publishing, 2020) 143-144). A key difference between the two jurisdictions is the absence of covenants controlling dividends in debt contracts governed by English law as opposed to US debt contracts where dividend restrictions are among the most commonly used covenants. The rarity of dividend restrictions in debt arrangements in the United Kingdom is related to the risk of a lender being classified as a shadow director of a borrowing company (Day and Taylor, *ibid*, 181-182).

110 M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3 J Financial Economics 305, 333-343; Day and Taylor, *ibid*, 176-178; Y. Amihud, K. Garbade, and M. Kahan, 'A New Governance Structure for Corporate Bonds' (1999) 51 Stanford L Rev 447, 454.

111 W.W. Bratton, 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process' (2006) 7 Eur Bus Org L Rev 39, 51-58; Tung, n 17 above, 145; W.W. Bratton, 'Bond and Loan Covenants, Theory and Practice' (2016) 11 Capital Markets L J 461, 468-475.

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but provide debtholders with little influence over the borrower's decisions outside distress. None of the commonly used covenants included in debt contracts provide debtholders with shareholder-like rights to vote and engage over the ongoing operating performance or ESG factors.[112] Limited debtholder rights limit opportunities for voting and engagement as an active steward during the normal functioning of a borrowing firm.

The reach of debt covenants is especially limited for the holders of publicly traded fixed-income instruments, such as bonds.[113] Bond markets have traditionally relied more on incurrence and less on maintenance financial covenant protection.[114] Consequently, as Professors Douglas Baird and Robert Rasmussen note, bondholders typically have very little room for action until the issuing company defaults on a loan payment.[115] Less restrictive bond covenants are not without reasons, such as easily accessible financial information on bond issuers, higher costs for monitoring, enforcing compliance and renegotiating bond terms by widely diversified bondholders, and easier exit through selling bonds.[116] Just like in public equity markets, the incentives of investors to engage with issuers, due to the availability of exit, are weaker in public debt markets.

To be clear, the contractual nature of debtholder rights means that no legal barriers prevent debtholders from requesting additional ESG-focused information disclosure and governance rights via covenants. But bondholders can achieve this only if there is a widely shared demand for such a fundamental change in bond contracts among all interested investors. Unlike private lenders, bondholders do not negotiate the terms directly with the issuers and invest based on take-it-or-leave-it offers.[117] The terms of newly issued bonds are defined by the issue's lead manager. The lead manager has an interest in including terms demanded by investors to market bonds successfully.[118] But this means that a small number of progressive debtholders with active stewardship agendas cannot influence the established market terms. Debtholder rights that can support stewardship practices are expected to be integrated in the design of bond deals once many investors become interested in those rights.[119] The lack

112 Carr, n 105 above.

113 Citron, n 109 above, 143 (finding that many public debt contracts of UK firms do not even contain covenants); S.H. Kwan and W.L. Carleton, 'Financial Contracting and the Choice between Private Placement and Publicly Offered Bonds' (2010) 42 J Money, Credit & Banking 907, 914-915. See also Triantis and Daniels, n 16 above, 1088; Amihud et al, n 110 above, 462-465; E. de Fontenay, 'Do the Securities Laws Matter? The Rise of the Leveraged Loan Market' (2014) 39 J Corp L 725, 737. Bonds are, in this sense, like preference shares without voting rights. The holders of both instruments have limited powers to engage with issuers.

114 S. Paterson, 'The Rise of Covenant-Lite Lending and Implications for the UK's Corporate Insolvency Law Toolbox' (2019) 39 OJLS 654, 664.

115 Baird and Rasmussen, n 19 above, 1211.

116 Whitehead, n 17 above, 651; de Fontenay, n 113 above, 744-745; Paterson, n 114 above, 664.

117 Even if this was not the case, many fragmented public bondholders would struggle to make credible demands to issuers. The involvement of the debt lead manager (underwriter) on behalf of bondholders eases this collective action problem.

118 A.D. Morrison and W.J. Wilhelm Jr., 'Trust, Reputation, and Law: The Evolution of Commitment in Investment Banking' (2015) 7 J Legal Analysis 363, 389 (describing investment banks as intermediaries channeling information flows between issuers and investors with the aim of accurately pricing and designing investment products).

119 For example, in a recent attempt to reverse deteriorating covenants in leveraged debt, Federated Hermes, an investment manager, tried to amass support by arguing that weak covenants are

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of adequate covenants in bonds is a suggestion that there is no shared consensus among bond investors that additional rights can add value. The complicated procedure for exercising those rights[120] and the availability of easy exit which reduces reliance on contract to mitigate credit risk[121] explain this situation. Accordingly, rights are absent because they are unlikely to be exercised, and thus are not valued, by bondholders.

The market for bondholder rights has, in fact, evolved in the opposite direction of gradually diluting, rather than broadening, bond covenants. The pressure on debtholders to give away their rights to receive a higher interest rate is especially strong when the supply of debt capital is abundant with investors competing for a limited pool of assets. Most debtholders are ready to sacrifice rights in exchange for higher interest, according to an early study.[122] The availability of cheap money leads to riskier lending with weaker controls, due to looser covenants, over borrowers and their managers.[123] The manifestation of this problem is the rise of so-called 'covenant-lite' (or 'cov-lite') debt – primarily in bank loans but more recently also in high-yield public bond markets[124] – with few or no covenant constraints during times when debt is cheap.[125] Modern debt contracts use maintenance covenants, which allow lenders to take control if the borrower's financial position deteriorates, less often and include weaker incurrence covenants restricting additional debt and dividend payments, according to The Economist.[126] Weak covenants clearly reduce further the already limited scope for debtholder stewardship via voting and engagement.[127]

not just a credit but also a governance problem that impact negatively the ESG performance of the borrowers (T. Walsh, 'ESG Reframes Weak Covenants as Governance Issue' *International Financing Review* 28 February 2020 at https://www.ifre.com/story/2266019/esg-reframes-weak-covenants-as-governance-issue-l5n2as4rf).

120 nn 128-132 below, and accompanying text.

121 Amihud et al, n 110 above, 459-460.

122 L. Light, 'Bondholder Beware: Value Subject to Change Without Notice' *Bloomberg* 29 March 1993 at https://www.bloomberg.com/news/articles/1993-03-28/bondholder-beware-value-subject-to-change-without-notice.

123 Tung, n 17 above, 161; A. Choi and G. Triantis, 'Market Conditions and Contract Design: Variations in Debt Contracting' (2013) 88 New York University L Rev 52, 61.

124 M. Gietzmann, H. Isidro, and I. Raonic, 'The Rise of Covenant-Lite Bond Contracting' (2021) J Accounting, Auditing & Finance 3-5 (forthcoming).

125 Tung, n 17 above, 161; Choi and Triantis, n 123 above, 61; Paterson, n 114 above, 659-64. Consider, for example, the growth in cov-lite debt in response to low benchmark interest rates during the last decade, which was exacerbated further by the enormous volumes of COVID-19 pandemic-related central bank support and near-zero interest rates. Competition among lenders for a decent return in the world of low interest rates has distorted credit risk pricing and has increased debt deals with less restrictive covenants (S. Çelik, G. Demirtaş and M. Isaksson, 'Corporate Bond Markets in a Time of Unconventional Monetary Policy' (2019) OECD Capital Market Series, Paris, 16-19 at http://www.oecd.org/corporate/Corporate-Bond-Markets-in-a-Time-of-Unconventional-Monetary-Policy.htm. See also S. Goldfarb and A. Chilkoti, 'Growth in Corporate Bonds Sounds Alarm' *Wall Street Journal* 28 May 2019, B 10; 'Risky Debt in America: The Junk Heap' *The Economist* 19 June 2021, 70).

126 *The Economist ibid*.

127 But see F. Tung, 'Do Lenders Still Monitor? Leveraged Lending and the Search for Covenants' (2021) 47 J Corp L 153, 191-194 (arguing that although covenants have become less restrictive, they are more efficient and better differentiate distress from non-distress situations). For the purposes of this article, this only confirms the centrality of a borrower's financial health for debt contracting.

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To conclude, the contractual nature of debtholder rights imposes additional costs on debtholders willing to broaden their rights beyond the traditional coverage of debt covenants. This means that most debtholders have rights that focus on credit risk and do not cover typical governance rights of shareholders that can be invoked to monitor governance and sustainability. Stewardship by debtholders is thus unlikely to go beyond what creditors already do, ie, credit risk oversight based on a company's financial health.

High transaction costs of active stewardship associated with layers of intermediated relationships on public debt capital markets

Not only are the contractual rights of bondholders very limited, but also the exercise of those rights is indirect. Even though promises in bonds run directly to bondholders, bonds are usually subject to a trust deed and cannot be enforced directly by bondholders.[128] In a typical bond issue, a borrower issues a bond note – a brief document which specifies the key terms of the bond issue, such as the value, interest, term to maturity, seniority rank, and security (if any) – and a trust deed, a detailed document which complements the minimum terms of the note, contains all other terms, including investor rights and bond covenants.[129] The issuer and the lead manager (underwriter) of bonds appoint an independent intermediary called a 'bond trustee' (or simply a 'trustee')[130] who exercises all powers specified in the trust deed on behalf of bondholders in dealings with the issuer, specifically rights arising from debt covenants of the issuer.[131] Trust deeds generally constrain the unilateral enforcement rights of bondholders, channeling enforcement through the trustee. The trust deed, then, not only facilitates enforcement by the dispersed bondholders, but also restrains such enforcement by protecting the issuer from bondholders.[132]

This structure creates an additional layer of actors between bondholders and issuers and, as such, reduces bondholder influence via formal direct voting and communication with borrowers. The exercise of rights stemming from narrow bond covenants, all communication with an issuer, and other engagement,

128 P. Rawlings, 'Case Comment: International Bonds and Trustees' (2005) 19 *Trust Law International* 205.

129 E. King, 'Excluding Fiduciary Duties: How Far Should Trustees Be Able to Go? Lessons from Bond Issues' (2018) JIBFL 675, 676.

130 The equivalent in US bond issues is the indenture trustee (S.W. Smith and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 J Financial Economics 117, 148; S.L. Schwarcz and G.M. Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee' (2008) 59 Alabama L Rev 1037, 1038).

131 P. Rawlings, 'The Changing Role of the Trustee in International Bond Issues' (2007) JBL 43, 47-48.

132 Smith and Warner, n 130 above, 149 (explaining that the role of the trustee is to solve the collective action problem of many small bondholders by pulling their resources together and to prevent inefficient duplication of enforcement by different bondholders or excessive enforcement efforts of some bondholders who seek to alter the *pari passu* principle during the distribution of the issuer's proceeds); W.W. Bratton Jr, 'Corporate Debt Relationships: Legal Theory in a Time of Restructuring' (1989) 1989 Duke L J 92, 108 (explaining the role of the trustee by the need to coordinate enforcement by widely dispersed debtholders); Schwarcz and Sergi, n 130 above, 1038-1043 (explaining the role and purpose of the indenture trustee).

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in almost all cases, takes place through a trustee.[133] Bondholders can enforce covenants only collectively, but not individually.[134] For example, bondholders may direct a trustee in writing by a specified percentage of all bondholders (usually 25 or 30 per cent) or by a resolution passed by a specified percentage of bondholders present at a meeting (simple or qualified majority by principal value of outstanding bonds) to accelerate the debt and take an enforcement action against the issuer of bonds.[135] But even this limited right is, as a matter of standard practice, qualified by trust deed provisions that require as a condition precedent an event of default that has been certified by the trustee, at the trustee's broad discretion, as materially prejudicial to the interests of the bondholders.[136]

Professors Kahan and Rock identify three factors associated with this design that have led to chronic underenforcement of bond covenant breaches: challenges in detecting covenant breaches, the lack of substantial trustee incentives to represent bondholder interests vigorously, and weak bondholder rights.[137] First, unlike failure to make scheduled interest payments, many breaches of covenants are hard to detect. The standard solution is the issuer obligation to supply annual certificates, sometimes with incomplete information, on compliance with all its covenants.[138] Trustees have no duty to monitor actively the financial health of an issuer and are permitted to rely on those compliance certificates.[139] Individual bondholders could perform their own investigation, but collective action problems discourage this in practice.[140]

Second, the additional agency layer of a bond trustee, as in any agency relationships,[141] creates a potential risk of misaligned interests.[142] Notwithstanding a claim that trustees have both legal (duties and contractual obligations) and strong reputational incentives to monitor and enforce bond covenants,[143]

133 Some bond terms strengthen bondholder voice by entitling the trustee to request the issuer to appoint to its management board a bondholder nominated director with powers to veto the issuer's certain transactions (*Concord Trust* v *The Law Debenture Trust Corporation plc* [2005] UKHL 27, [2005] 1 WLR 1591, 1594-1595; *The Law Debenture Trust Corporation plc* v *Elektrim Finance B.V.* [2005] EWHC 1999 (Ch) at [8]). Likewise, some bond deals involve a controlling bondholder representative who takes a more active role in engagement than the trustee. But this practice is often limited to bonds that are effectively privately placed to a small group of focused investors and applies if the original investors retain a minimum share – typically, at least two-thirds (66.6 per cent) – of bonds. The concept of the controlling bondholder representative should not be confused with bondholder representatives in deals governed by the laws of civil law countries where bondholder representatives are the functional equivalents of common law bond trustees (P. Dupont, 'Bondholder Representation Under Luxembourg Law' (1987) 6 Int'l Fin L Rev 26; E. Fournier, 'Structured to Succeed' (2010) 29 Int'l Fin L Rev 32, 33).

134 M. Kahan, 'Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights' (2002) 77 NYU L Rev 1040, 1049-1052.

135 Rawlings, n 131 above, 49.

136 Amihud et al, n 110 above, 477-478; Rawlings, *ibid*, 58; Rawlings, n 128 above, 206.

137 Kahan and Rock, n 23 above, 297-300.

138 *ibid*, 297.

139 Rawlings, n 131 above, 54.

140 Kahan and Rock, n 23 above, 298.

141 T. Frankel, 'Fiduciary Law' (1983) 71 California L Rev 795, 808-810.

142 The terms 'agents', 'agency relationships' and 'agency problems' are used in an economic sense, as bond trustees are certainly not the agents of bondholders from formal legal perspective (Rawlings, n 131 above, 47).

143 Smith and Warner, n 130 above, 149.

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trustee monitoring and enforcement is far from being perfect. Trustees have no economic incentives whatsoever to do more than the minimum required. The fixed fee paid to a trustee in a marketplace where trustees compete based on charged fees encourages minimum action in pursuit of lower monitoring and enforcement costs.[144] The potential threat of costly litigation initiated by a bond issuer for wrong enforcement actions that caused damage to the issuer, such as cross-default on other debts or reputational harm, weaken enforcement further.[145] Weak pre-default duties do not correct trustee incentives to be active during normal times.[146] A trustee owes duties to bondholders, but those duties are typically triggered only after a covenant breach is detected and a default occurs.[147] Standard contractual practices of trustee duty limitations further dilute the effect of duties.[148]

Last, even if we disregard the problem of weak trustee incentives to monitor and engage with bond issuers, there are other important features of this agency relationship that are not well-suited to the idea of active stewardship. A trustee is brought into the relationships between bondholders and issuers to silence individual bondholders. The threat that any individual bondholder, including direct competitors of the issuer, may declare a default for trivial infringements and accelerate the debt with tremendous negative consequences for the issuer is one of the key reasons for using trust deeds in bond issues.[149] In line with this purpose, as a matter of widespread practice, bondholders collectively, but not individually, can direct a trustee to take a specific action.[150] The practical difficulty of assembling the minimum required investor votes obstructs the communication of the preferences of bondholders to trustees, thereby limiting bondholder intervention to the most serious cases of default, such as repeated failure to pay bond interest.[151] Even assuming that bond ownership is more concentrated and that bondholders interact routinely, the requirement of offering

144 Kahan and Rock, n 23 above, 299-300; Rawlings, n 131 above, 55.

145 Rawlings, *ibid*, 60.

146 Amihud et al, n 110 above, 473; Triantis and Daniels, n 16 above, 1089.

147 Rawlings, n 131 above, 50. For similar duties of indenture trustees of US bonds, see M.W. McDaniel, 'Bondholders and Corporate Governance' (1986) 41 Bus Lawyer 413, 429-431 (noting that the trustee's pre-default duties are minimal and in some cases practically nonexistent); Schwarcz and Sergi, n 132 above, 1044-1045 (explaining that indenture trustees have merely ministerial pre-default responsibilities limited to distributing payments to bondholders, maintaining a list of registered bondholders, and monitoring covenants; this changes after default when trustees owe a duty governed by a 'prudent man' standard); S.L. Schwarcz, 'Indenture Trustee Duties: The Pre-Default Puzzle' (2020) 88 U Cincinnati L Rev 659, 662-663 (the same).

148 Professor Rawlings relies on case law to document common duty limitations and liability exculpations for breach of duty in bond deeds governed by English law, such as limitations of the scope of the duty of care or waivers of liability for negligence or for an error of judgment made in good faith (Rawlings, *ibid*, 51, 53-54).

149 Rawlings, n 128 above, 205; E.A. Schaffer, 'Cross-Border Risks for Indenture Trustees: The Limits of Comity and the Need to Adapt Standard Provisions of the Trust Indenture' (2022) 17 Capital Markets L J 29, 30.

150 Amihud et al, n 110 above, 470, 473; Kahan, n 134 above, 1049-1052; Kahan and Rock, n 23 above, 298-299; Rawlings, n 131 above, 49.

151 By comparison, every single shareholder can be involved in stewardship activities regardless of the number of voting rights controlled by the shareholder and although shareholder influence is linked to votes, even small shareholders can be active stewards by relying on their rights and being vocal.

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indemnification to the trustee before giving enforcement directions impedes bondholder stewardship.[152] To complicate matters further, sometimes bondholders may have conflicting preferences and interests on engagement topics, putting the trustee in a challenging situation of choosing one group over the other. Trustees then are likely to choose actions that limit their liability but are suboptimal for some or all investors, sometimes with significant social costs.[153] Hence, even where bond deeds include extensive rights over ESG matters, the exercise of those rights by trustees is not warranted.

The question then is whether debtholder stewardship can be improved by imposing stewardship duties on bond trustees, rather than bondholders. This is unlikely to make any difference because of weak trustee rights to monitor and engage with bond issuers actively and trustee compensation structures that do not offer proper incentives for active monitoring and engagement. Trustees act within the standard limited terms negotiated and agreed between the issuer and the lead manager of the bonds usually without trustee participation.[154] The trust deed is not designed with active monitoring and engagement in mind and instead assumes limited involvement of a trustee, at least until the point when an issuer default occurs.[155] Fixed fees paid to trustees reflect this arrangement with limited incentives to engage apart from serious default cases.[156] Indeed, trustees are well known for their passive approach to monitoring.[157] The prospect that bond issuers and lead managers could appoint trustees with necessary authority and incentives is far from clear considering highly standard provisions of trust deeds used for bond issues on capital markets with very little flexibility in practice to change trustee's powers.[158] It is not even clear that investors are interested in demanding additional roles for a trustee considering that this is likely to increase substantially the trustee compensation.[159] Regulatory action that will provide trustees with standard rights and impose on them a duty to intervene and monitor ESG factors is also unwarranted, because the need for those rights will vary across borrowers and a standard approach will only increase debt financing costs.

To conclude, bond deals have not been designed with active monitoring and engagement in mind. Individual bondholders that want to be active stewards face high coordination costs of directing the trustee. The trustee can deal directly with the bond issuer, but it neither has authority nor is compensated in a manner that creates incentives for active monitoring and engagement prior to

152 Kahan, n 134 above, 1061-1062.
153 S.L. Schwarcz, 'Fiduciaries with Conflicting Obligations' (2010) 94 Minnesota L Rev 1867, 1874.
154 Rawlings, n 131 above, 44. The situation is similar in the United States (Baird and Rasmussen, n 19 above, 1216; Schwarcz, n 147 above, 668).
155 Amihud et al, n 110 above, 470, 473.
156 *ibid*, 477-478, 484.
157 n 146 above.
158 Schaffer, n 149 above, 31; Lexis PSL, 'Debt Capital Markets: Trustees – Overview' at https://www.lexisnexis.com/uk/lexispsl/bankingandfinance/document/391289/57FJ-2NP1-F185-X1W1-00000-00/Debt_capital_markets__trustees_overview.
159 Schwarcz, n 147 above, 669. A proposal to create a 'supertrustee' was floated more than 20 years ago in the United States but it has had little, if any, practical impact on the design of corporate bond deals (n 189 below).

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default. This limits the trustee's role to the performance of largely administrative tasks that is clearly not in line with the expectations of debtholder stewardship. To be clear, this article does not argue that the conventional design of bonds is flawed and that bond trustees perform their duties poorly. This is a design that has been in place for long time and seems to satisfy the core needs of the parties involved. The analysis rather shows that the practice of structuring bonds via trust deeds is not fit for the purpose of active debtholder voting and engagement as envisioned in the Stewardship Code 2020.

Engagement by private debtholders

Private lenders have extensive shareholder-like, if not stronger, powers to influence corporate borrowers.[160] Extremely detailed loan and credit agreements include different debt covenants that provide debtholders with extensive and individualised rights to intervene in the borrower's corporate governance matters directly.[161] Those covenants are much stricter and more expansive than in public bonds.[162] Corporate managers, in turn, have strong incentives to comply with restrictive covenants because of the leverage lenders have over borrowers: a covenant breach allows a lender to refuse extending further credit to the borrower or to accelerate the loan and demand immediate repayment of outstanding debts.[163] The concentration of private debt in the hands of a few large creditors also means that private lenders face weaker coordination problems compared to bondholders and can monitor debtors more efficiently.[164] Lastly, larger holdings of private debtholders increase their exposure to a single borrower, thereby strengthening incentives to invest in firm-specific monitoring.

Lender powers become even stronger where a borrower defaults on payments or breaches other non-payment covenants of the loan contract, also known as 'technical default', (extensive maintenance covenants, which are more likely to be breached than incurrence covenants, are the hallmark of private loans) and, accordingly, needs to restructure its debt or renegotiate waivers of debt covenants. Once there is a covenant breach, the prospect of debt acceleration, as well as the negative legal implications for the borrower's directors, leave little choice but to engage with lenders.[165] Private creditors enjoy substantial bargaining power in those circumstances.[166] Debt covenant

160 Baird and Rasmussen, n 19 above, 1217; Tung, n 17 above, 152, 160.
161 Baird and Rasmussen, *ibid*, 1211, 1216-1217; Whitehead, n 17 above, 651; Yadav, n 25 above, 787.
162 Amihud et al, n 110 above, 462-465; Kwan and Carleton, n 113 above, 914-915; Yadav, n 19 above, 787.
163 Tung, n 17 above, 125, 146; Tung, n 127 above, 162.
164 D.W. Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 51 Rev Economic Studies 393, 405 (showing the efficiency of bank monitoring of debtors as opposed to monitoring by many individual lenders); Triantis and Daniels, n 16 above, 1083-1084 (explaining the reasons of bank monitoring advantages).
165 Paterson, n 114 above, 666 (explaining how non-engaging directors may be in breach of the duty to consider creditor interests and of the wrongful trading regime). See also n 107 above.
166 Amihud et al, n 110 above, 467. Unlike private lenders, public bondholders rarely use this leverage to influence borrower's corporate decision-making (A.B. Badawi, 'Debt Contract Terms and Creditor Control' (2019) 4 J Law, Finance, & Accounting 1, 8).

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waivers for technical defaults are often granted in exchange for stronger creditor controls.[167]

The fundamental question then is whether private lenders have adequate incentives to rely on their strong rights to engage with borrowers on sustainability matters that cannot be easily associated with credit risk. Pricing mechanisms on private debt markets offer the answer. Because private debt is not traded on markets – on the contrary, contracts often restrict private debt transfers[168] – there are no constantly updating market price mechanisms that would link debt with better than expected borrower performance.[169] In other words, private debtholders are buy-and-hold investors which do not have a direct stake in the borrower's ongoing performance as long as this performance is suffiicient to meet the covenants, make regular interest payments, and return the principal at the maturity date. Accordingly, private lenders intervene decisively where debtors face financial challenges threatening their solvency, including by forcing changes at the top management level.[170] But they have weak incentives to act as stewards and engage over matters related to the ongoing financial or ESG performance of a financially healthy borrower, unless those risks may have a potential non-distant impact on the borrower's solvency during the debt maturity term.[171]

Furthermore, debt decoupling through securitisation transactions, which have become an increasingly common feature of debt markets,[172] weakens the general role of private lenders in corporate governance.[173] Debt securitisation allows private lenders to manage risks through market purchases and sales of

167 Triantis and Daniels, n 16 above, 1096; Tung, n 17 above, 141-142, 151; Gullifer and Penn, n 109 above, 144; 151-152; Tung, n 127 above, 163.

168 Amihud et al, n 110 above, 459; G. Penn, 'Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?' (2022) 37 J Int'l Banking L & Reg 85, 100-102.

169 Even where bank loans and private fixed income instruments are traded, the pricing mechanism on secondary private loan markets mostly reflects the financial health of borrowers (Baird and Rasmussen, n 19 above, 1244; Whitehead, n 17 above, 668-669).

170 Baird and Rasmussen, n 19 above, 1212 (describing how a failure of a large firm to deliver quarterly financial statements violated its bank loan covenants and led to negotiations with the banks over the waiver of the covenants – to avoid early loan repayment and potential insolvency – in exchange for replacing the firm's CEO).

171 Examples may include the potential near-term impact of climate risks on borrowers via direct damage to assets or transition costs. Only then do private debtholders have a material interest to genuinely engage over climate risks beyond efforts to showcase their climate-friendly profile. The situation may also be different where a private lender is subject to pressure from its own shareholders, and possibly also employees and activist groups, to be an active steward of borrowers on governance and sustainability matters. Existing empirical evidence suggests that the latter is currently a more plausible reason for lender interest in ESG-related lending (S. Kim et al, 'ESG Lending' (2022) European Corporate Governance Institute, Finance Working Paper No 817/2022, 4 at https://ssrn.com/abstract=3865147 (finding evidence that lenders use ESG-linked loans to signal ESG commitment for reputational reasons)).

172 McClane, n 108 above, 212-216.

173 In a typical private debt securitisation, a financial organisation (called the 'collateral manager') collects a large pool of different bank loans or other private debt instruments and incorporates a special purpose entity that holds the bundled corporate debt as a single risk pool. This entity becomes the issuer of new securities – called collateralised debt obligations (CDOs) generally or collateralised loan obligations (CLOs) if backed primarily by bank loans – with rights over the cash flows from the pooled debt, and markets them among investors (H.T.C. Hu and B. Black, 'Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications' (2008) 14 *European Financial Management* 663, 686). CLOs have a tranche structure where each tranche receives its own credit rating (from triple-A and lower to double-B, the riskiest fixed-income

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loans, thereby weakening their incentives and ability to monitor and enforce covenants.[174] In recent years, CLOs have bought more than 60 per cent of newly issued leveraged loans, making CLOs an important channel directing capital to firms with low credit ratings.[175] Debt securitisation replaces private lenders with fragmented holders of securitised debt that face intermediated layers in monitoring and engaging with borrowers. Similar to bonds, CLO holders exercise rights via a trustee which has very little incentive to become actively involved in any one loan included in the pool of debt.[176] CLO holders could potentially direct the trustee to engage more, but debt securitisation removes almost all incentives of collateralised debtholders to become informed about the original borrowers because the impact of one borrower on the CLO market pricing, especially in large pools, is minimal.[177] Investors may sometimes not even be aware about the composition of individual loans and firms associated with those loans in the portfolio.[178] But even assuming that some CLO holders have an interest in engaging with borrowers, rights in loans that form CLOs are typically weaker compared to traditional loans because debt securitisation increases the distance between banks that negotiate the original debt and the parties that bear the default risk.[179] The transfer of risks from originating banks that negotiate those loans to many dispersed investors weakens the incentives of banks to request strong debtholder rights.[180] This brings

tranche) and corresponding interest rate. Cash flows collected from all underlying loans back interest payments on tranches in decreasing order of seniority. Higher tranches are the least likely to default – and, in fact, no triple-A tranche has ever defaulted – because when the first individual loan within the pool defaults, the risk is borne by the lowest tranche. As a trade-off, the lowest-ranked tranche, CLO equity layer, has the potential of the highest returns backed by the difference between the cash flows from the underlying pool of loans and interest paid to higher tranches (McClane, n 108 above, 227-228; C. Podkul and P.J. Davies, 'Risky Loans Face a Huge Test from Crisis' *Wall Street Journal* 21/22 March 2020, B11; J. Rennison and R. Smith, 'Stress Points in the System' *Financial Times* 14 May 2020, 19).

174 C.K. Whitehead, 'Creditors and Debt Governance' in C.A. Hill and B.H. McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Cheltenham: Edward Elgar Publishing, 2012) 68, 76.

175 M. Wirz, 'Loan Deals Offer Bad Omen for Junk Debt' *Wall Street Journal* 12 November 2019, B1-B2. The Covid-19 pandemic has accelerated CLO issuances as a source of additional return amid low interest rates: after paying interest to investors in the higher- and lower-coupon tranches, all leftover cashflows from the loans bundled within the CLO are distributed among the CLO equity holders sitting at the bottom of the structure. (J. Rennison, 'CLOs Drew in New Support After Showing Resilience' *Financial Times* 15 June 2021, 13).

176 Hu and Black, n 173 above, 686-687.

177 McClane, n 108 above, 228 (explaining that issuer-specific governance or other improvements cannot lead to meaningful price increases of the pooled debt instrument).

178 Indeed, a recent empirical study of debtholder governance interventions in the United States shows a significant decline in the influence of debtholders in companies whose loans are primarily securitised (McClane, *ibid*, 255-260).

179 U. Rajan, A. Seru, and V. Vig, 'Statistical Default Models and Incentives' (2010) 100 Am Econ Rev 506.

180 Paterson, n 114 above, 662-663. To be clear, securitisation does not fully detach the originator's risks from the performance of underlying assets. Bank and credit organisation originators of CLOs retain significant risks through overcollaterisation – the practice of including more assets in the underlying portfolio that exceed the value of the issued CLOs – and own investments in the high-risk tranches of CLOs (G. Penn and T. Papadogiannis, 'Regulating Securitisation in the Aftermath of the Global Financial Crisis: Lessons from Europe' (2021) 36 J Int'l Banking

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the loan markets closer to the bond markets by diluting private debtholder rights.[181]

Finally, private lenders also need to walk a fine line between engagement and the risk of being treated as a shadow director with all negative consequences. A lender acting to protect its own interest is unlikely to be qualified as a shadow director,[182] but the risk increases where a private lender relies on covenants to demand actions that go beyond the protection of its own interest, for example, by making demands that lead to benefits that are unrelated to the loan itself.[183] Therefore, a debtholder making ESG demands in relation to a loan not expressly linked to sustainability targets risks being held a shadow director.[184] This threat further deters engagement by private lenders beyond credit risk strictly defined.

IMPLICATIONS FOR INVESTOR STEWARDSHIP AND REGULATORY REFORM

The conclusion that stewardship integration is the only effective tool of debtholder stewardship has key implications for the potential contribution of debtholders in improving the overall quality of investor stewardship. A major concern for stewardship integration in equity markets is the loss of the escalation power of shareholders. When responsible shareholders exit portfolio companies, they are replaced by less responsible shareholders who reinforce poor management practices. As such, exit does not deprive companies of capital. Moreover, the new ownership structure strengthens the discretion of corporate managers who can refuse to change behaviour if they are maximising shareholder value under conditions where not all shareholders are socially responsible.[185] By contrast, strategies that involve direct engagement and voting leave less room for managerial discretion and make the actions of large institutional investor

L & Reg 225, 232-233). The prospects of high profits, instead, obscure the vigilance of private lenders to properly assess credit risks at the lending stage (*ibid*, 232).

181 de Fontenay, n 113 above, 744-746; Paterson, n 114 above, 664. Pooled debt instruments may also be a concern for stewardship integration, but it is easier to overcome this problem by creating pooled debt from issuers that meet certain standards defined by stewards. The manager of a CLO can be tasked with monitoring compliance with those standards and actively managing the CLO portfolio in an effort to maintain alignment with the CLO's pre-defined profile.

182 E. Hadjinestoros, 'Fear of the Dark: Banks as Shadow Directors' (2013) 34 *Company Lawyer* 169, 171-172.

183 Gullifer and Penn, n 109 above, 155.

184 According to a more expansive view, over-restrictive covenants that substantially interfere with the borrower's business decision-making are enough to make a lender a shadow director under UK law (Hadjinestoros, n 182 above, 177). Debtholders face less risk in the United States where large corporate creditors, in contrast to a controlling stockholder, typically do not owe fiduciary duties to stockholders (*Hamilton Partners, L.P.* v *Highland Capital Management, L.P.* 2014 WL 1813340 (Del. Ch. May 7, 2014), 13). But even in the US a debtholder may be deemed a controller and, therefore, owe the corporation's stockholders a duty of loyalty (*Blue* v *Fireman* 2022 WL 593899 (Del. Ch. Feb. 28, 2022), 15-17 (holding that a corporation's principal creditor which controlled 83 per cent of the corporation's voting power via an irrevocable proxy included in the debt arrangements as a creditor protection device effectively controlled the corporation and thus owed fiduciary duties to the corporation's stockholders)).

185 E. Broccardo, O. Hart, and L. Zingales, 'Exit vs. Voice' (2022) 130 J Pol Econ 21-23 (forthcoming).

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groups more decisive.[186] Accordingly, the divestment strategy is a controversial tool for responsible shareholders because it weakens the more effective voice strategy.[187]

This study shows that the concerns about the negative impact of divestment strategy on voice are less significant in public debt markets compared to equity markets. Bondholders can safely employ the exit strategy without causing negative side effects for engagement because bondholders, outside distress, have very limited scope for employing the engagement strategy anyway. This leaves the possibility of other debtors supplying the needed capital as the only weakness of exit in debt markets. But bond issuers need to return to markets regularly to raise funds for new projects or for refinancing existing debt. As a result, divestment of bonds turns over time into a decision to withhold capital, rather than simply selling to someone else who is less conscious towards stewardship integration. This means that bondholders can not only use stewardship integration more freely than shareholders, but this use is also expected to have a bigger impact on corporate decisions than stewardship integration by shareholders. This article thus reveals the more important role of divestment strategy in the broader concept of stewardship that includes debtholders. As such, debtholder stewardship complements shareholder stewardship and makes investor stewardship in general more complete by broadening the tools available to investors for influencing corporate decision-making. In addition to the reasons identified earlier,[188] this finding highlights a new benefit of strengthening debtholder stewardship.

The analysis above also has important normative implications regarding the role that governments must undertake in accompanying investor efforts in stewardship. Debtholder stewardship is new not only for investors, but for regulators as well. Regulatory bodies need time to understand what they can require from debtholder stewards. Meanwhile, without setting clear guidelines and expectations on desired activities of debtholders, the concept of debtholder stewardship cannot develop and close the gap with shareholder stewardship. The discussion of regulatory implications and proposed suggestions below aim to assist regulators in their efforts to advance debtholder stewardship. Scholars put forward several proposals for strengthening the role of debtholders in

186 *ibid*, 18. See also J.N. Gordon, 'Corporate Governance, the Depth of Altruism and the Polyphony of Voice' in A. Engert, L. Enriques, G. Ringe, U. Varottil, and T. Wetzer (eds), *Business Law and the Transition to a Net Zero Carbon Economy* (München and Oxford: CH Beck – Hart Publishing, 2022) 33; Pacces, n 69 above, 12-13.

187 Consider, for example, the recent decision by Dutch pension fund ABP to divest its entire shareholdings in fossil fuel companies, including Royal Dutch Shell plc, the Anglo-Dutch multinational oil and gas company. Around the same period, a leading activist hedge fund started a campaign to split Royal Dutch Shell into two parts: the legacy oil and gas and clean energy businesses. Commenting on the Dutch pension fund's decision to exit fossil fuel companies, the CEO of Royal Dutch Shell warned about the negative consequences of changes in shareholder base for the transition plans of energy companies: 'We prefer to have long-term investors in our share base with whom we can talk about our strategy … Replacing long-term thoughtful investors by, say, hedge funds, is not necessarily for the benefit of the energy transition either, because they typically do tend to have a different philosophy' (T. Wilson, 'Shell Sounds Warning Over Role of Hedge Fund Investors' *Financial Times* 10 October 2021, 10).

188 n 18 above and accompanying text.

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corporate governance in the past.[189] The discussion below gives priority to measures that do not require radical and substantial rethinking of corporate governance. The aim is thus to focus attention and resources on reforms that are more likely to be implemented or can address the shortcomings of already ongoing developments in the field of debtholder stewardship.

Improving sustainability reporting frameworks

Effective stewardship by debtholders (and other investors) both via investment decision-making and engagement, including by using sustainability-linked debt discussed below, requires the minimum necessary framework in the form of standard and credible stewardship targets. However many ESG factors linked to stewardship fail to meet these requirements. The development of disclosure frameworks for ESG information is thus a mission priority for the effective functioning of debtholder stewardship.

Private actors and associations have made significant progress in improving corporate non-financial sustainability reporting during the past few years.[190] Those private actor-led efforts may, in principle, be sufficient for developing adequate labeling standards for sustainable investing. Over time, the highest quality and the most consistent labels will prevail, becoming the dominant model and bringing order in the market of sustainable investments. But many global challenges are urgent, and we do not have the luxury of waiting until efficient private standards evolve. Furthermore, the effectiveness of private efforts depends upon the availability of data points supplied by firms. Accordingly, there is also a need for complementary public intervention.

189 One such proposal is the introduction of statutory rights allowing bondholders to appoint minority representatives on corporate boards or the introduction of a director duty to bondholders applicable outside insolvency or financial distress (Schwarcz, n 25 above, 1352-1358). The challenging aspect of this approach is the risk of shaking the delicate balance of creditor protections by giving additional rights to some but not all creditors. Earlier, prominent US legal and finance scholars proposed a new governance structure for public corporate bonds with a supertrustee with stronger powers to monitor the compliance of issuers with bond terms and enforce those terms, and with compensation design that is better aligned with the tasks of active monitoring and enforcement (Amihud et al, n 110 above, 469-485). But this idea had little practical impact on the design of corporate bond deals. Last, a recent sector-specific study relies on special features of bank governance to propose statutory rights for unsecured bank creditors as a way to balance shareholder pressure for excessive risk taking (E. Martino, 'Getting Bank Governance Right: The Interplay Between the Resolution Framework and the Role of Creditors, With an Application to EU Law' (2022) 23 J Banking Reg 302, 308-309).

190 Jacobs and Finney, n 56 above, 127-129; LoPucki, n 58 above, 1466-1469; P. Bolton, S. Reichelstein, M. Kacperczyk, C. Leuz, G. Ormazabal, and D. Schoenmaker, 'Mandatory Corporate Carbon Disclosures and the Path to Net Zero' CEPR Policy Insight No 111 (October 2021), 2 at https://cepr.org/active/publications/policy_insights/viewpi.php?pino=111. The notable efforts include initiatives led by the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-Related Financial Disclosures (TCFD), the Global Reporting Initiative (GRI), the Climate Disclosure Standards Board (CDSB), and the International Financial Reporting Standards Foundation (IFRS). The latter's efforts in creating the International Sustainability Standards Board (ISSB) are supported by the International Organisation of Securities Commissions, the global body of securities regulators.

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In this regard, the EU, as a global regulatory powerhouse, has taken the lead in building regulatory frameworks for better sustainability disclosures by introducing a taxonomy of sustainable invesments[191] and proposing detailed corporate reporting requirements based on mandatory sustainability reporting standards.[192] The disclosure rules, which are set to apply to publicly traded firms and large private companies, include a requirement for the audit of reported information.[193] Although the UK government considers sustainable investing a priority, it has been slower in setting the required standards. Nevertheless, progress has been made on climate risk disclosures: the UK government plans to make climate risk disclosure mandatory for premium and standard litsed companies, as well as large private companies, by 2023.[194] Notwithstanding the proliferation of private initiatives on creating standard sustainability reporting frameworks, public initiatives play an important role in making such reporting mandatory.[195]

The EU is also leading in the introduction of a framework for the classification of sustainable funds based on objective standards and for their transparency, known as the Sustainable Finance Disclosure Regulation or SFDR.[196] Other major economies are likely to follow. US regulators are planning similar action to prevent the improper use of marketing strategies for misleading investors.[197] The UK government has set ambitious plans to go beyond the leading global standards on climate and environmental disclosures in the Green Finance Roadmap published ahead of the UN's climate conference, COP26, in Glasgow in November 2021.[198] The introduction of a new classification and labelling system for sustainable investment

191 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2020] OJ L 198/13 (EU Taxonomy Regulation).

192 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 5372014, as regards corporate sustainability reporting, Brussels 21.4.2021, COM(2021) 189 final (known as Proposal for a Corporate Sustainability Reporting Directive).

193 *ibid*.

194 HM Treasury, *A Roadmap Towards Mandatory Climate-Related Disclosures* (London: HM Treasury, 2020) 1.18-1.20.

195 Indeed, a recent report found that only a small number of UK public companies are comprehensively reporting on climate risks under the new voluntary reporting standards (A. Mooney, 'UK Plc Struggles to Report Adequately on Climate Risks' *Financial Times* 7 April 2021, 11).

196 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector [2019] OJ L 317/1 (SFDR). SFDR requires asset managers to classify products into one of the three categories based on their climate and social impact: dark green funds having sustainability or carbon emission reductions as their sole objective (so-called Article 9 funds), light green funds promoting some sustainability objectives (Article 8 funds), and non-sustainable funds without clear focus on ESG factors or objectives (Article 6 funds). SFDR is further supported by the EU Taxonomy Regulation which lists economic activities deemed to be environmentally sustainable (n 191 above).

197 G. Gensler, 'Public Statement: Prepared Remarks Before the Asset Management Advisory Committee' 7 July 2021 at https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07. See also P. Kiernan, 'SEC Chief Considers Green Disclosures' *Wall Street Journal* 2 September 2021, B9.

198 HM Treasury, *Greening Finance: A Roadmap to Sustainable Investing* ((London: HM Treasury, 2021).

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products is part of the UK government's sustainability disclosure requirements regime.[199]

The critics of standard classifications of funds and firms based on ESG criteria point to the risk of impeding creative thinking in capital allocation decisions through groupthink.[200] This concern is not justified because standardisation neither requires nor encourages investors to make similar investment decisions. Standardisation intends to create a common language that market participants can use when dealing with sustainable investments, thereby bringing order in a chaotic investing sector. Better disclosure will help investors to identify firms that meet their stewardship preferences, ensuring better capital allocation and more effective stewardship.

Addressing ESG risk mispricing

Regulatory efforts to bring order in markets through reporting standards can help investors to classify assets on an informed basis and reduce the impact of greenwashing on mispricing risks. Current valuations of sustainable assets rely on ESG scores that are not always consistent and backed by sound underlying information, leading to inefficient allocation of capital. Better disclosure frameworks for non-financial sustainability information can improve the measurement of ESG risks. Disclosure rules can also clarify the scope of sustainability by identifying factors that regulators consider important in terms of ESG risks. But markets also need time to learn how to use this information better.

Meanwhile, both debtholders and governments can act to mitigate the impact of mispricing. It is important to recognise that ESG ratings are an opinion and differences of measurement will never disappear. This means that although third-party supplied ESG ratings have an important informational role, they cannot be fully relied upon for stewardship integration. Debtholders must supplement external ratings with in-house analysis to identify risks more relevant for their portfolios and stewardship priorities. Deviations from commonly used ESG ratings can, of course, fuel accusations in greenwashing or social washing, but debtholders can avoid this by better explaining their investment decisions. Government-led stress tests of financial organisations on ESG risks, in turn, can add certainty to the expected impact of different ESG risks on asset prices.

Designing innovative debt structures linked to sustainable goals

Limited scope for bondholder engagement after bond placement means that bondholders can influence corporate behaviour by investing in debt instruments that incorporate very specific sustainability targets and reliable

199 Financial Conduct Authority, *Sustainability Disclosure Requirements (SDR) and Investment Labels*, Discussion Paper DP21/4 (London: FRC, 2021).

200 This danger was higlighted by one of the US SEC's Commissioners in a recent public statement (H.M. Pierce, 'Public Statement: Rethinking Global ESG Metrics' 14 April 2021 at https://www.sec.gov/news/public-statement/rethinking-global-esg-metrics).

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mechanisms for monitoring compliance with those targets into the debt design. The recent introduction of so-called 'sustainability-linked' (or 'ESG-linked') debt instruments is a transactional design innovation responding to this need.[201] These instruments reward the borrower by reducing the interest payments for meeting certain pre-determined ESG performance targets, such as reduction of carbon emissions, or punish by charging higher interest rates for the failure to meet those targets.[202] Performance targets can be broad and linked to achieving various ESG goals.[203]

The concept of sustainability-linked debt is not new. Creditors have long applied ratchets to loans or step-ups to bonds that adjust interest rates depending on a borrower's financial performance.[204] The innovative aspect of sustainability-linked debt is the use of non-financial ESG targets for adjusting interest rates. This feature brings together the two debtholder stewardship tools. Directing funds towards sustainability-linked debt is a form of ESG integration. The design of sustainability-linked debt also allows investors to engage with borrowers by defining the underlying ESG targets, monitoring compliance with those targets, and adjusting interest payments based on the compliance of borrowers with the agreed targets.[205] The increasing borrowing

201 Sustainability-linked debt is different from climate bonds, also known as green bonds, in several respects. Green bonds are used to fund projects with climate or environmental benefits, whereas sustainability-linked debt instruments do not specify the ways of using the raised funds. Also, green bonds do not include legally binding assurances that the funds will be spent exceptionally on eligible projects. Hence, investors have little power to hold a green bond issuer to account where the promises are not kept and can effectively rely only on the reputational risk for policing green bond issuers (Stubbington and Nauman, n 71 above (quoting an industry expert that green bonds are a 'gentleman's agreement saying that we [investors] expect an issuer to do what they say they're intending to do with the money')). Another novel, and yet to be tested, proposal is the use of corporate social responsibility bonds (CSR bonds) (D.S. Lund, 'Corporate Finance for Social Good' (2021) 121 Columbia L Rev 1617). The issuer of CSR bonds – likely a third-party NGO – would identify harmful corporate activities and raise funds from interested investors to induce firms to take profit-sacrificing actions that would reduce negative externalities. If a firm agrees to participate and the project is implemented successfully, the CSR bond's contribution would be forgiven; the firm would otherwise need to return the money with penalty interest (*ibid*, 1636-1637).

202 B. Nauman, 'Green Impact: Growth Spurt for Issuance of Sustainability-Linked Loans' *Financial Times* 21 January 2020, 15; B. Nauman, 'Bumper Year Ahead for Green Bonds With $500bn Issuance' *Financial Times* 5 January 2021, 13.

203 P.J. Davies, 'Social Incentives Hitched to Debt Issuance' *Wall Street Journal* 5 May 2021, B1, B2. As an illustration, Klöckner Pentaplast Group, a plastic packaging company, sold €1.175 billion of loans linked to three ESG targets, including increasing the number of women in management and the use of recycled plastic in its products. Meeting any of the targets would cut the loan interest by 0.025 percentage point; meeting all three targets would cut the interest by 0.075 percentage points. But the interest-rate change mechanism could work in the opposite direction too if the company fell below the agreed minimums on every or all three ESG measures. For example, the borrower is rewarded if its use of recycled plastic increases to 26 per cent but is punished if the share of recycled plastic in production is below 20 per cent (P.J. Davies, 'Risky Borrowers Hope to Boost Green, Diversity Credentials' *Wall Street Journal* 3 February 2021, B 13).

204 Davis, *ibid*, B1.

205 The challenges of setting clear and easily measurable targets to assist with the enforcement of sustainability-linked debt by lenders and, in the case of bonds, trustees, are discussed below (see n 211 below, and accompanying text).

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by companies under terms linked to ESG targets can strengthen stewardship by debtholders.[206]

Although sustainability-linked debt has been enthusiastically received by large corporate borrowers[207] and scholars working on sustainable finance topics,[208] the effective use of this novel instrument for debtholder stewardship purposes requires improvements in several directions. One is the need to identify the appropriate size of financial rewards or penalties that would have meaningful effect on the behavioural incentives of borrowers. In large debt deals, even small interest rate changes can lead to substantial financial outcomes in absolute terms.[209] But this effect may be modest relative to a borrower's size, especially considering potential financial gains from 'unsustainable' behaviour.[210] The reputational risk for borrowers from missing the ESG targets of debt somewhat mitigates this concern. What's more, the reputational damage is not driven solely by the changing debtholder attitudes towards the borrower but is likely to have spillover effects on the borrower's customers, employees, or other affected stakeholders, thereby increasing the indirect costs of non-compliance. As such, even a single debt issue that is linked to sustainable targets effectively binds the company to those targets.

More urgent design challenge is information asymmetry between borrowers and creditors regarding the adequacy of targets. Creditor reliance on rating service providers for defining the targets that are not too easy to achieve presupposes the accuracy of those ratings and their methodologies.[211] Creditors also need reliable tools, preferably supplied by independent service providers rather than borrowers, for periodic assessment of compliance with the targets. Complicating the matter is the absence of clear standards for setting and measuring sustainability targets, as opposed to financial targets, which increases the risks of manipulations by borrowers and of disputes driven by disagreements over the exact meaning of targets. If the sustainability agent overseeing and enforcing the terms of sustainability-linked loans and bonds needs to rely on

206 According to the Financial Times and the Wall Street Journal, the top sustainability-linked borrowers include Enel, Anheuser-Busch InBev, Trafigura, Intel, BlackRock, and Novartis, with borrowing targets tied to increases in renewable energy capacity, expanding access to medicines, carbon emission reductions, or diversity in workforce. At present, loans make up the substantial share of sustainability-linked debt, but companies also issue sustainability-linked bonds (Stubbington and Nauman, n 71 above; Davis, n 203 above, B1).

207 K. Broughton, 'CFOs Aim to Tie Debt, Sustainability' *Wall Street Journal* 27 September 2021, B 4.

208 For example, John Armour, Luca Enriques, and Thom Wetzer consider a form of sustainability-linked debt as a means to make ESG promises of borrowers credible (J. Armour, L. Enriques, and T. Wetzer, 'Corporate Carbon Reduction Pledges: Beyond Greenwashing' in A. Engert, L. Enriques, G. Ringe, U. Varottil, and T. Wetzer (eds), *Business Law and the Transition to a Net Zero Carbon Economy* (München and Oxford: CH Beck – Hart Publishing, 2022) 12-13; J. Armour, L. Enriques, and T. Wetzer, 'Green Pills' (2022) European Corporate Governance Institute, Law Working Paper No 657/2022 at https://ssrn.com/abstract=4190268).

209 For example, BlackRock's $4.4 billion credit facility linked to racial diversity in workforce, women in leadership, and sustainable assets under management arranged in 2021 could potentially raise or lower the company's financing costs by $22 million annually if the facility were fully drawn (Davis, n 203 above, B1-B2).

210 J. Rennison, 'Sustainability-Linked Bonds Attract Cash and Scrutiny' *Financial Times* 17 November 2021, 13.

211 Stubbington and Nauman, n 71 above.

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borrower self-disclosure under non-standard disclosure practices, borrowers will have broad leeway in manipulating their compliance with the committed targets. But if adequate ESG targets can be set and the quality of periodic measurements of borrowers is reliable, private lenders and bondholders (via the sustainability agent of the facility) could easily monitor borrower compliance with the targets and apply interest rate adjustments as part of their stewardship activities.[212] Once again, this stresses the importance of improved disclosure of ESG-related information by borrowers.

Extending debtholder stewardship beyond public capital markets

Public issuer-centered stewardship cannot offer a meaningful solution to global challenges. Firms with publicly traded securities, due to pressure from institutional investors and activists, are expected to move their assets with the highest negative externalities to other owners. Even ignoring this problem, many business activities are outside the firms that can be influenced by institutional investors. Accordingly, debtholder stewardship will have limited impact with outcomes distorting business financing unless it becomes a norm at a broader scale. This can be achieved by extending debtholder stewardship beyond public capital markets.[213]

Many powerful private debtholders, such as banks and insurance companies, are currently not signatories of the stewardship code.[214] This leaves the most influential debtholders outside the present debtholder stewardship framework.[215] By extending capital to firms outside public capital markets, private lenders

212 Information asymmetries may be the reason why ESG-linked bonds, as opposed to ESG-linked loans, remain a niche market (Kim et al, n 171 above, 2). Most ESG-linked loans are structured as revolving credit facilities (55 per cent) and involve lenders with past lending relationships with the borrower (59 per cent) (*ibid*, 16, 20-21). These two features could potentially improve contracting around ESG commitments by tailoring ESG contingent targets and helping with monitoring and enforcing those targets. Weaker relationships on public bond markets complicate efficient contracting around ESG targets.

213 This step can reduce, but not eliminate completely, discrimination against certain ownership forms and business models. As an illustration, consider the case of ExxonMobil, oil and gas company, which is the biggest emitter in the United States. Unlike many other large companies, ExxonMobil produces much of the electricity that it uses itself ('Green Investing: Hotting Up' *The Economist* 20 June 2020, 58, 59). This business model increases direct emissions of ExxonMobil ('scope-one' emissions) compared to others which purchase electricity produced externally ('scope-two' emissions). If ExxonMobil, under pressure from investors, changes its internal processes to move to the model used by its competitors, it will improve its own scope-one emission status but there will not be any meaningful reduction in overall carbon emissions. This example also stresses the importance of developing standards for disclosure that would make comparisons across firms meaningful.

214 Financial Reporting Council, 'UK Stewardship Code Signatories' (September 2022) at https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-signatories (listing the signatories of the stewardship code by signatory types).

215 Large institutional investors that hold securities issued by private lenders can and do exert pressure on private lenders to be active stewards, particularly on ESG matters (A. Mooney and S. Morris, 'Big Banks Urged to Defund Carbon Emitters' *Financial Times* 19 April 2021, 10). But not every private lender has securities trading on capital markets to be subject to such pressure. Besides, the additional agency layer weakens the impact of stewardship on end targets.

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could subject those firms to external oversight similar to the stewardship of publicly traded firms by institutional investors. The benefits of bank monitoring have been discussed extensively in the earlier debates on the importance of creditors in corporate governance – in particular, from a comparative perspective with a focus on the German bank-centered model of corporate governance.[216] This article's proposal differs from the debated governance role of private lenders in two ways. First, regarding the mechanisms of influence, the German model of bank monitoring relied more on the powers of banks as shareholders than as creditors.[217] Second, and more significantly, this article proposes private lender oversight as a means to complement shareholder stewardship and embed non-listed firms in the investor stewardship framework. This contrasts with normative claims giving preference to a monitoring model dominated by one actor.

Regulators can extend debtholder stewardship beyond public capital markets either by designing stewardship guidelines for private lenders or by revising the existing banking supervision frameworks to make sustainability oversight part of lending decisions.[218] Both approaches are not optimal but the second offers stronger incentives for private lenders to consider stewardship beyond the traditional oversight of a borrower's financial health by linking ESG factors (or other stewardship preferences) with bank stress tests or capital requirements. Stress tests that assess the vulnerability of banks to systemic sustainability risks and require extra capital from those failing the tests[219] encourage banks to integrate sustainability in financing decisions and monitor borrowers on a regular basis. For example, requiring banks to conduct scenario analysis to account for physical and transition risks of climate change encourages banks to consider climate risk, along with other factors, at lending and subsequent monitoring stages. By contrast, soft law stewardship recommendations for private lenders offer very limited incentives for stewardship across broad topics because of the poor link between private debt and the ongoing performance of a financially healthy borrower.

216 For example, M.J. Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 Yale L J 1927, 1977-1989; R. Romano, 'A Cautionary Note on Drawing Lessons from Comparative Corporate Law' (1993) 102 Yale L J 2021, 2025-2030; E.B. Rock, 'America's Shifting Fascination with Comparative Corporate Governance' (1996) 74 Washington University L Q 367, 379-381. The German corporate governance model has changed since then with banks divesting their shareholdings in large firms (W.-G. Ringe, 'Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG' (2015) 63 American J Comp L 493, 522-524).

217 T. Baums, 'Corporate Governance in Germany: The Role of Banks' (1992) 40 American J Comp L 503, 505-512 (explaining that the governance influence of German banks came from three sources: from directly owned shares, from voting shares held by banks as custodians for their clients, and from appointing supervisory board members representing shareholder interests); J. Edwards and M. Nibler, 'Corporate Governance in Germany: The Role of Banks and Ownership Concentration' (2000) 15 Econ Policy 238, 244 (explaining that bank loan finance played minor role for large German firms and was not a significant mechanism by which German banks influenced the governance of those firms).

218 Early work in the direction of integrating climate risk into banking supervision has already started (Basel Committee on Banking Supervision, *Principles for the Effective Management and Supervision of Climate-Related Financial Risks* (BIS, November 2021) at https://www.bis.org/bcbs/publ/d530.pdf).

219 Higher capital requirements can be set for loans to high-risk industries or businesses.

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Furthermore, the use of supervisory tools for the addition of private lenders to the debtholder stewardship framework is more advantageous in enhancing the impact of stewardship by involving more lenders. In global markets where the supply of debt capital from various sources is abundant, there will always be lenders willing to fill the capital supply gaps left by more responsible lenders that voluntarily comply with stewardship recommendati. This will create fragmented debt markets where firms work with various types of lenders based on the borrowers' sustainability credentials. Supervisory tools, especially if coordinated on a global basis,[220] leave less scope for market fragmentation than soft law guidelines by applying across a broader range of private lenders.[221]

Developing reporting expectations for debtholder stewardship

Although the Stewardship Code now covers the stewardship of non-equity investments, the code offers very little detail on reporting expectations of non-equity stewards. Without more explicit guidelines to accompany abstract and generalist debtholder stewardship principles, significant changes in current practices are unlikely. The code recognises the relative immaturity of stewardship in asset classes other than listed equity in a statement that the code, as a reflection of the relative advanced stage of shareholder stewardship, contains 'more detailed reporting expectations for listed equity assets.'[222] According to Claudia Chapman, corporate governance policy advisor at the FRC which designed the Stewardship Code 2020, the FRC is being pragmatic in recognising that institutional investors require time to understand how to be active stewards in asset classes other than listed shares.[223] The current approach of the FRC may be described as setting expectations regarding the future role of stewards.[224]

But the contrasting approaches of the Stewardship Code to shareholder and debtholder stewardship regarding the level of detail on reporting expectations limit the development of debtholder stewardship because investors will concentrate their efforts on engagement aspects where more reporting is expected.[225] As such, debtholder stewardship will be confined to the margins of

220 See for example n 218 above.

221 It is, however, necessary to recognise that any solution that relies on the existing banking supervision frameworks may unwittingly promote lending by alternate credit providers, also known as non-regulated shadow banks.

222 Stewardship Code 2020, n 1 above, 6. A vivid example of the more developed toolkit for shareholder stewardship is the Code's Principle 12 for asset owners and asset managers which offers detailed disclosure guidelines for exercising shareholder rights but is more concise on exercising the rights of debtholders or other asset class owners.

223 Financial Reporting Council, *Podcast in Conversation With … Jen Sisson and Claudia Chapman on the Strengthened Stewardship Code* (1 November 2019) [00:04:58] at https://www.frc.org.uk/news/november-2019/podcast-in-conversation-with-jen-sisson-and-c.

224 *ibid*, [00:05:07].

225 In fact, the FRC assessment of reports by the first set of applicants to the UK Stewardship Code 2020 found reporting on asset classes other than listed equity to be insufficient across the board (Financial Reporting Council, *Effective Stewardship Reporting: Examples From 2021 and Expectations For 2022* (November 2021) 26 at https://www.frc.org.uk/getattachment/42122e31-bc04-47ca-ad8c-23157e56c9a5/FRC-Effective-Stewardship-Reporting-Review_November-2021.pdf).

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mostly shareholder engagement-focused stewardship reports. Even institutional investors that are the most active in terms of stewardship may disregard their role as debtholder stewards where the stewardship guidelines are abstract and do not clearly specify the steps that debtholder stewards are expected to take. The status quo can be changed by designing reporting expectations for debtholder stewardship, similar to the approach taken on shareholder stewardship.

CONCLUSION

The Stewardship Code 2020 attempts to broaden the concept of investor stewardship by encompassing investors in debt securities. Debtholders have always monitored and engaged with borrowers, but debtholder oversight, due to debtholders being more risk averse investors than shareholders, has been more conservative and focused on maintaining the solvency of borrowers. The revision of the stewardship code is then, in part, an attempt to embed debtholders within the stewardship paradigm where debtholders, in addition to credit risk, are paying increasing attention to ESG matters. Debtholders are thus expected to join shareholders in efforts to use stewardship as a means for strengthening managerial accountability and promoting sustainable business practices.

This article shows that although there are good reasons for including debtholders in the corporate governance and stewardship frameworks of companies, the existing infrastructure is not fully ready for this. The analysis exposes the limits of debtholder voting and engagement beyond a borrower's financial health oversight. Stewardship integration offers more promise but even here the path is bumpy, and regulators need to tread carefully to strengthen the effectiveness of this stewardship tool and not to undermine its increasing popularity. If successful, debtholders can bring their own perspective to the existing investor stewardship ecosystem and lead to an overall more balanced and complete stewardship framework with diverse perspectives and preferences.

The article has global relevance despite its focus on stewardship in the UK. The UK has been a stewardship norm exporter as several countries modelled their stewardship codes on the earlier versions of the UK code.[226] It is not unreasonable to predict similar exporting of the innovative norms of the Stewardship Code 2020 on debtholder stewardship. We are likely to witness revisions of the first generation of stewardship codes – which have been nearly silent on climate change, social and economic inequalities, and other global challenges – in the coming years. Therefore, debtholder stewardship, if effective in strengthening the overall quality of investor stewardship in the UK, can diffuse to other parts of the world. This study is thus relevant for all countries closely watching stewardship developments in Britain as a source of ideas for revising or designing their own stewardship codes.

The novelty of the concept of debtholder stewardship poses many interesting questions for future research and exploration. One important aspect of

226 D. Katelouzou and M. Siems, 'The Global Diffusion of Stewardship Codes' in Katelouzou and Puchniak (eds), n 11 above, 645-648.

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debtholder stewardship that deserves more attention is the impact of the conflicting interests of debtholders and shareholders, particularly where one investor holds both equity and debt from the same issuer, on investor stewardship. The fixed term of debt limits the holder's time horizon and creates a bias towards stewardship activities that give priority to investments with lower risk profile and to short-term targets within the maturity term.[227] By contrast, shareholders have potentially unlimited time-interest because future performance is reflected in the firm's net present value. This difference in time horizons may, for example, reduce the interest of debtholders in distant risks, including climate risk. To the contrary, debtholders may be interested in reducing costly investments in addressing distant risks, especially in firms facing financial distress.

The Covid-19 and the invasion of Ukraine by Russia are also likely to influence investor stewardship. This impact will be multifaceted and will depend on the outcomes of many 'known unknowns' like the length and the outcome of the war, the fate of sanctions after the war, the extent of destruction or disruptions on the production and global supply of goods. For example, the topics and priorities of investor stewardship, especially its ESG aspect, may undergo serious revisions. Matters like food and energy security, due to the growing concerns about global food and energy crises, may outweigh, at least in the short- to medium-term, other sustainability topics that are stewardship priorities at present, including environmental and climate change concerns. Similarly, we may see reassessment of the components of ESG stewardship, in particular, regarding the role of the defence industry.

227 Certainly, there may be circumstances where the time horizons of debtholders and shareholders are more aligned, like in the case of long-term debt contracts or where a lender has a revolving relationship with a borrower. Besides, in a bigger stewardship ecosystem, where debtholders are just one of the stewards, actors with different stewardship perspectives balance each other's claims and shortcomings. In this regard, debtholder monitoring can, to a certain degree, be aligned with employee interests who are similarly interested in the survival of the firm. Corporate boards moderate different interest group influences and select actions that better suit company interests.

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