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BARBARIANS AT THE GATE OR ANGELS AT THE CROSSROADS?

EXAMINING THE IMPACT OF THE UK GREEN TAXONOMY ON PRIVATE EQUITY FIRMS

Melek Redzheb[*] *and Fatjon Kaja*[†]

ABSTRACT

This Article explores whether the UK Green Taxonomy will foster sustainable corporate governance in private equity-backed portfolio companies. We explore how the Taxonomy will address the greenwashing problem that plagues financial markets, including the private equity industry. Our analysis suggests that general partners will have a twofold response to the new reforms. In the short term, they will seek to address the social concerns of limited partners by negatively screening unsustainable companies and cherry-picking more sustainable ones (the so-called "exit" strategy). In the long term, however, they will adopt a dynamic strategy to transform unsustainable targets into sustainable enterprises on exit (the so-called "voice" strategy). We explain these findings through the lens of law and economics and show that competitive pressure and better integration of sustainability in market pricing shape this dynamic. Lastly, we advance a policy proposal that can further incentivize engagement on environmental sustainability issues.

INTRODUCTION

Recent years have witnessed a dramatic increase in consumer support for sustainability, leading to a strong demand from limited partners ("LPs") for investment opportunities that align with environmental, social, and governance ("ESG") goals. [1] In fact, research from Bain & Company and the Institutional Limited Partners Association ("ILPA") showed that 93 percent of LPs said they would walk away from an investment opportunity if it posed

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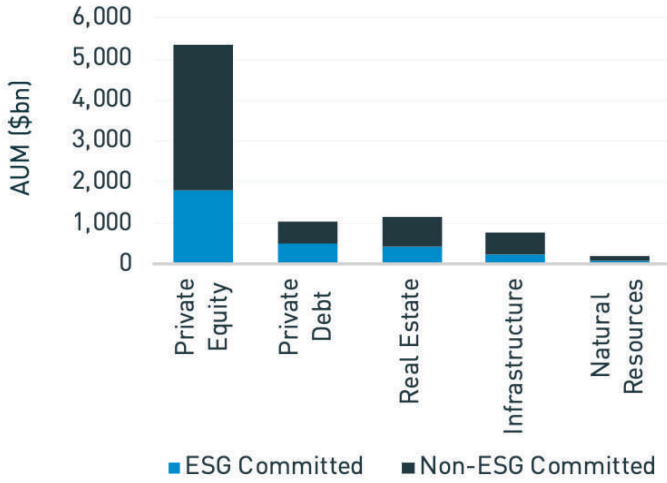
1. EUROSIF, EUROPEAN SRI STUDY (2014), https://www.eurosif.org/wp-content/uploads/2022/03/Eurosif-SRI-Study-2014.pdf; REYAZ A. AHMAD, ET. AL., PRIVATE EQUITY AND VENTURE CAPITAL'S ROLE IN CATALYZING SUSTAINABLE INVESTMENT, INT'L FIN. CORP. (2018), https://documents1.worldbank.org/curated/en/548171545210571956/pdf/133090-WP-PUBLIC-G20-Input-Paper-2018-PE-and-VCs-Role-in-Catalyzing-Sustainable-Investment.pdf.

an ESG concern.[2] To respond to this rising investor demand, private equity ("PE") firms are now incorporating ESG criteria into their investment strategies, thus portraying themselves as ESG proponents. As of October 2021, Preqin—a leading provider of financial data on the alternative assets market—estimates that firms committed to ESG investing manage $3.1tn of private capital assets, which represents 36 percent of the total $8.52tn of private capital assets under management ("AUM") globally.[3] Notably, PE leads the sector by assets, with roughly $1.82tn (34 percent) of AUM being managed by ESG-committed funds (see Figure 1).

Figure 1: Assets Under Management Under ESG-Committed vs. Non-ESG-Committed Firms by Asset Class[4]



This trend comes off as surprising, however, given the industry's profit-driven agenda. In fact, the financial press is full of reports of PE firms adopting "rhetoric around sustainability" while at the same time investing in fossil fuels to "boost short-term profits at the expense of the long-term wellbeing of communities."[5] Furthermore, academic and industry research reveals that the information asymmetry between asset managers and investors amplifies the incentives for PE firms to engage in greenwashing—"a practice where

2. MARC LINO, ET. AL., ILPA AND BAIN & CO. INC., LIMITED PARTNERS AND PRIVATE EQUITY FIRMS EMBRACE ESG (2022), https://ilpa.org/wp-content/uploads/2022/02/ILPA-BAIN-REPORT-LPs-and-PE-Firms-Embrace-ESG-2022 .pdf.

3. PREQIN LTD., ESG IN ALTERNATIVES: NAVIGATING THE CLIMATE CRISIS (Oct. 26, 2021), https://www.preqin.com/insights/research/reports/esg-in-alternatives-navigating-the-climate-crisis.

4. *Id.*

5. Nina Lakhani, *Private Equity's Dirty Dozen: The 12 US Firms Funding Dirty Energy Projects*, THE GUARDIAN (Feb. 15, 2022, 5:00 AM), https://www.theguardian.com/environment/2022/feb/15/us-private-equity-firms-funding-dirty-energy-projects; Hiroko Tabuchi, *Private Equity Funds, Sensing Profit in Tumult, Are Propping Up Oil*, N.Y. TIMES (Oct. 13, 2021), https://www.nytimes.com/2021/10/13/climate/private-equity-funds-oil-gas-fossil-fuels.html.

sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services". [6] This information asymmetry is related to the difficulty LPs experience in assessing the ESG performance of private companies, which historically had limited ESG reporting obligations in the past.

Additionally, with the proliferation of ESG standards and voluntary disclosure requirements, alongside growing investor demand for ESG investments, PE firms are incentivized to exploit this asymmetry by using misleading narratives and dubious third-party ESG scores. This, in turn, exacerbates the information asymmetry problem by impeding LPs from accurately comparing companies based on their ESG commitments. Ultimately, such greenwashing practices hinder the reallocation of private capital to sustainable projects, despite the broad commitment to ESG investing within the PE industry.[7] Yet, it is clear that the climate emergency requires action from a broad range of stakeholders, including PE firms, and a staggering amount of public and private financing (see Figure 2). Therefore, policymakers are starting to pay more attention to private actors' role in mobilizing capital to fund the net-zero transition and looking for ways to incentivize private sector engagement.[8] Most recently, the UK Government outlined its plan to advance the development of a UK Green Taxonomy in the Green Finance Roadmap—an overarching umbrella for the Government's initiatives to combat greenwashing and shift investment into sustainable projects and green technology.[9] It is important to note that the UK decided to

6. We borrow such definition of greenwashing from ESMA. Press Release, ESMA, ESAs Put Forward Common Understanding of Greenwashing and Warn on Risks, (Jun. 1, 2023), https://www.esma.europa.eu/press-news/esma-news/esas-put-forward-common-understanding-greenwashing-and-warn-risks. Annikka Villegas, *ESG, Impact, and Greenwashing in PE and VC*, PITCHBOOK DATA INC. (2022), https://pitchbook.com/news/reports/q1-2022-pitchbook-analyst-note-esg-impact-and-greenwashing-in-pe-and-vc; *see* MARC LINO ET AL, *supra* note 2; Addisu A. Lashitew, *Corporate Uptake of the Sustainable Development Goals: Mere Greenwashing or an Advent of Institutional Change?*, 4 J. INT'L BUS. POL'Y 185 (2021); Christian Ott et. al., *Disentangling the Determinants of the Response and the Publication Decisions: The Case of the Carbon Disclosure Project*, 36 J. ACCT. & PUB. POL'Y 14, 19 (2017); Edeltraud T. Guenther et. al., *Stakeholder Relevance for Reporting: Explanatory Factors of Carbon Disclosure*, 55 BUS. & SOC'Y 361, 366 (2016)

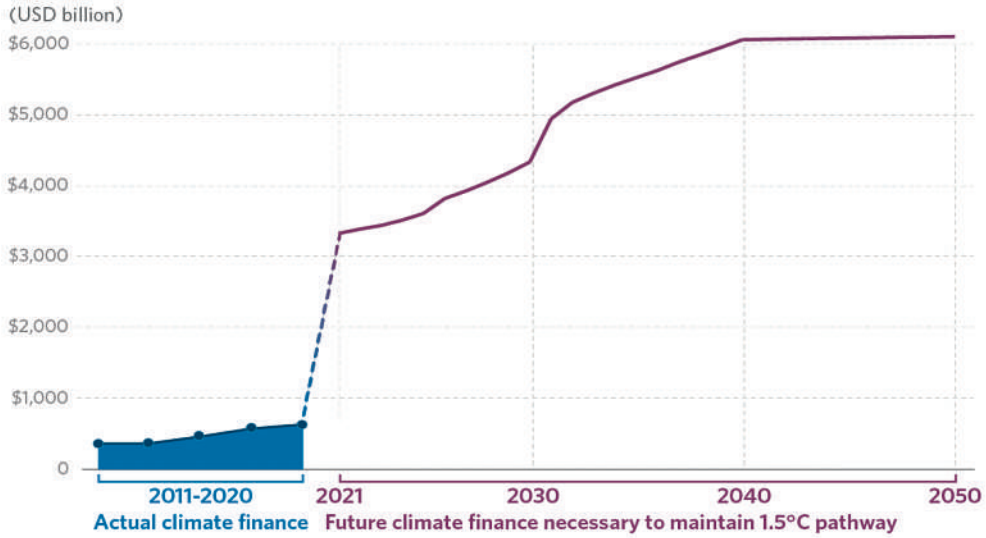
7. In its press release, ESMA cautions that the practice of greenwashing "may be misleading to consumers, investors, or other market participants." *See* Press Release, ESMA, *supra* note 6. *See* also, F. Kaja, *Not Good Enough: Efforts to Support Ethical Corporate Purpose*, 9(5) FIN. COMMON GOOD [BIEN COMMUN] 51 (2023) (highlighting how greenwashing often impedes genuine endeavors to advance sustainable solutions to environmental concerns).

8. *See* US International Climate Finance Plan. THE WHITE HOUSE (2021), https://www.whitehouse.gov/wp-content/uploads/2021/04/U.S.-International-Climate-Finance-Plan-4.22.21-Updated-Spacing.pdf; GREEN FIN. INST., FINANCE GAP FOR UK NATURE REPORT (2021), https://www.greenfinanceinstitute.co.uk/wp-content/uploads/2021/10/The-Finance-Gap-for-UK-Nature-13102021.pdf.

9. H.M. GOV'T, H.M. TREASURY, GREENING FINANCE: A ROADMAP TO SUSTAINABLE INVESTING (2021) available at https://assets.publishing.service.gov.uk/media/61890e64d3bf7f56077ce865/CCS0821102722-

onshore the EU Taxonomy Regulation post-Brexit, thereby inheriting several elements into its regulatory framework. [10] As such, like its EU counterpart, the UK Green Taxonomy will provide a common framework for determining which economic activities can be environmentally sustainable. Its primary focus will be on UK financial market participants, including actors in the PE market. Given that the PE market often operates through complex, opaque structures with limited transparency, and that its profit-maximizing incentives can conflict with long-term sustainability goals, the effectiveness of the UK Green Taxonomy in fostering genuine sustainable corporate governance within PE-backed companies remains uncertain. This potential disconnect raises questions about whether the UK taxonomy can truly drive a meaningful change, or if it will merely serve as a tool for greenwashing in a market where transparency is still a significant challenge. Hence, the aim of this Article is to explore the question of whether the UK Taxonomy can foster sustainable corporate governance in PE-backed companies.

Figure 2: Global Tracked Climate Finance Flows and the Average Estimated Climate Investment Needs Through 2050[11]



006_Green_Finance_ Paper_2021_v6_Web_Accessible.pdf [*hereinafter* ROADMAP]; H.M. GOV'T, H.M. TREASURY, MOBILISING GREEN INVESTMENT 2023 GREEN FINANCE STRATEGY (2023), https://assets.publishing.service.gov.uk/media /643583fb877741001368d815/mobilising-green-investment-2023-green-finance-strategy.pdf [hereinafter MOBILISING GREEN INVESTMENT].

10. 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 EU L 198/13 [hereinafter EU Taxonomy Regulation].

11. CLIMATE POL'Y INITIATIVE, GLOBAL LANDSCAPE OF CLIMATE FINANCE 2021, 5 (DEC. 2021).

The idea of a green taxonomy is scarcely new. Scholars have explored the benefits and shortcomings of the EU Taxonomy, its impact on corporate governance or on stakeholder sentiment, as well as its role in reducing divergences in ESG measurements.[12] However, to our knowledge, no study has analyzed the effects of the EU Taxonomy on PE. While the EU Taxonomy[13] and the Sustainable Finance Disclosure Regulation ("SFDR")[14] remain applicable to UK asset managers distributing funds in Europe, scholarly attention to the UK regulatory framework is warranted by the prominent position of the UK PE market as the largest and most dynamic single regional market within Europe, with significant potential to shape market behaviors within the PE industry.[15]

We provide the first detailed analysis of the prospective UK Green Taxonomy in the context of the PE market, which establishes the groundwork for what we see as our most important contribution: predicting how PE firms will respond to this new regulatory environment. Drawing on economic and finance theory, we show that PE firms have the financial incentives, expertise, and time horizon to influence change by engaging with portfolio companies. Furthermore, since the UK Taxonomy is a work in progress, we put it in the context of a wider debate on ESG labelling and advance a policy proposal that we believe can further incentivize engagement on environmental sustainability issues in the PE sphere and beyond. The contributions of this Article blend well with existing scholarship, particularly as it relates to sustainable corporate governance[16] and sustainable finance.[17]

12. Rui de Oliveira Neves, *The EU Taxonomy Regulation and its Implications for Companies*, *in* THE PALGRAVE HANDBOOK OF ESG AND CORPORATE GOVERNANCE, 249 (Paulo Câmara and Filipe Morais eds., 2022); Alessio M. Pacces, *Will the EU Taxonomy Regulation Foster Sustainable Corporate Governance?*, 13 Sustain. 12316 (2021); Katrin Hummel and Karina Bauernhofer, *Early Evidence on Stakeholders' Perceptions of the EU Green Taxonomy Regulation*, ACCT. FORUM (forthcoming); Maurice Dumrose, Sebastian Rink and Julia Eckert, *Disaggregating Confusion? The EU Taxonomy and its Relation to ESG Rating*, 48 FIN. RSCH. LETT. 102928 (2022).

13. EU Taxonomy Regulation, *supra* note 10.

14. 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 EU L 317/1, as amended by 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 EU L 198/13 [hereinafter SFDR].

15. In 2022 alone, PE funds based in the UK invested approximately $55bn, while UK companies received $33bn in PE funding, accounting for almost 8 percent of the total $1.02tn spent globally by PE firms. STATISTA RSCH. DEP'T, EUROPEAN PRIVATE EQUITY INVESTMENTS 2022, BY COUNTRY, STATISTA (2024), https://www.statista.com/statistics/324047/uk-equity-market-private-equity-investments-europe/.

16. *See* Alessio M. Pacces, *Sustainable Corporate Governance: The Role of Law*, *in* SUSTAINABLE FINANCE IN EUROPE, EBI STUDIES IN BANKING AND CAPITAL MARKETS LAW 151 (Danny Busch, Guido Ferrarini and Seraina Grünewald eds., 2021); *see* Sebastian Steuer & Tobias H. Tröger, *The Role of Disclosure in Green Finance*, 8 J. FIN. REG. 1 (2022); John Armour et. al., *Mandatory Corporate Climate Disclosures*, 2021 COLUM. BUS. L. REV. 1085 (2022).

17. Alex Edmans, *The End of ESG*, 52 FIN. MGMT. 1, 7 (2023); Rob Bauer et al., *Get Real! Individuals Prefer More Sustainable Investments*, 34 REV. FIN. STUD. 3976 (2021).

Nonetheless, there are also limitations to the scope of this article. It discusses mandatory disclosure under the UK Taxonomy, making the analysis jurisdiction-specific; hence, one should be conscious of the differences when using its conclusions. It also deals with buyout funds because these tend to be more economically significant than venture capital or growth equity. Furthermore, in buyout funds, GPs hold a larger stake and exert more control over a portfolio company's strategy and operations and, by extension, its ESG performance, compared to growth capital, where GPs often take a smaller stake and may have less direct influence over operational decisions and ESG performance. Thus, this Article purposefully excludes venture capital and growth equity from its scope. Lastly, it focuses exclusively on environmental issues, so any references to the terms sustainability, ESG, and environmental sustainability should be construed to encompass solely environmental concerns.

The rest of the paper is structured as follows. Part I discusses the academic frameworks that offer a valuable lens to analyze corporate governance in PE-backed companies. Parts II and III deal with the greenwashing problem and explore how the UK Taxonomy will address this problem. Part IV predicts how GPs will respond to this new regulatory environment, followed by policy recommendations to enhance sustainable corporate responsibility in GPs. Lastly, we conclude with suggestions for future research.

I. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Milton Friedman's article in The New York Times Magazine is often a natural starting point for any discussion of corporate social responsibility ("CSR"). In that article, Friedman made the famous—or infamous—statement that "the social responsibility of business is to increase its profits."[18] Friedman's view on the social responsibility of business became "a seminal turning point in corporate legal theory."[19] It has been credited with—or blamed for—launching a still ongoing era of "shareholder primacy" where directors assume their job is to maximize shareholder wealth at all costs.[20]

18. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES (Sep. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

19. Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 42 (2004).

20. Karen Ho, *In the Name of Shareholder Value: Origin Myths of Corporations and their Ongoing Implications*, 43 SEATTLE U. L. REV. 609, 610; Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020). For a historical perspective that challenges the view of shareholder primacy as black-letter corporate law, *see* Fatjon Kaja, *Reframing Corporate Purpose: A Historical Perspective* (2024), https://doi.org/10.2139/ssrn.5052314.

At the same time, the CSR literature argues that this neoclassical view that businesses should focus on maximizing profit whereas governments should address social concerns is no longer valid.[21] Tirole and Bénabou explain that governments may fail to correct negative externalities for three reasons.[22] First, large corporations use lobbying to influence legislation and regulation, which can lead to regulatory capture. Second, legislative powers can only be exercised within a state's territory, and hence governments have little control over transboundary environmental harm. Third, governments respond to the preferences of the median voter, which undermines the interests of younger (and socially conscious) generations. Besides, the economic literature notes that the separation theorem underlying Friedman's reasoning does not hold because some externalities, such as climate change, are hard to reverse or separate from production activities.[23] Instead, Hart and Zingales argue that companies have a comparative advantage relative to governments in addressing social concerns in those circumstances.[24] Furthermore, research shows that shareholders may have prosocial preferences and wish to pursue an agenda broader than profit maximization.[25] Taken together, these insights reinforce the idea that businesses have a role to play in addressing societal and environmental issues.

Building upon the above literature, current academic research is focused on how shareholders (and other stakeholders) can achieve the socially desirable outcome—by way of *exit* (divestment) or *voice* (engagement).[26] Although divestment is not the only *exit* strategy—it includes everything from boycotting[27] to negative and positive screening[28]—they all follow the same principle. Divestment is based on the stranded assets hypothesis, which states that carbon-intensive assets will face devaluations in the long run as the world transitions to a carbon-free economy.[29] Hence, investors have

21. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Markus Kitzmueller and Jay Shimshack, *Economic Perspectives on Corporate Social Responsibility*, 50 J. ECON. LITERATURE 51 (2012).

22. Jean Tirole & Roland Bénabou, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1, 2 (2010).

23. *See* David P. Baron, *Corporate Social Responsibility and Social Entrepreneurship*, 16 J. ECON. & MGMT. STRATEGY 683, 683–88 (2007).

24. *See* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCOUNT. 247 (2017).

25. Gary Charness & Matthew Rabin, *Understanding Social Preferences with Simple Tests*, 117 Q. J. ECON. 817 (2002); Hart and Zingales, *supra* note 24; Bauer et al., *supra* note 18.

26. *See generally* Eleonora Broccardo et al., *Exit vs Voice*, 130 J. POLIT. ECON. 3101 (2022) (discussing "the relative effectiveness of exit (divestment and boycott) and voice (engagement)").

27. *Id*.

28. *See* Russell Sparkes & Christopher J. Cowton, *The Maturing of Socially Responsible Investment: A Review of the Developing Link with Corporate Social Responsibility*, 52 J. BUS. ETHICS 45 (2004); Elroy Dimson et al., *Exclusionary Screening*, 1 J. IMPACT & ESG INV. 66 (2020).

29. Ben Caldecott, *Introduction to Special Issue: Stranded Assets and the Environment*, 7 J. SUSTAIN. FIN. INV. 1 (2016); Neil Gunningham, *Building Norms from the Grassroots Up: Divestment, Expressive Politics, and Climate Change*, 39 L. & POL'Y 372, 380 (2017).

sound economic reasons to exit these assets.[30] Gantchev et al. show that *exit* strategies achieve the socially desired outcome by causing the share price of a polluting firm to fall.[31] The threat of divestment incentivizes a value-maximizing manager to switch to clean solutions rather than wait to see how things pan out. Yet, Heinkel et al.[32] show that a substantially higher number of green investors must exist to have a direct impact on a firm's cost of capital, as a brown firm will only transition to a more sustainable business model if its higher cost of financing outweighs the cost of going green[33].

Alternatively, investors can exercise *voice* by voting or engaging with management to influence corporate behavior towards sustainability goals. The impact of shareholder engagement is well-documented in the literature: it is associated with higher returns,[34] emission reductions,[35] and downside risk reduction.[36] Furthermore, the economic literature shows that *voice* is more effective than *exit* in correcting negative externalities and maximizing social welfare.[37]

Yet, Pacces argues that *voice* strategies alone cannot influence corporate behavior towards sustainability due to greenwashing.[38] Instead, recent scholarly work adopts a different theoretical framework which focuses on the role of securities regulation[39] and contract law[40] in curbing greenwashing and thereby supporting sustainable corporate governance. As uncertainty is pervasive when it comes to climate change (its scale, its impact, how to calculate it), the intuitive explanation is that mandatory disclosure will mitigate greenwashing and reduce the agency costs of sustainable corporate governance. As more information is disclosed, market participants will

30. Auke Plantinga & Bert Scholtens, *The Financial Impact of Fossil Fuel Divestment*, 21 CLIMATE POL'Y 107 (2020).

31. *See generally* Nikolay Gantchev et. al., *Does Money Talk? Divestitures and Corporate Environmental and Social Policies*, 26 REV. FIN. 1469 (2022).

32. Robert Heinkel et al., *The Effect of Green Investment on Corporate Behavior*, 36 J. FIN. & QUANTITATIVE ANALYSIS 431, 447–48 (2001).

33. *See* Dongyang Zhang et al., *Green vs. Brown: Climate Risk Showdown—Who's Thriving, Who's Diving?*, 149 J. INT'L MONEY & FIN 103198 (2024), https://doi.org/10.1016/j.jimonfin.2024.103198 (detailing the differences between green and brown firms when it comes to their environmental impact. One of the key differences highlighted is the fact that brown firms are more prone to traditional business models, which rely heavily on high energy consumption and pollution-intensive production techniques.

34. Marco Becht et. al., *The Benefits of Access: Evidence from Private Meetings with Portfolio Firms* 1 (Eur. Corp. Gov. Inst., Fin. Working Paper No 751/2021, 2021), https://ssrn.com/abstract=3813948.

35. S. Lakshmi Naaraayanan et. al., *The Real Effects of Environmental Activist Investing* (Eur. Corp. Gov. Inst., Fin. Working Paper No 743/2021, 2020), https://ssrn.com/abstract=3483692.

36. *See generally* Andreas G.F. Hoepner et. al., *ESG Shareholder Engagement and Downside Risk*, 28 REV. FIN. 2 (2024).

37. *See generally* Martin Oehmke and Marcus Opp, *A Theory of Socially Responsible Investment*, 00 REV. ECON. STUD. 1; Broccardo et. al., *supra* note 26.

38. Pacces, *supra* note 16, at 155.

39. Pacces, *supra* note 12, at 17; Steuer & Tröger, *supra* note 16, at 47.

40. Armour et. al., *supra* note 16, at 155.

understand better the actual status of the progress, so they will price more accurately all firms' idiosyncratic risks. Furthermore, given that mandatory disclosure would apply equally to all firms, there would be little incentive to hide information for competitive purposes.

Although the aforementioned theoretical framework is now the dominant academic lens through which corporate governance is analyzed, the academic discourse is focused on public financial markets[41] and mutual funds.[42] That being said, to our knowledge, no studies to date have applied this framework to PE. On the other hand, responsible governance in PE is well-documented in the literature. It is discussed that PE firms should act according to social and environmental objectives.[43] It is further shown that they are increasingly integrating ESG factors into their practices due to investor demand.[44] The benefits of this implementation are also observed[45] and measured.[46] However, the impact of mandatory sustainability disclosure on PE fund governance remains largely unexplored.[47]

Breaking the scholarly silence on this topic becomes crucial due to the instrumental role that PE firms have in the net-zero transition, serving as intermediaries between LPs and portfolio companies. With an ever-increasing pool of capital, full-ownership model, and longer time horizon, relative to public markets, these firms are uniquely positioned to stimulate innovation and accelerate the adoption of sustainable practices at the portfolio company level. Therefore, the unexplored dynamics of sustainability disclosure within the PE industry have implications not only for LPs but also for the broader sustainable finance ecosystem. We address this gap in the literature by applying the aforementioned theoretical framework to PE. In particular, we investigate how the UK Taxonomy will curb greenwashing in PE markets. Then, we apply rational choice theory to predict the corporate governance response of GPs, weighing the costs and benefits of each option, and choose what we believe will maximize their interest. The *exit* option for PE firms is screening, i.e. picking Taxonomy-

41. Hanne Søndergaard Birkmose, *European Challenges for Institutional Investor Engagement—Is Mandatory Disclosure the Way Forward*, 11 EUR. CO. & FIN. L. REV. 214 (2014); Hans B Christensen et. al., *Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review*, 26 REV. ACCOUNT. STUD. 1176, 1215 (2021).

42. Pacces, *supra* note 12; *See generally* Bertrand Candelon et. al., *ESG-Washing in the Mutual Funds Industry? From Information Asymmetry to Regulation*, 9 RISKS 199 (2021).

43. David A. Zalewski, *Corporate Objectives—Maximizing Social Versus Private Equity*, 37 J. ECON. ISSUES 503, 505 (2003).

44. Joseph McCahery et. al., *Institutional Investors, Alternative Asset Managers, and ESG Preferences*, 23 EUR. BUS. ORG. L. REV. 821, 829, 836 (2023).

45. *See generally* Reynir Indahl & Hannah G Jacobsen, *Private Equity 4.0: Using ESG to Create More Value with Less Risk*, 31 J. APPLIED CORP. FIN. 34 (2019).

46. Avis Devine et. al., *Sustainability and Private Equity Real Estate Returns*, 1 J. REAL EST. FIN. & ECON. 56, 18 (2022) (preprint submission).

47. Alperen Gözlügöl & Wolf-Georg Ringe, *Private Companies: The Missing Link on the Path to Net Zero* 60 (Eur. Corp. Gov. Inst. Fin. Working Paper No. 342, 2022) (Now published under the same title in the Journal of Corporate Law Studies, 22(2) J. CORP. L. STUD. 887 (2023)).

aligned companies (the so-called "positive screening") at the expense of unsustainable ones (the so-called "negative screening"). The *voice* option is engagement with the management of portfolio companies using the means of communication available to GPs.

II. WHEN MARKETS FAIL—GREENWASHING IN PRIVATE EQUITY

A. PRIVATE EQUITY'S GOVERNANCE ADVANTAGE

In the Anglo-Saxon system of corporate governance, the public corporation has two significant drawbacks.[48] First, shareholders in a public company are so small and numerous that they face difficulties coordinating and exercising control over the management (the so-called "collective action problem"). In effect, shareholders in a widely held company become passive providers of equity financing with little to no control over the management. The second (related) issue pertains to the lack of monitoring: the manager of a public company could pursue his own agenda, which would reduce shareholder wealth (the so-called "agency problem").[49] In the eyes of scholars, these agency costs made the public corporation an inefficient form of organization.[50]

Michael Jensen made the case that PE, as a new organizational form that transcended manager vs shareholder conflicts, eclipsed the public corporation early on. Among the benefits that allowed PE to eliminate the agency problem between investors and managers, are its concentrated ownership, effective monitoring, strong managerial incentives, and efficient capital structure. Given these attributes, it follows that PE firms are theoretically well-placed to aggregate LPs' financial and non-financial preferences.

B. AGENCY COSTS IN PRIVATE EQUITY

Although PE managed to reduce the transaction costs of corporate governance, GPs may still be ill-positioned to address environmental externalities. There are two reasons for this.[51] First, in the true economic sense, GPs act as agents for their investors. Hence, whether they take a proactive approach to ESG depends on the sustainability preferences of LPs. Second, even if the latter had such preferences, GPs' incentives may be insufficiently aligned with the preferences of their investors due to agency costs.

48. ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119–25 (1932).

49. *See generally* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

50. Michael Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 1, 4 (1989).

51. Pacces, *supra* note 12, at 2.

The CSR scholarship provides an answer to the first question. In particular, Benabou and Tirole offer three models to explain why investors demand corporate social responsibility (see Figure 3).[52] According to the first model—doing well by doing good—a company can make a profit and behave responsibly simultaneously. In this case, CSR is seen as a risk management tool which allows businesses to tackle different forms of climate risk and ultimately outperform their competitors. In effect, companies reduce externalities to maximize their profitability. Notably, this model describes market myopia and does not envisage a long-term trade-off between financial and non-financial preferences.

Figure 3: Benabou and Tirole's Models of Corporate Social Responsibility

	Limited Partners	**General Partners**
Doing Well by Doing Good	Financial preferences Neutral position on sustainability	Reduction in externalities = profit maximisation
Delegated Philanthropy	Financial preferences Sustainability preferences	Reduction in externalities + profit sacrifice = profit maximisation
Corporate Philanthropy*	Sustainability preferences	Profit sacrifice

Doing well by doing good is implicit for LPs when they commit capital with a PE fund. GPs make large-scale investments on behalf of LPs. This way, they get exposure to risks from physical hazards (e.g. floods, fires, and drought) and transition risks (e.g. technology, consumer demand, and legal changes) across portfolio companies. In this sense, mitigating different types of climate risk is akin to maximizing returns. Therefore, GPs are incentivized to pursue sustainable governance in portfolio companies to tackle climate risk. This approach, in turn, resonates with LPs that have financial preferences but take a neutral position on sustainability. In fact, this proposition is empirically validated by McCahery et al., who find that LPs are motivated to incorporate ESG into their asset allocation processes because they believe that ESG is correlated with financial performance; in contrast, GPs are motivated by increased client demand (i.e. LP demand) for sustainable products. [53]

52. Tirole & Bénabou, *supra* note 22, at 15.
53. McCahery et. al., *supra* note 44, at 823.

According to the second model—delegated philanthropy—a company may adopt sustainability practices to satisfy shareholders, even though this may lead to lower long-term returns. This model implies that LPs themselves may have wider preferences than financial returns, and/or they may impose certain ESG restrictions on PE funds at the expense of returns to meet their own beneficiaries' ethical concerns. In fact, in McCahery et. al.'s study, many LPs (and GPs) cited "explicit mandate" or "investor demand" as reasons for their ESG focus, and such mandates are likely driven by underlying investors' ESG preferences. [54] Furthermore, it is common market practice for PE firms to exclude investments in specific sectors, such as alcohol, tobacco, and gambling, or in certain types of businesses, such as firearms manufacturers and retailers, indicating restrictions imposed beyond purely financial considerations. This supports the idea that ESG mandates within PE may also stem from underlying investors' ethical concerns rather than strictly financial motives, aligning with the second CSR model in Tirole and Bénabou's framework.

According to the third model—corporate philanthropy—companies should follow CSR with little to no regard for the impact on their investment returns. This last model implies that management has full discretion over firm resources. It disenfranchises shareholders and gives rise to prohibitive agency costs. Consequently, this model undermines the effectiveness of sustainable corporate governance and will not be considered further in this article. [55]

So far, the analysis indicates that, in PE markets, LPs' environmental concerns can be explained by the first two CSR models in Tirole and Bénabou's framework. In addition, empirical evidence suggests that there is sufficient investor demand for environmental impact to push for change in portfolio companies.[56] This brings us to another plausible explanation for why GPs may be ill-positioned to address environmental externalities: GPs' incentives may not be adequately aligned with the preferences of their investors, which in turn creates opportunities for greenwashing.

In a traditional investment fund structure, LPs incentivize the GP by granting them carried interest (that is, a percentage of the returns generated by the fund). In line with the recent interest in sustainability, some LPs have started tying GPs' carried interest to ESG targets in one of two ways.[57] Some LPs take a stick-based approach to structuring "impact carry", such that a part of the carried interest to be distributed to the GP is held in an escrow account

54. *Id.* at 852.

55. Alex Edmans & Luca Enriques, *EC Corporate Governance Initiative Series: Call for Reflection on Sustainable Corporate Governance*, OXFORD BUS. L. BLOG (Apr. 7, 2021), https://www.law.ox.ac.uk/business-law-blog/blog/2021/04/ec-corporate-governance-initiative-series-call-reflection-sustainable.

56. McCahery et. al., *supra* note 44, at 836.

57. Charmaine Tam & Karen Chao, GOODWIN, *How to Approach Impact-Linked Carry*, NEW PRIVATE MKTS. (Dec. 14, 2023), https://www.newprivatemarkets.com/how-to-approach-impact-linked-carry/.

until the pre-defined impact target is reached. If the GP fails to reach their targets, they may forfeit a percentage of the carried interest as a penalty for underperformance. Other LPs take a carrot-based approach to designing an impact carry structure, such that a pre-defined goal or threshold must be reached before additional impact-linked carried interest (that is, beyond the base carry) is distributed to the GP.

However, incentive schemes tied to non-financial measures—and impact carry in particular—are a difficult endeavor. Even when adopted, how impact is assessed and linked to compensation can vary considerably due to the lack of a uniform methodology for measuring ESG goals. Linked to this is the difficulty of getting a holistic picture of a PE firm's portfolio in light of the voluntary nature of ESG-related disclosure in private markets, which further incentivizes GPs to cherry-pick positive ESG data for reporting purposes. In theory, GPs can send a costly yet credible signal that they are committed to sustainability, for example, by providing an ESG report that is externally audited. This way, they would reduce the information asymmetry with LPs. [58] Yet, GPs have reduced incentives to report accurate information because LPs cannot differentiate between greenwashing and a credible signal for the reasons discussed above. Hence, greenwashing becomes a cheaper alternative for GPs.

Furthermore, the adoption of impact carry remains very limited, as demonstrated by BlueMark's impact investing practice benchmark for 2021, and, more often than not, GPs are not rewarded for their non-financial performance at all.[59] Consequently, this lack of incentive would further amplify the greenwashing motives in PE, which information asymmetries only facilitate.

Notably, the traditional understanding in PE is that LPs are highly sophisticated investors that can contract for credible information to regularly assess the sustainability performance of the fund/portfolio companies. They can use tools such as ESG questionnaires (e.g. ILPA's Due Diligence Questionnaire or Invest Europe's ESG Due Diligence Questionnaire), sometimes with ESG Data Convergence metrics added, or side letters with ESG requirements to engage with GPs. However, research shows that given their differing sustainability objectives, many LPs struggle with a common approach to request and assess ESG disclosures and impacts.[60] In light of this, it is unlikely that PE firms would agree to produce credible ESG information privately to a diverse set of individual LPs, each potentially requiring

58. Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

59. Christina Leijonhufvud et al., *Making the Mark 2021: The Benchmark for Impact Investing Practice*, BLUEMARK (2021), https://bluemark.co/making-the-mark-2021/.

60. Umachander Balakumar & Tense Whelan, *Responsible Private Equity: Insights and Tools to Generate Financial Value from Embedding Sustainability*, N.Y.U. STERN CTR. FOR SUSTAINABLE BUS. (2023), https://drive.google.com/file/d/1IEY—rCv_OxK83r-5Wg6OrsvYuuGk_3B/view.

different ESG reports with varying frequencies, as this would be a very costly strategy, as explained above.

Collectively, this demonstrates that, notwithstanding the existence of private-contract mechanisms and innovations, there is still a misalignment of LP and GP interests which incentivizes greenwashing in PE markets. Indeed, the existence of greenwashing is validated empirically. As evidence of greenwashing, Markarian et al. find that 71% of PE firms are signatories to ESG initiatives that are easy to implement and are subject to lower accountability.[61] Hence, their findings are consistent with existing research, which shows that UN PRI investors engage in greenwashing.[62] Likewise, industry research reveals that ESG reports in PE are still filled with greenwashing, whitewashing, and superficial claims.[63] In particular, Brackendale's 2020 survey found that LPs tend to be dissatisfied with ESG reports because they lack detail, are too vague, focus on form over substance, and provide superficial statements on intent, with no data to back them up.[64] Furthermore, LPs explicitly criticized greenwashing, whitewashing of evident issues, and the lack of a top management member responsible for ESG. Overall, evidence suggests that voluntary ESG initiatives are unreliable because they are not consistently associated with active steps to reduce negative externalities.

A closer examination reveals that the greenwashing problem is twofold. First, there are many ESG metrics, which diverge significantly across providers.[65] As a result, GPs are incentivized to arbitrage between ratings to get the best ESG score for their portfolio at the lowest price possible. Second, ESG rating providers seek to assess how responsible companies are, but such prosocial goals are hard to measure, let alone rank against each other.[66] These dynamics reduce both the incentives to accurately disclose sustainability data and the market value of sustainability leadership. This is because GPs that accurately report on their sustainability performance may nonetheless be accused of greenwashing due to the disclosure of inaccurate or misleading information by others (the so-called "adverse selection" problem). As a result, the market for corporate sustainability becomes a market for lemons:

61. *See generally* Garen Markarian et. al., *ESG in the Top 100 US Private Equity Firms*, 27 J. ALTERNATIVE INV. 138 (2024).

62. Hyun-Soo Choi et. al., *Dishonest or Misunderstood? Corporate Environmental Commitment and the Value of Persistence*, (SSRN Electronic J., Working Paper, 2022), https://ssrn.com/abstract=4035580. The "UN PRI" are the United Nations' Principles for Responsible Investment.

63. Villegas, *supra* note 6; MARC LINO ET AL., *supra* note 2.

64. BRACKENDALE CONSULTING, THE BRACKENDALE PRIVATE EQUITY ESG LP SENTIMENT SURVEY 2020 (2020), https://brackendaleconsulting.com/downloads/Brackendale_ESG_Survey_final.pdf.

65. *See generally* Florian Berg et. al., *Aggregate Confusion: The Divergence of ESG Ratings*, 26 REV. FIN. 1315 (2022).

66. *See generally* Sebastião V. de Freitas Netto et. al., *Concepts and Forms of Greenwashing: A Systematic Review*, 32 ENVIRON. SCI. EUR. 19 (2020).

because LPs cannot distinguish between GPs genuinely committed to sustainability and sustainability imitators, they will not commit capital to PE funds that follow sustainable corporate governance.[67] Given that private ordering fails to produce the efficient allocation of resources, there is a need for government intervention to eliminate greenwashing.

III. THE UK GREEN TAXONOMY: THE TIPPING POINT IN GREENWASHING

One of the core objectives of securities regulation is investor protection, which includes facilitating informed decision-making by investors.[68] Historically, mandatory disclosure has been the preferred regulatory tool to attain that objective. In the same spirit, the UK legislature announced a new mandatory disclosure regime to tackle yet another problem in financial markets, namely greenwashing. On 18 October 2021, the UK Government released *Greening Finance: A Roadmap to Sustainable Investing* (the "Roadmap"), which focuses on three principal areas:

1. The UK Sustainability Disclosure Requirements and investment labels, together known as the UK SDR, whereby in-scope financial market participants will have to make sustainability disclosures.

2. A UK Green Taxonomy, which will classify and define green assets and companies.

3. Responsible Stewardship, which is expected to incentivize the pensions and investment sectors to actively engage with companies on climate change and promote long-term value creation.[69]

Notably, the Roadmap is a very ambitious plan by the UK Government, but a complete discussion of it is beyond the scope of this article. [70] In the following paragraphs, we focus exclusively on the UK Taxonomy and discuss how it can help reduce agency costs in the principal-agent relationship between GPs and socially-minded LPs. We purposefully exclude the UK SDR from the scope of this paper because the narrow scope of the SDR regime—that includes only UK asset managers but not overseas funds

67. George Akerlof, *The Market for "Lemons": Quality Uncertainty and The Market Mechanism*, 84 Q.J. ECON. 488 (1970).

68. JOHN ARMOUR ET. AL., PRINCIPLES OF FINANCIAL REGULATION 44 (Oxford Univ. Press 2016).

69. H.M. TREASURY, ROADMAP, *supra* note 9.

70. Antony Hainsworth of Latham and Watkins provides an overview of the various legislative proposals. *See* Anthony Hainsworth, *Going Green: Global Finance and the UK Green Taxonomy*, 37 J. INT'L BANK. L. REGUL. 77 [2022]; David Berman et al., LATHAM & WATKINS LLP, *UK Government Releases Roadmap to Sustainable Investing*, GLOBAL FIN. REG. BLOG (Oct. 22, 2021), https://www.globalfinregblog.com/2021/10/uk-government-releases-roadmap-to-sustainable-investing/.

and portfolio management services—limits its practical impact on the UK's institutional alternative investment market.[71]

The UK Taxonomy seeks to define the criteria that specific economic activities must meet to be considered environmentally sustainable under UK securities law (the so-called "Taxonomy alignment"). It will apply to UK-registered companies, certain UK-listed issuers, UK managers and asset owners, as well as investment products. However, the specific thresholds have not been worked out yet. Regarding the asset management industry, the UK Taxonomy will also capture PE, which is the focus of this article.

The overarching framework of the UK Taxonomy, at least superficially, looks very similar to the EU Taxonomy. Hence, both regimes share the same six environmental objectives: (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) pollution prevention and control, (v) transition to a circular economy, and (vi) protection and restoration of biodiversity and ecosystems.[72]

Like the EU regime, Technical Screening Criteria ("TSC") underpin each environmental objective. An individual TSC will be developed for each economic activity in the Taxonomy. They will set out how that specific activity can substantially contribute to the relevant environmental objective. This assessment will take the form of a quantitative threshold, typically but not exclusively, in terms of greenhouse gas emissions. TSC for the first two environmental objectives—climate change mitigation and adaptation—will be implemented first and will be based on the EU drafts. At the time of writing, the UK government is expected to consult on TSCs for the remaining four objectives.

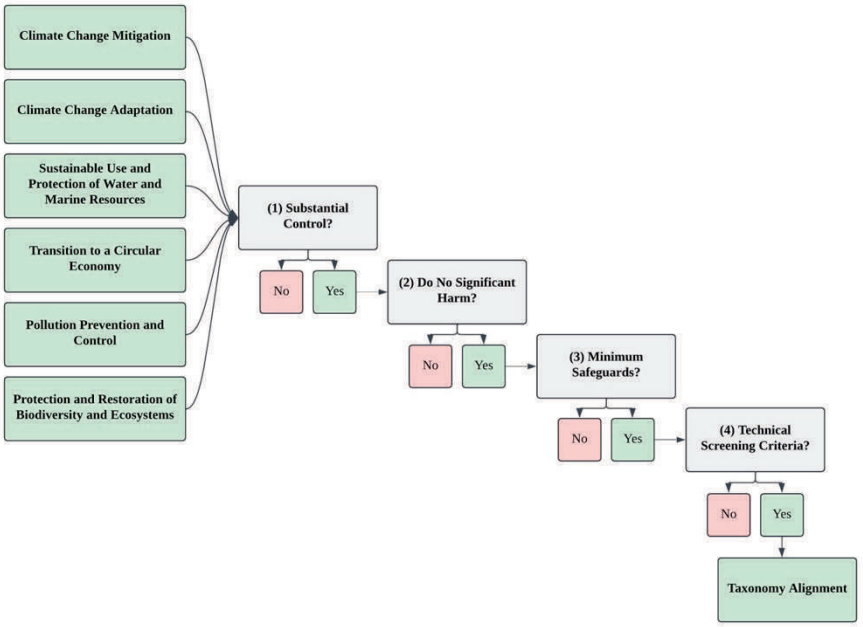
To be Taxonomy-aligned, every economic activity must satisfy three tests (see Figure 4), which are consistent with those established at the EU level: first, it must contribute substantially to one of the six environmental objectives—i.e. it must perform above the quantitative threshold set in the relevant Technical Screening Criteria (TSC); second, it must do no significant harm ("DNSH") to the other environmental objectives, in accordance with the DNSH principle outlined in the relevant TSC; and third, it must comply with a set of minimum safeguards, which will be aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.[73]

71. Greg Norman et al, *FCA Finalises UK Sustainable Investment Rules, With More To Follow After Further Consultation*, SKADDEN INSIGHTS (Jan. 8, 2024), https://www.skadden.com/insights/publications/2024/01/fca-finalises-uk-sustainable-investment-rules.

72. H.M. GOV'T, ROADMAP, *supra* note 9, at 23; EU Taxonomy Regulation, *supra* note 10, recital 24.

73. H.M. GOV'T, ROADMAP, *supra* note 9, at 24; EU Taxonomy Regulation, *supra* note 10, recital 20.

Figure 4: What is "Green" Under the UK Taxonomy?



To that end, in-scope businesses will be required to assess both their current practices and their future objectives. With respect to current practices, companies must evaluate how their economic activities contribute to the relevant environmental objectives based on reported data, rather than forward-looking projections. [74] That being said, the UK Taxonomy also recognizes that certain economic activities may not presently deliver a positive environmental contribution but can nonetheless be aligned with long-term sustainability goals. These include *transitional activities and investments,* as well as *enabling activities*.

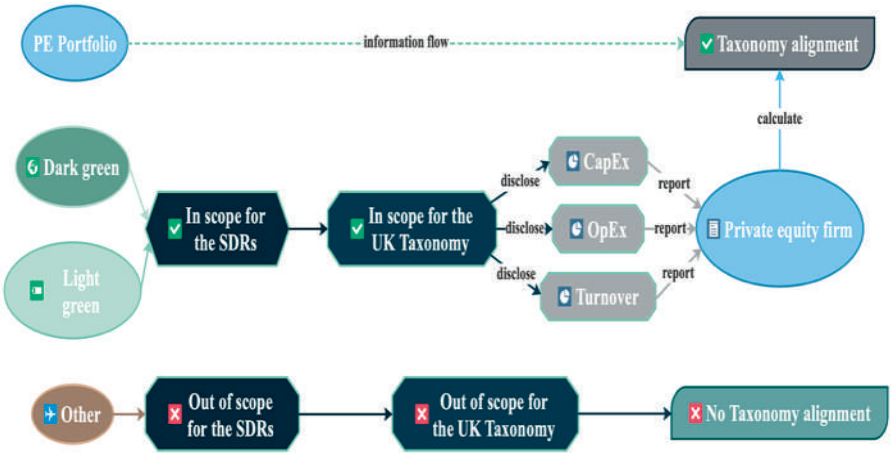
Under the former, the Technical Screening Criteria (TSC) may, in some cases, set the threshold for alignment at the level of best-in-sector emissions, acknowledging that some sectors cannot yet operate in a fully Taxonomy-aligned manner. Consequently, activities that represent credible steps towards a more sustainable business model may still qualify as aligned. Under the latter, activities that support the environmental transition by enabling other sectors to meet their sustainability commitments may also be recognized under the Taxonomy framework, even if the enabling activity itself is not inherently sustainable, such as the manufacturing of components for wind turbines. [75]

Financial and non-financial firms in scope for the UK SDR will have to disclose the proportion of their capital expenditure, operational expenditure,

74. H.M. GOV'T, ROADMAP, *supra* note 9, at 26.
75. *Id.*

and turnover that, in each case, relates to UK Taxonomy-aligned activities. Using that disclosed data, providers of investment funds and products will be required to disclose the extent to which their products are UK Taxonomy-aligned based on the underlying assets. Ultimately, GPs will have to disclose a straight percentage, indicating what proportion of their total investments are sustainable according to the UK Taxonomy (see Figure 5).

Figure 5: Taxonomy Alignment of Financial Products



The UK securities regulation will decrease the information asymmetry between PE firms and LPs by imposing mandatory disclosure obligations on the former. First and foremost, the UK Taxonomy alignment of a GP will, in theory, send a credible signal about the environmental sustainability of its portfolio. Information about, for instance, the proportion of revenue that a PE-backed company derives from selling sustainable products will allow LPs to track sustainability-driven revenue growth. This way, the UK Taxonomy will enable investors to distinguish between GPs that put ESG at the heart of their portfolio from GPs that are "all talk and no action". In addition, having a common definition of sustainability and a standardized disclosure regime will enable LPs to meaningfully compare sustainability performance across different GPs. This way, investors will be able to allocate capital in an ESG-conscious way.

Second, introducing an objective and transparent metric for evaluating action on ESG and sustainability, such as the level of CO_2 emissions, will help increase LPs' confidence in the accuracy of the data. This also implies that the information that GPs will disclose can be subjected to the rigor of external verification. As a result, it will be difficult to make untrue or misleading claims that PE-backed companies are sustainable. Furthermore, the disclosed information also makes for strong evidence that LPs could use if they decide to make litigation claims against portfolio companies or funds.

Therefore, the fact that these sustainability measures will be established and legally enforced will make the signal of environmental sustainability credible.

Of course, it could be argued that, while quantifiable inputs such as the current level of CO_2 emissions can be captured easily, environmental sustainability is a dynamic process which is not entirely measurable.[76] This, in turn, will ensure that arbitrage opportunities, unfortunately, remain present, regardless of how efficient the UK Taxonomy is. This problem is further exacerbated by the fact that the UK Taxonomy will be based on backwards-looking data.

That being said, the UK Government is taking steps to address this issue.[77] In particular, GPs subject to the UK SDR will have to disclose the environmental objective to which their portfolio companies contribute and describe how and to what extent they invest in Taxonomy-aligned economic activities. This combination of qualitative and quantitative information will provide LPs with additional data points to assess the current level of CO_2 emissions and the emission reduction trajectory. On the other hand, having a standard metric in the form of UK Taxonomy alignment is essential to tackle greenwashing. This is because, unlike narrative disclosure, it makes sustainability fraud easier to detect and facilitates verification by courts.[78]

Another concern could be that GPs will still be responsible for calculating their own UK Taxonomy alignment and will retain indirect control over the analysis done by portfolio companies. In turn, this may undermine the credibility of the UK Taxonomy.[79] However, while GPs will have discretion in calculating Taxonomy alignment, they will not be able to select the metrics for measuring sustainability; rather, regulation will establish standard measures. In turn, this would make the signal costlier to imitate. In other words, GPs will find it difficult to calculate their Taxonomy alignment in a way that will emphasize positive sustainability information and hide information about unsustainable practices. This way, the UK Taxonomy promises to reduce the adverse selection problem associated with private ESG metrics.

Based on the preceding analysis, the UK Taxonomy is expected to effectively curb greenwashing, thereby reducing the agency costs of sustainable corporate governance in PE. Furthermore, the implementation of the UK Taxonomy is expected to have a profound impact on the PE industry because the UK lacks a comparable sustainability disclosure regime that covers private companies or affects their business operations. Although asset

76. Steuer & Tröger, *supra* note 16.

77. H.M. TREASURY, MOBILISING GREEN INVESTMENT, *supra* note 9.

78. Pacces, *supra* note 12.

79. *See generally* Daniel Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 YALE J. ON REGUL. 625 (2019).

managers in the UK with AUM exceeding £5bn are now subject to the Task Force on Climate-Related Financial Disclosures ("TCFD") disclosure regime[80] that mandates annual reporting with specific metrics at both entity and product levels, this regulatory tool falls short in several key aspects. Notably, PE firms are not expected to disclose quantitative information if underlying data is missing, potentially allowing for inadequate disclosure (a mere explanation would suffice in this case). But even when underlying data is available, the lack of a uniform reporting methodology enables PE firms to use subjective approaches in metric calculations, potentially portraying sustainability performance in a biased manner. Therefore, the UK Taxonomy is anticipated to bring about a transformative impact on the PE industry by establishing clear standards, requiring comprehensive disclosures, and promoting transparency and accountability.

IV. THE CORPORATE GOVERNANCE RESPONSE OF GENERAL PARTNERS

A. THE ALPHA OF PRIVATE EQUITY INVESTMENTS

PE firms have strong incentives to take actions that are value increasing or maximizing. First, the structure of the industry is such that LPs commit capital to selected funds that will be typically locked in for ten years. In turn, this inability of investors to trade shares warrants a significant illiquidity premium. Put another way, LPs choose to invest in PE because they seek higher returns than what is available from more liquid investments or from conservative fixed-income instruments.

Second, the fee structure that prevails in the industry reinforces GPs' value-maximizing objectives. GPs charge investors a management fee of around two percent of committed capital and a performance fee of typically 20 percent of fund returns. This means that they also have a strong personal interest in maximizing each investment they make on behalf of LPs. Therefore, PE's ability to outperform traditional asset classes over the long term makes it different from other investment classes. This competitive advantage has important implications for sustainable corporate governance in PE, especially on the incentive to use *voice*. Indeed, we posit that any discussion on the matter shall begin by asking whether choosing *exit* over *voice* is in the financial best interest of GPs.

80. TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES, https://www.fsb-tcfd.org/ (last visited Feb. 22, 2025).

B. BASELINE ASSUMPTIONS AND THE UK TAXONOMY

Eugene F. Fama[81] developed a simple framework that can be applied to show when GPs can outperform the market.[82] We begin by assuming that all actors in the PE market are rational and markets are efficient. Under this assumption, the efficient market hypothesis ("EMH") states that market participants incorporate all available information into asset prices.[83] In practice, markets react to publicly available new information very quickly, so investors cannot systemically earn excess returns by trading on that information ("semi-strong-form efficiency").[84] This suggests that once the UK Taxonomy is in force and in-scope companies disclose their alignment, the market will rapidly adjust to this new information to capture the impact of Taxonomy alignment on market value (see the green line in Figure 6).[85] Consequently, GPs will not be able to "beat the market" by investing in sustainable companies or avoiding unsustainable ones, i.e. by way of *exit*. Therefore, in this case, it is not in the financial best interest of GPs to choose *exit* over *voice*.

81. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

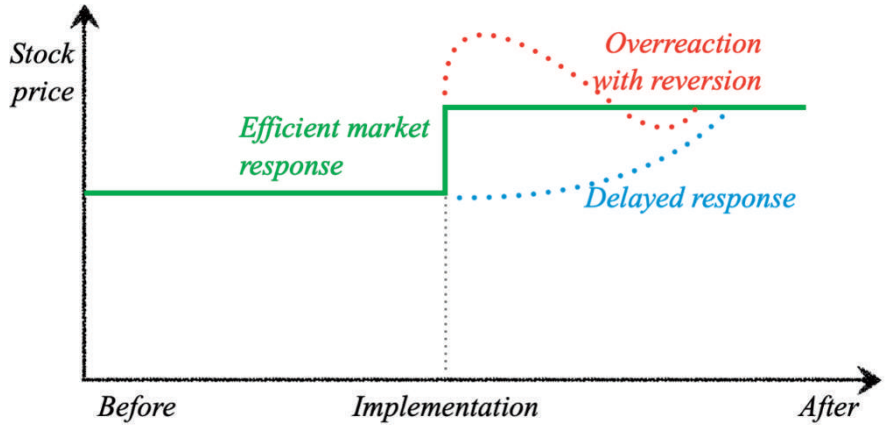
82. While the EMH is traditionally applied to public markets, we believe that it also offers valuable insights for understanding market behavior and price dynamics in PE, particularly as it relates to mandatory ESG disclosures. The UK Green Taxonomy will require in-scope PE firms to calculate a Taxonomy alignment score based on the ESG data reported by the companies within their portfolios and include this information in pre-contractual documents and/or on firm websites and through periodic disclosures, depending on the fund's investment objective. As such, this new requirement will introduce a significant amount of previously unavailable information to private markets. Thus, applying the EMH to analyze the effects of the UK Green Taxonomy on PE is warranted, as it helps predict how the introduction of this new information might influence the valuations of investee companies, which have historically been exempt from such disclosure requirements.

83. Fama, *supra* note 81.

84. *See* Andrew C. Worthington & Helen Higgs, *Random Walks and Market Efficiency in European Equity Markets*, 1 GLOB. J. FIN. ECON. 59 (2004).

85. DELOITTE, DOES A COMPANY'S ESG SCORE HAVE A MEASURABLE IMPACT ON ITS MARKET VALUE? (2022), https://www2.deloitte.com/ch/en/pages/financial-advisory/articles/does-a-company-ESG-score-have-a-measurable-impact-on-its-market-value.html.

Figure 6: Market Reaction to Disclosure Under the UK Green Taxonomy



The above conclusion assumes that markets are efficient and rational. Yet, the UK Taxonomy will introduce a new sustainability classification system, so markets may be slow to recognize the impact of Taxonomy alignment on companies' competitive positions and long-term valuations. Consequently, asset prices may not reflect that information (see the blue line in Figure 6). This is because, in a private M&A context, buyers can include public or private companies, not just PE firms. If the buyer falls outside the scope of the UK Taxonomy, particularly if they are a private company that does not meet the threshold requirements, they may lack the incentive to perform detailed ESG due diligence, as they are much more sensitive to the additional costs associated with that. Conversely, potential targets will likely wait until they can assess the premium associated with Taxonomy alignment before voluntarily including comparable ESG data in their vendor due diligence reports. This way, they will ensure the premium outweighs the cost of producing such data.

In this state of market inefficiency, GPs can achieve excess returns by choosing *exit* over *voice* if they invest ahead of or during this adjustment process, which will be the most likely outcome in the short run.[86] With the mandatory nature of the UK Taxonomy, and hence the higher risk of litigation, PE firms will be incentivized to conduct rigorous ESG due diligence on potential targets, enabling them to identify Taxonomy-aligned companies at lower valuations. While we cannot precisely determine how long the price adjustment process will take, a potential concern is that if it occurs more quickly than anticipated, PE firms might fail to capitalize on

86. Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 389 (1980); G. William Schwert, *Anomalies and Market Efficiency*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 939 (George M. Constantinides M. Harris and Rene M. Stulz eds., 2022).

arbitrage opportunities due to a traditionally prolonged buyout process. However, it is important to note that PE firms might be able to realize profits more quickly in this market environment compared to a typical buyout scenario. Simply by disclosing the readily available ESG information to the market once the price adjustment is complete, PE firms can potentially flip the companies for a profit without holding them for extended periods or engaging deeply with management on ESG matters. Indeed, the proposition that GPs are in the best position to take advantage of such opportunities is empirically validated.[87]

This would be a one-time adjustment.[88] That is because GPs will turn the market efficient in the long run by acting on arbitrage opportunities.[89] While this process might take a long period of time, prices will strive towards their equilibrium level as arbitrage opportunities start to diminish. As explained earlier, screening potential portfolio companies can no longer produce better-than-average performance in a state of market efficiency. As an illustration of this adjustment process, Bebchuk, Cohen, and Wang document that abnormal returns initially correlated with highly rated corporate governance subsequently disappeared. [90] They explain that market participants initially did not pay much attention to good governance; thus, companies that followed good governance were undervalued and delivered excess returns. Yet, the market gradually learned to appreciate the difference between good and bad governance; hence, the governance indices no longer generated abnormal returns. In this regard, increased disclosure under the UK Taxonomy will likely speed up the adjustment process. Nonetheless, we anticipate that at the beginning, GPs will seek to attract socially-minded LPs by way of *exit* because they can outperform the market simply by acting on arbitrage opportunities.

C. *VOICE* STRATEGIES IN PRIVATE EQUITY: A PARADIGM SHIFT

However, to use an analogy applicable to the moniker "barbarians at the gate", PE firms, once like barbarians with free rein, may end up facing closed gates and insurmountable barriers. This is because the metaphorical drawbridge of *exit* strategies will be slowly pulled up by three mighty forces, and the invaders will be left standing outside, unable to breach the castle's defenses. First, there is a limited number of companies that are already

87. Steven Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPECTIVES 121 (2009) (finding that PE investors either successfully identify undervalued companies or take advantage of market timing).

88. Jeroen Derwall et. al., *The Eco-Efficiency Premium Puzzle*, 61 FIN. ANALYSTS J. 51 (2005); *see* Luc Renneboog et. al., *Socially Responsible Investments: Institutional Aspects, Performance, and Investor Behavior*, 32 J. BANK. FIN. 1723 (2008).

89. Charles M.C. Lee, *Market Efficiency and Accounting Research: A Discussion of "Capital Market Research in Accounting" by SP Kothari*, 31 J. ACCT. ECON. 233 (2001).

90. Lucian A. Bebchuk et. al., *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013).

green,[91] and naturally, screening reduces the range of investee companies available to GPs. However, by investing in a narrower range of companies, GPs will lose on diversification benefits, exposing themselves to higher idiosyncratic risk compared to conventional PE firms. [92] Consequently, screening will lead to a diversification penalty.

Second, the price of excluded unsustainable companies will drop, and therefore, they will yield higher risk-adjusted returns. Inevitably, some conventional GPs will find those companies more attractive and ultimately outperform green funds (the so-called "brown spinning").[93] In this case, committing capital to green funds means that LPs may miss out on opportunities that generate returns they might otherwise enjoy. Third, green investment opportunities are not only relatively scarce but also small in size. As a result, they limit GPs' ability to invest at scale, which is what PE firms seek to do in buyouts. Therefore, if adopted at all, it is highly unlikely that *exit* will be the dominant strategy in PE.

In an alternative scenario, investors may overreact to the implementation of the UK Taxonomy. In this case, investors will get too optimistic about the impact of Taxonomy alignment on companies' competitive positions and long-term valuations, which will lead to excessive trading. In turn, this overreaction will cause asset prices to increase too much (see the red line in Figure 6). Subsequently, investors will realize their mistake, and asset prices will revert to equilibrium. However, it is unlikely that PE firms will buy overvalued companies and sell them at a lower price—indeed, they are known for quite the opposite, as discussed earlier. Hence, *exit* is not a viable option in this context.

Bringing market pricing into the analysis has an important implication. It suggests that, apart from investing ahead of or during market transitions, PE firms can generate excess returns only by adopting a dynamic strategy to transform portfolio companies into Taxonomy-aligned businesses on exit. Notably, this is standard practice in PE, which is empirically validated.[94] Instead of screening companies, any payoff will stem from active engagement with management to help build sustainable businesses that the market will price highly on exit. Therefore, this makes GPs natural candidates for *voice*. While a rigorous empirical study on this issue is yet to be conducted, anecdotal evidence supports the argument that *voice* will likely become the dominant strategy in PE. An excellent example of active

91. Gagan D. Sharma et. al., *Is There a Cost for Sustainable Investments: Evidence from Dynamic Conditional Correlation*, 1 J. SUSTAIN. FIN. INV. 1 (2021).

92. Andrew Rudd, *Social Responsibility and Portfolio Performance*, 23 CALIF. MGMT. REV. 55 (1981).

93. The phenomenon of brown-spinning is an open question that cannot be addressed in this article. *But see* Gözlügöl & Ringe, *supra* note 47.

94. Luc Renneboog et. al., *Why do Public Firms go Private in the UK? The Impact of Private Equity Investors, Incentive Realignment and Undervaluation*, 13 J. CORP. FIN. 591 (2007).

engagement is the acquisition of Żabka, a chain of convenience stores in Poland, by CVC in 2017.[95]

Although GPs will likely achieve financial gains from choosing *voice* over *exit*, those may be offset by potential monitoring costs and free-rider issues associated with shareholder engagement.[96] Yet, we posit that PE's *modus operandi* puts GPs in an excellent position to implement a sustainability agenda and mitigate the market failure induced by free-riding.

PE-backed companies have a unique structure. First, their boards have one or more representatives of the GP. Therefore, the GP has a strong influence in appointing other members to the board, as well as pressuring the board into making valuable changes. Second, the GP tends to have full access to management accounts within portfolio companies. As a result, they can access significant additional information, including sustainability-related data, upon request. This is in stark contrast to investors in publicly listed companies that see only what the company reports. Third, the GP primarily determines executive compensation in portfolio companies. In addition, it is not unusual for a PE firm to initiate a management change if a CEO is not delivering.[97] This implies that GPs have virtual control over portfolio companies, enabling them to propose a sustainability agenda and effectively monitor its implementation. Hence, the PE governance model makes the industry well-suited to actively transform portfolio companies with poor environmental performance.

Furthermore, PE firms have a unique ownership structure: they usually acquire a majority or significant stake in portfolio companies. Such concentrated ownership stakes magnify GPs' incentives to execute engagement activities, short of free-rider problems.[98] This is because they can *capture* most of the resulting benefits from their engagement activities. Besides, once the engagement campaign is ultimately successful in achieving Taxonomy alignment, GPs can *capitalize* on the subsequent increase in the company's value. Under the UK Taxonomy, PE-backed companies will have

95. Before the acquisition, Żabka was a typical convenience store operating in a stagnant industry. But CVC decided to engage with the company and implemented several ESG-related efficiencies and savings. In particular, it replaced refrigerants to offset CO_2 production at the company, and it reduced the weight of the packaging for one of the sandwich brands Żabka was working with, thereby eliminating three tons of plastic waste—to name but a few examples of engagement with the portfolio company. Żabka became the first retailer in the country to sell its branded beverages in 100 percent recycled plastic bottles. In financial metrics, this engagement resulted in a 20 percent increase in annual revenue between 2017–2020 and a 3.9 percent increase in gross margin. AXEL SEEMANN, ET. AL., BAIN & CO. THE EXPANDING CASE FOR ESG IN PRIVATE EQUITY (2021), https://www.bain.com/insights/esg-investing-global-private-equity-report-2021/.

96. Willard T. Carleton et. al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335, 1339 (1998).

97. Leonce Bargeron, et al., *What is the Shareholder Wealth Impact of Target CEO Retention in Private Equity Deals?*, 46 J. CORP. FIN. 186 (2017) (finding that the target CEO is dismissed in about 32 percent of the PE deals in their sample).

98. *See generally* Sanford J. Grossman and Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL. J. ECON. 42 (1980).

to measure their environmental performance so that GPs can produce Taxonomy alignment figures for the whole portfolio. Ultimately, the greenness of a company will be expressed as a straight percentage, easily recognizable by a sustainability-focused buyer. This will enable GPs to articulate the company's sustainability performance and achieve an additional return on the incurred costs of engagement.[99] This analysis shows that PE's ownership model and governance structure will enable the industry to buy and transform companies with lagging sustainability performance in a cost-effective way. Hence, this reinforces the argument that *voice* will likely become the dominant corporate governance response in PE.

Lastly, another factor that will help incentivize PE firms to choose *voice* over *exit* is competitive pressure. On the one hand, GPs compete for sustainability-conscious investors with public markets and other alternative investment classes. Empirical evidence confirms that a growing number of LPs and their beneficiaries, particularly millennials and Generation Z, are interested in making a social impact at the expense of profits.[100] In turn, those interests are more compatible with the exercise of *voice* in organizations. Furthermore, to attract such investors, GPs may be encouraged to choose *voice* over *exit* even in the short term. This is because PE firms are engaged in a "repeated game"[101]—while achieving "alpha" in any one investment is important to their financial success, it is only one in a number of interactions with LPs. If GPs choose *exit* after the immediate implementation of the UK Taxonomy, as expected, sustainability-conscious investors may be less inclined to participate in subsequent fundraisings. Therefore, to remain competitive in the market, GPs will likely prefer *voice*, regardless of how attractive short-term returns from *exit* may be.

On the other hand, GPs compete for portfolio companies, which affects their profitability. Indeed, recent research shows that PE returns have been trending downwards over the past few decades.[102] The main reason for this drop is that, on average, PE firms are paying more for targets than ever due to increased competition.[103] As explained earlier, one of the limitations of choosing *exit* is that green investment opportunities are relatively scarce. Given the competition for green investments—which will only increase in

99. DELOITTE, *supra* note 85.

100. Florencio Lopez de Silanes et. al., *Institutional Investors and ESG Preferences*, 32 CORP. GOVERNANCE INT. REV. 1060 (2024).

101. Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANK'G & FIN. L. 115, 119 (2014).

102. Antti Ilmanen et. al., *Demystifying Illiquid Assets: Expected Returns for Private Equity*, 22 J. ALTERNATIVE INV. 8 (2019) (finding that PE returns relative to public market equivalents have declined in the past 15-20 years); Erik Stafford, *Replicating Private Equity with Value Investing, Homemade Leverage, and Hold-To-Maturity Accounting*, 35 REV. FIN. STUD. 299 (2021) (finding subpar buyout returns since the financial crisis).

103. *Id*.

light of the heightened regulatory scrutiny—GPs will have to pay higher prices to acquire companies, further limiting their gains on exit.

In contrast, choosing *voice* will enable GPs to secure a competitive edge in auctions, where they can have a bidding advantage over other buyers. In particular, PE's governance and ownership model puts GPs in an excellent position to transform a company from grey to green. Because they have a sustainability agenda to make more from an investment, they are justified in paying more for it. Therefore, *voice* strategies can also enhance GPs' ability to maximize portfolio performance.

D. RESPONSES TO POTENTIAL COUNTERARGUMENTS

It is important to note that such active ESG engagement by GPs with portfolio companies is time-bound (unlike other professional block holders in public companies). The life of a fund following a buyout strategy is typically set at 10 years from its establishment, but it can and frequently will be extended by up to four years.[104] Yet, in practice, on average, PE funds hold their portfolio assets between three and six years.[105] Therefore, the incentives to engage with a portfolio company on ESG issues are focused on a specific time horizon and could be reduced as a result. In particular, it could be argued that given the limited life of PE funds, it is not optimal for GPs to choose *voice* over *exit*.

The "medium" holding period of PE funds, however, does not change our analysis. This is because the exit value of a portfolio company is the core driver of returns in a PE buyout.[106] In turn, the exit value is linked to the company's long-term value and growth trajectory as it is passed on to the next owner.[107] As shown above, buying out an unsustainable business and making capital expenditures that create ESG value make the PE-backed company more attractive to investors. This is because it reduces (transition) risk and increases liquidity for the next owner, thereby leading to a higher valuation multiple for GPs. Therefore, the financial incentive for *voice* discussed earlier is magnified by the legal structure of PE funds.

Yet, in the context of Goshen and Squire's calculus, the sustainable corporate governance model envisioned in this Article could also give rise to "principal" costs, i.e. costs that arise when investors—in this case, GPs on behalf of their LPs—exercise control.[108] In particular, PE has often been perceived as oriented towards producing short-term returns. This may

104. Simon Witney, CORPORATE GOVERNANCE AND RESPONSIBLE INVESTMENT IN PRIVATE EQUITY, ch.1 (2022); *see also* Kaplan & Strömberg, *supra* note 87.

105. Kaplan and Strömberg, *supra* note 87; Juha Joenväärä et. al., *Prolonged Private Equity Holding Periods: Six Years is the New Normal*, 1 J. ALTERNATIVE INV. 165 (2022).

106. *See* Indahl & Jacobsen, *supra* note 45, at 41.

107. *Id.*

108. Zohir Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017).

undermine portfolio managers' long-term vision of sustainability for their companies. However, we posit that PE funds are particularly well-suited both to cater to the sustainability needs of their LPs and drive changes in portfolio companies in alignment with the values of the management.

First, the main goal of GPs is to create value upon exit, not at the time of investment. To generate excess returns, they must build a better business than the one they acquired. To that end, employing cost-cutting measures alone is usually not enough. Reducing costs will, of course, positively affect margins and provide some value. But high-performing PE owners seek to sustainably increase growth trajectory during the holding period because growth is rewarded with a higher valuation than margin.[109]

Second, sustainability transformations are complex and volatile, and as a result, these investments do not promise short-term profits. Indeed, given the delicate balance portfolio companies must strike between financial return and social impact, they tend to require patient capital. GPs, focusing on building a close relationship with management, are uniquely positioned to meet that need. By its nature, the PE asset class is illiquid and intended to be a long-term investment for LPs. This implies that portfolio companies have a built-in period to grow. Therefore, GPs' engagement in sustainable corporate governance will not necessarily increase principal costs. On the contrary, the PE business model can mitigate those costs.

E. POLICY RECOMMENDATIONS TO ENHANCE SYNERGIES BETWEEN THE UK GREEN TAXONOMY AND THE UK SDR

The discussion so far points to the fact that the UK Taxonomy will address some of the concerns of greenwashing by defining what is "green." In this way, it will reduce the agency costs of sustainable corporate governance in PE. However, it is important to note that the UK Taxonomy is just one tool in the Government's regulatory toolbox aimed at achieving net zero. Another key tool is the UK SDR, as mentioned earlier. While a detailed discussion of the UK SDR regime is beyond the scope of this paper, it is important to analyze its interaction with the UK Taxonomy, particularly regarding potential unintended behavioral consequences within the alternative assets market.

The EU's experience with the Taxonomy Regulation[110] and the Sustainable Finance Disclosure Regulation ("SFDR")[111] is a case in point. Under the EU regime, any in-scope fund will have to calculate its alignment score made up of the scores of its portfolio companies under the Taxonomy Regulation. However, only funds classified as "light green"[112] and "dark

109. *See generally* Witney, *supra* note 104.
110. EU Taxonomy Regulation, *supra* note 10.
111. *See generally* SFDR, *supra* note 14.
112. *Id.* art 8.

green"[113] under the SFDR are required to report their scores. This current SFDR classification of investment funds has been widely perceived as a *de facto* labelling regime within the industry, at both the market participant and investor level, where investment funds are either deemed "green" or not.[114]

The problem with such a binary approach is that it runs the risk of being both too strict and too loose in its labelling. In turn, this may lead to ill-informed decision-making by investors. For example, an LP might rule out a highly ESG-motivated PE fund classified as an Article 6 product[115] because it cannot meet the data requirements yet. At the same time, if an LP commits capital to a fund that can easily meet the green threshold, it may discourage the GP from engaging with its portfolio companies. This, in turn, would undermine the primary goal of the UK Government to transition the economy towards net zero. Therefore, divergence from the EU approach is desirable to ensure that private sector engagement is incentivized.

Another more promising approach could be the introduction of a greater level of granularity into the UK SDR (see Figure 7). In particular, it should cover investment funds targeting positive change but not green yet (e.g. aiming for a reduction in greenhouse gas emissions on exit) alongside funds which will easily qualify as "green" under the UK SDR. Notably, such a step could open the possibility of greenwashing in this category. This is because GPs may be tempted to overpromise what their funds can deliver to attract capital without improving the environmental performance of portfolio companies afterwards. To mitigate the risk of potential greenwashing, careful thought will need to be given to translating longer-term targets into thresholds for Key Performance Indicators ("KPIs") that gradually change over time.

113. *Id.* art 9.

114. EUR. COMM'N, SUMMARY REPORT OF THE OPEN AND TARGETED CONSULTATIONS ON THE SFDR ASSESSMENT 14 SEPTEMBER 2023–22 DECEMBER 2023 1, 14 (May 3, 2024), https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2023-sfdr-implementation_en.

115. *See generally* SFDR, *supra* note 14, at art. 6.

Figure 7: Proposed Classification of Investment Products

SDR Product Label (mapping SFDR)	Overview of Category	Eligibility Criteria (mapping to SFDR)
Dark Green	Products pursuing a sustainable objective	Article 9 SFDR
Light Green	Products promoting environmental or social characteristics	Article 8 SFDR
Transitioning	Products with sustainable objectives and low or no allocation of Taxonomy-aligned investments	N/A

To provide a sense of direction for designing an adequate taxonomy for transition funds, we suggest breaking down long-term targets into annual targets, as was done for the entire UK economy. In this case, the interim target is to reduce emissions by 78 percent by 2035 compared to 1990. As UK emissions were 48 percent below 1990 levels in 2020, the 2035 interim target implies a reduction of approximately 30 percent over the next 15 years, or about two percent per annum. Taking the example of a two percent annual greenhouse gas reduction, a natural choice for transition funds would be a yearly threshold of two percent greenhouse gas reduction. If individual targets for specific industries exist, the annual target should be tailored accordingly. In this way, LPs will be able to track the sustainability performance of such funds. At the same time, GPs will be incentivized to engage with their portfolio companies to ensure compliance with annual targets.

Although the overall architecture of the EU's and UK's green regimes will be similar, it is essential to recognize that the EU rules have not entirely hit their mark, and some divergence between the two regimes is necessary.[116] By learning lessons from the EU experience, the UK may benefit from some second-mover advantages and design a regulatory framework that will help investors better assess the sustainability characteristics of economic activities and financial products. Ultimately, this will support the UK's transition to a net-zero economy.

116. *See generally*, Caterina Lucarelli et al., *The Impact of EU Taxonomy on Corporate Investments*, 11 J. FIN. MGMT., MKTS., & INSTS. 235004 (2023)

CONCLUSION

There has been no shortage of finger-pointing towards the classic *modus operandi* of PE. British labor leaders dubbed PE firms "casino capitalists" and "amoral asset strippers,"[117] while Bryan Borrough and John Helyar famously described them as "barbarians at the gate."[118] More recently, the industry has been facing accusations of greenwashing due to considerable investor interest in sustainability. In response to the growing concern over greenwashing, the UK Government announced the development of its own Green Taxonomy—a fundamental pillar of the UK's *Greening Finance: A Roadmap to Sustainable Investing*.[119] It seeks to shift capital flows towards sustainable investments by utilizing all significant economic actors, including PE firms, in the process. This raises the question of whether these barbarians at the gate, long blamed for destroying portfolio companies, can be relied upon to make them sustainable and future-proof.

This article's investigation into PE shows that the UK Taxonomy will mitigate the asymmetric information problem between GPs and LPs. In turn, this will reduce the agency cost of sustainable corporate governance. In addition, it illustrates that PE firms have the expertise, time horizon, and financial incentives to drive positive change in investee companies. In particular, over the long term, GPs will likely adopt a dynamic strategy to transform unsustainable businesses into sustainable enterprises on exit. This is because using *voice* will ultimately attract higher valuations in financial markets. Yet, during the first years of implementation, GPs may seek to attract socially-minded LPs by way of *exit*, screening for companies that are already Taxonomy-aligned. This is because they will achieve outperformance by investing ahead of or during a market transition when markets are slow to price in new information. However, this will be a one-time adjustment. When equilibrium is reached, green companies will have high valuations, which will make them unattractive PE targets. This, together with the other limitations of *exit* over *voice* discussed earlier, suggests that the adoption of *exit* strategies will likely be limited.

Engaging with portfolio companies makes good economic sense. But perhaps even more importantly, because many LPs are themselves increasingly focused on ESG investing, it may also be critical for the continued growth of PE as an asset class.[120] As regulators, investors, and society at large are increasingly concerned about climate change, the PE industry, like other financial market participants, may face an existential threat if it does not prove its value to society. The findings in this Article

117. Christopher Adams & Peter Smith, *TUC Chief Attacks Private Equity Industry*, FIN. TIMES (Feb. 20, 2007), https://www.ft.com/content/d95fdd3a-c124-11db-bf18-000b5df10621.

118. BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (2d ed. 2009).

119. H.M. GOV'T, ROADMAP, *supra* note 9.

120. *See* Witney, *supra* note 104, at 4.

suggest that sustainable corporate governance by way of *voice* will stand PE in good stead to meet this social value challenge.

Although this Article offers a new perspective on the UK Green Taxonomy and its impact on the corporate governance of PE-backed portfolio companies, it is not without its limitations. First, the questions addressed in this research cannot be settled by logic or anecdotal evidence but by data. Yet, as it currently stands, they cannot be answered empirically because the regulations discussed in this paper are not yet in force. In addition, although evidence shows that LPs have environmental preferences, the exact number of sustainability-minded investors and the amount of capital they are willing to sacrifice are empirical questions which have not been answered yet. Although this Article utilized empirical research on the matter, it is important to acknowledge that extant studies rely on private ESG ratings, which may currently be affected by greenwashing.

Second, given the nature of the PE market, academic research on the industry tends to be limited, and analyzing ESG developments in PE is challenging. To overcome this problem, this Article utilized relevant industry research, surveys, and interviews. Yet, there is a general concern that this type of research is biased and that study results are more often positive when PE houses sponsor the research. Therefore, more rigorous empirical work is necessary to quantify better the effect of the UK Taxonomy on the industry. Further empirical studies are needed to advance knowledge of sustainable corporate governance in venture capital and growth equity. These future studies will provide a better understanding of how climate change and green finance regulation transform all segments of the PE industry.