

Estimating the Cost of Weak Corporate Governance

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Abstract

The purpose of this article is to estimate the cost of poor corporate governance in Korea. Using corporate lawsuit data, a novel high-frequency event study methodology is employed. The key identification strategy is to compare the stock price reaction to the announcement of corporate-governance litigation with the stock price reaction to the announcement of other types of lawsuits. Poor corporate governance is estimated to cost KOSDAQ-listed companies between 4.1 and 9.3 percent of their market value. In contrast, the cost of weak corporate governance appears to be negligible for Korea Exchange-listed companies.

Keywords: Corporate Governance, Lawsuit, Event Study

JEL Codes: G12, G14, G32, K42

I. Introduction

Recently, the importance of ESG investments has become a global priority. Policymakers are exerting their utmost efforts to encourage companies to comply with ESG requirements and to firmly establish ESG standards. Simultaneously, the academic community is engaged in an extensive discussion to understand the economic and financial effects of fast rising ESG norms.

To further comprehend the ongoing debate regarding ESG standards, it is necessary to first understand the cost incurred when the economy fails to fulfill ESG criteria. Narrowing down the focus to corporate governance, we aim to assess the cost of poor corporate governance in Korea by focusing on corporate governance.

Strong corporate governance ensures the efficient allocation of resources, which fosters economic growth. Therefore, poor corporate governance is costly because it has a detrimental impact on economic growth and because monitoring corporate misconduct incurs unnecessary costs. Jensen and Meckling (1976) and La Porte et al. (2001) also emphasize these costs (2002).

While theoretical findings indicate that implementing strong corporate governance improves welfare, it is an empirical question whether implementing strong corporate governance is effective due to the expenses associated with its implementation (Bruno and Claessens 2010; Chhaochharia and Grinstein, 2007; Gillane et al. 2003).

Therefore, it is essential to quantitatively evaluate the cost of poor corporate governance with accuracy. There is already a substantial body of research measuring the impact of corporate governance on firm values. For example Ammann et al. (2011), Bebchuk et al. (2009), Cremers and Nair (2005), Core et al. (2006), Gompers et al. (2003), Yermack (1996), Khan (2019), Bebchuk and Cohen (2005), Bebchuk et al. (2009) and Gompers et al. (2003) estimate how the corporate governance affect the value of the firm using the U.S. sample. In addition Durnve

and Kim (2005), Francis et al. (1998), Klapper and Love (2004) and La Porta et al. (2002) provide international evidence.

Although enormous efforts have been made to estimate the impact of corporate governance, a number of concerns remain. First, according to Khanna et al. (2006), measuring corporate governance is not straightforward. Ertugrul and Hegde (2009) and Larcker et al. (2007) agree that there is no consensus on how to measure corporate governance. In practice, the majority of previous studies measure the effect of corporate governance on firm values using corporate governance ratings data. Unfortunately, according to Wintoki et al. (2012), Hermalin and Weisbach (2004), and Coles et al. (2012), corporate governance ratings data are susceptible to endogeneity issues. Not only does the corporate governance rating have an impact on the business performance of a company, but the business performance also influences the corporate governance rating. Consequently, it is not straightforward to quantify the effect of corporate governance rating on the value of enterprises using corporate governance rating data in a regression context.

In this research we aim to estimate the cost of poor corporate governance in Korea taking advantage of a unique data set on corporate lawsuits. In particular, we take an event study approach to identify how the poor corporate governance affect the value of the firm. The key identification strategy is to compare the stock price reaction to the announcement of corporate-governance litigation with the stock price reaction to the announcement of other types of lawsuits.

Poor corporate governance is estimated to cost KOSDAQ-listed companies between 4.1 and 9.3 percent of their market value. In contrast, the cost of weak corporate governance appears to be negligible for Korea Exchange-listed companies.

II. Identification Strategy and Data

II.1. Identification Strategy

The effect of corporate governance on the firm's value has been a fundamental research question in corporate financial studies for decades. To quantify the cost of weak corporate governance, regressing firm value on corporate governance rating is a frequent empirical approach taken in the existing research. In such situations, a firm value is typically approximated by stock returns or Tobin'Q, and corporate governance rating data is typically obtained from ESG rating agencies.

These approaches are attractive because they are straightforward and intuitive. In addition, data collection is considerably less challenging because commercial data providers offer readily available corporate governance ratings data as part of ESG rating. Despite the simplicity of the methodology, there are several limitations to regressing business values on corporate governance rating and other control variables. Ertugrul and Hegde (2009) and Larcker et al. (2007), for instance, contend that the profession is absent from the unified method of measuring corporate governance. Moreover, Wintoki et al. (2012), Hermalin and Weisbach (2004), and Coles et al. (2012) emphasize that corporate governance level is affected by business performance, implying that simply regressing firm value on corporate governance rating may potentially result in endogeneity bias due to the reverse causality.

This research focuses primarily on overcoming the reverse causality issue that the conventional approach suffers from. To accurately evaluate the cost of weak corporate governance and the influence of corporate governance on the firm's value, we employ an event study approach.

The key identifying assumption is to examine changes in stock price around the date when

firms announce that a lawsuit related to corporate governance issues has been filed. The identifying strategy relies on two assumptions. First, the stock market is subject to semi-strong form efficiency. In other words, the stock price incorporates all publicly available information. The second premise is that the precise timing of the lawsuit is unknown. To be more specific, investors recognize that all companies are susceptible to legal risks and all firms suffer from the certain degree of corporate governance issues. Therefore, investors factor potential legal concerns into stock prices. In other words, investors view corporate governance concerns as probabilistic. However, investors cannot precisely predict when legal concerns will materialize, and therefore, the stock price will respond to the materialization of the corporate governance risk. In the empirical framework of this study, the announcement of a lawsuit related to corporate governance is treated as the realization of the corporate governance risk.

Above discussion translates into the following regression model,

$$r_{i,t+h} - r_m = \beta_0 + \beta_1 D.CGL_{i,t} + \beta_2 D.OL_{i,t} + \beta_3 X_{i,t} + \epsilon_{i,t} \quad (1)$$

where $r_{i,t+h}$ and r_m , respectively are, cumulated stock return from date $t - 1$ to $t + h$ for firm i , and return of the market portfolio. t denotes the date when the lawsuit against firm i has been announced. $D.CGL_{i,t}$ denotes a dummy variable of corporate governance lawsuit (CGL) for firm i at date t . We assign 1 to this dummy variables if firm i announces corporate governance lawsuit at date t , and 0 otherwise. $D.OL_{i,t}$ denotes a dummy variable of non-corporate governance lawsuit (other lawsuit, OL) for firm i at date t . We assign 1 to this dummy variables if firm i announces non-corporate governance lawsuit at date t , and 0 otherwise.

We introduce the non-corporate governance lawsuit dummy to account for the fact that legal risks have a negative impact on the value of firms in general (Bhagat et al., 1998). When a

lawsuit is filed, legal costs are incurred regardless of the nature of the case. Therefore, when non-corporate governance lawsuit dummy are excluded, β_1 can be statistically significant even if poor corporate governance is not at all costly.

Lastly, $X_{i,t}$ denotes other controls which covariates with both $r_{i,t+h}$ and $D.CGL_{i,t}$, which will be discussed in detail in the following sections.

Under this empirical setup, we can conclude that the poor corporate governance is costly if β_1 is negative and $\beta_1 < \beta_2$. In addition, $|\beta_1 - \beta_2|$ measures the cost of poor corporate governance, net of legal costs.

II. 2. Data

A corporate lawsuit data is obtained from DataGuide provided by FnGuide. The key information included in the dataset is the reason of litigation, the date of the announcement, the date lawsuit was filed, plaintiff, and the competent court.

We categorized the following types of corporate lawsuits as corporate governance-related lawsuit: “related to task of board members ((대표)이사 직무 관련 소송)”, “related to shareholders' meeting and board meeting (주주총회 및 이사회 관련 소송)”, “related to shareholder list (주주명부 관련소송)”, and “related to accounting (회계장부 관련소송)”. All other types of lawsuits are considered to be non-corporate governance lawsuit.

We are only interested in cases where firms are defendants and not plaintiffs. There are two reasons why we do not consider cases in which corporations are the plaintiffs. First, if firms are plaintiffs, it is more natural to assume that they intentionally choose to file a lawsuit

endogenously rather than randomly. In such circumstances, it is not straightforward to estimate the regression model without an endogeneity in concern. Second, it is difficult to imagine a large number of directors filing for their misconduct, i.e. poor corporate governance.

We also limit the sample to the initial trials because investors can anticipate the results of the second and third trials based on the outcome of the first trial. In this regard, we view the initial trials as the only purely exogenous event. However, such information is not provided directly by the data provider. Consequently, we regarded the cases handled by district courts as the initial trial. In addition, we only focus on lawsuits handled by Korean judiciary.

Each litigation event is associated with two significant dates: the filing and announcement dates. For nearly all cases, the filing date precedes the announcement date. The point at which an investor acknowledges the occurrence of a lawsuit must be established by empirical analysis. Nevertheless, empirical evidence about the timing of acknowledgement is currently lacking. We therefore assume that investors are aware of the occurrence on the day it is announced, given that only a small number of insiders may have access to such news.

DataGuide provided by FnGuide is the source for daily firm-level stock price data and stock market indices, KOSPI and KOSDAQ. We winsorize cumulative stock returns at the top and bottom 1% levels to prevent estimation results from being influenced by extreme outliers. The sample span is from 2010 to 2021. The starting of the sample period is chosen based on the availability of lawsuit data.

This process yields a sample of 788 corporate governance litigation, 871 non-corporate governance lawsuits, and 2,264,875 observations that are neither subject to corporate nor non-corporate lawsuits. 217 out of 2,696 sample firms faced at least one lawsuit related to corporate governance. The number of firms facing corporate governance lawsuits is less than the sample's number of corporate governance lawsuits. This shows that multiple firms were affected by the

corporate governance issue. At least 422 firms in the sample suffered litigation unrelated to corporate governance at least once.

III. Quantitative Results

As noted previously, one of the primary benefits of the event study method is that estimation employing ordinary least squares is less susceptible to endogeneity concerns. To reiterate, the commencement of the legal procedure as a result of the lawsuit is a random and exogenous event for both firms and investors. In other words, neither investors nor firms can accurately predict the timing of a lawsuit because they are not the plaintiffs. This argument supports the application of the ordinary least squares method.

Panel A of Table 1 summarizes the estimation of the regression model. The model is estimated in its most basic form, with no additional control variables added; $X_{i,t}$ is omitted. The standard errors are clustered at a firm level in accordance with the standard in the literature. The Table reports the estimated coefficients of β_1 and β_2 . We analyze abnormal cumulative returns on the day of the event and one business day, five business days, twenty business days (one month), and sixty business days (one quarter) after the event. At least for the first 20 business days following the event of a corporate lawsuit, cumulative returns are not statistically different from those of firms without the incident. After 60 business days (or one quarter), however, cumulative returns are lower compared to no-event firms by 3.7%, indicating that the cost of weak corporate governance is approximately 3.7% of the firm's market value.

It is important to note is that β_1 evaluates the cost of poor corporate governance gross of legal costs, such as employing attorneys, etc. If legal costs account for a significant portion of

the β_1 , it is difficult to establish that the cost of corporate lawsuit is solely attributable to poor corporate governance. To evaluate the cost of poor corporate governance rigorously, we should calculate the cost of poor corporate governance *net* of legal fees. To do so, we estimate the gross cost of non-corporate governance lawsuits, β_2 , and subtract it from β_1 . Assuming that the average legal expenses of all types of litigation are identical, $\beta_1 - \beta_2$ estimates the cost of weak corporate governance after accounting for legal fees.

Panel A of Table 1 demonstrates that abnormal returns decrease immediately following the filing of the non-corporate governance lawsuit. After sixty business days (or one quarter), the abnormal cumulative return decreases by 2.4% (β_2), indicating that the firm's legal expenditures comprise around 2.4% of its market value. When combined with β_1 , the estimation result suggests that the cost of poor corporate governance is approximately 1.3% (3.7% - 2.4%) of the firm's market value.

Since macroeconomic conditions tend to fluctuate at a lower frequency, macroeconomic variables are less likely to impact the risk of lawsuit and stock prices on a daily basis, particularly when high frequency data are employed for identification. Nonetheless, previous studies have demonstrated that macroeconomic conditions and stock market conditions are deeply linked. To ensure that the results given in Panel A of Table 1 are not attributable to the exclusion of macroeconomic factors, the regression equation (1) is re-estimated with additional controls. In particular, year-quarter fixed effects are added in order to control for arbitrary macroeconomic factors that could potentially influence the probability of a lawsuit and the cumulative abnormal return simultaneously. Additionally, we include the industry fixed effect (3-digit Korea Standard Industry Code) to control for industry-specific effects.

Panel B of Table 1 reports the estimation results. Quantitatively, the estimation result is comparable to the result provided in Panel A. 60 business days (one quarter) following the

news of a corporate governance-related lawsuit, the cumulative abnormal return decreases by about 3.8% compared to non-event corporations. The cumulative abnormal return decreases by 2.3% 60 business days after a non-corporate governance lawsuit is announced. All together, the estimation results imply that the cost of poor corporate governance, net of pure legal fees, approximates 1.5% of the firm's market value (3.8% minus 2.3%).

We will now discuss additional firm-level controls. It is evident from previous research that business performance influences stock returns. Likewise, it is not reasonable to presumptively rule out the idea that the business performance of a firm influences its level of corporate governance. Collectively, ignoring the firm level variables that represent firms' business performance may result in omitted variable bias. In addition to year-quarter fixed effects and industry fixed effects, firm-level balance sheet variables are included in order to address the aforementioned concerns. The regression model includes changes in balance sheet variables normalized by the size of total assets at an annual frequency. To be more concrete, changes in balance sheet variables are measured as follows.

$$dY_{t-1} = \frac{Y_{t-1} - Y_{t-2}}{Total\ Asset_{t-2}}$$

Variables of interests are total debt, sales, gross sales profit, operating income, and net income. In addition log of total assets is included. Considering that firms' stock market performance could influence their balance sheet variables, balance sheet variables at time t-1 are included in the model, but not at time t. All balance sheet variables are winsorized at top and bottom 1% level.

It is evident that firms' corporate governance level affects the likelihood of corporate governance lawsuits. Furthermore, it is reasonable to assume that corporate governance influences the stock market performance of firms. Considering this rationale, the regression

model also includes the corporate governance rating at time $t-1$. As the evaluations for corporate governance are presented on A, B, and C scales, they are included as dummy variables. Korea Institute of Corporate Governance and Sustainability provides the corporate governance rating statistics. Table 2 provides a summary of the estimation result. Surprisingly, coefficients associated with lawsuits are not statistically significant at any time horizon, showing that there is no cost associated with poor corporate governance in Korea.

In order to better understand the result, we re-estimate the model by splitting the sample into two groups: firms listed on the Korea Exchange and Korea Securities Dealers Automated Quotation (KOSDAQ). Table 3 reports the estimation results for two subsamples.

Panel A depicts the estimation result using KOSDAQ-listed samples. Cumulative abnormal return reduces by 8.9% after 20 business days following the news of the corporate governance lawsuits, and by 14.0% approximately 60 business days later. The magnitude of the effect is significantly greater than the pooled regression presented in Tables 1 and 2. In the meanwhile, the cumulative abnormal return decreases by approximately 4.7% from 20 to 60 business days after the announcement of other types of lawsuits. Overall, the estimation result indicates that the cost of weak corporate governance, net of legal fees, ranges from 4.1% (8.9 minus 4.7) to 9.3% (14.0 minus 4.7) of the market value, which is significantly higher than the result of the pooled regression. In contrast, according to Panel B of Table 3, the effect of lawsuits on cumulative abnormal returns, regardless of the type of lawsuit, appears to be negligible for Korea Exchange-listed firms.

Although not test empirically, three potential explanations exist for the striking difference between two subsamples. First, firms listed on the Korea Exchange are larger and more accessible to the general public and investors than those listed on the KOSDAQ. Consequently, it is more probable that unfavorable news about the corporate governance of firms listed on the

Korea Exchange will spread far faster than that of firms listed on the KOSDAQ. If these news are significantly informative in projecting future likelihood or timing of the corporate governance lawsuits, investors will take these information into account prior to the realization of the legal risk. In such a scenario, the stock price would not react to the announcement of corporate governance-related lawsuits because this risk has already been factored in.

The second possibility is that the cost of poor corporate governance for Korea Exchange-listed firms is indeed negligible. As mentioned previously, Korea Exchange-listed companies are larger and more established than KOSDAQ-listed companies. This could imply that the majority of corporations listed on the Korea Exchange have already reached a certain level of corporate governance where corporate governance becomes a secondary concern. Simply put, Korea Exchange-listed firms are already above a particular level of corporate governance, such that a marginal decline in corporate governance is not a concern and does not damage the firm value.

Lastly, the estimation results could be influenced by the characteristics of lawsuits which are not accounted for in the current regression model. Clearly, every lawsuit is unique from the rest. For instance, the size, severity, plaintiff types, and specifics of disagreements would vary. Once these variables are considered, the estimation result may differ.

IV. Conclusion

The purpose of this article is to estimate the cost of poor corporate governance in Korea. Using corporate lawsuit data, a novel high-frequency event study methodology is employed. The key identification strategy is to compare the stock price reaction to the announcement of corporate-governance litigation with the stock price reaction to the announcement of other types of

lawsuits. Poor corporate governance is estimated to cost KOSDAQ-listed companies between 4.1 and 9.3 percent of their market value. In contrast, the cost of weak corporate governance appears to be negligible for Korea Exchange-listed companies.

The difference between two subsamples may be explained in three ways. First, information about Korea Exchange-listed companies spreads considerably more rapidly than that about KOSDAQ-listed companies. In such a case, the identification strategy for Korea Exchange-listed companies becomes irrelevant. Second, it is possible that firms listed on the Korea Exchange have already reached a certain level of corporate governance, such that a marginal decline in governance does not alter the value of the firms. Lastly, it is possible that the model is biased since lawsuit characteristics are not fully controlled.

Table 1: Benchmark Regression

Panel A

	(1) day 0	(2) day 1	(3) day 5	(4) day 20	(5) day 60
β_1	0.0416 -0.33	0.124 -0.68	-0.0532 (-0.17)	-0.861 (-1.35)	-3.739*** (-2.87)
β_2	-0.11 (-1.01)	-0.291* (-1.93)	-0.798*** (-2.72)	-1.798*** (-3.26)	-2.368** (-2.22)
r^2	0	0	0	0	0
Adj r^2	0	0	0	0	0
Num obs	2,266,534	2,266,534	2,266,534	2,266,534	2,266,534

Panel B

	(1) day 0	(2) day 1	(3) day 5	(4) day 20	(5) day 60
β_1	-0.0394 (-0.33)	0.0135 -0.08	-0.156 (-0.48)	-1.114* (-1.88)	-3.833*** (-3.05)
β_2	-0.0445 (-0.38)	-0.162 (-1.02)	-0.664** (-2.17)	-1.524*** (-2.70)	-2.304** (-2.22)
r^2	0.001	0.002	0.005	0.017	0.04
Adj r^2	0.001	0.002	0.004	0.017	0.04
Num obs	2,059,324	2,059,324	2,059,324	2,059,324	2,059,324

Table 2: Adding Firm Level Controls

	(1) day 0	(2) day 1	(3) day 5	(4) day 20	(5) day 60
β_1	0.225 -0.9	0.288 -0.72	0.619 -0.94	-0.993 (-0.65)	-0.477 (-0.18)
β_2	0.304 -1.53	0.0478 -0.17	-0.608 (-1.13)	-0.871 (-1.01)	-0.497 (-0.29)
r^2	0.001	0.002	0.005	0.018	0.046
Adj r^2	0.001	0.002	0.004	0.018	0.046
Num obs	767,054	767,054	767,054	767,054	767,054

Table 3: Splitting the Sample

Panel A: KOSDAQ-listed firms

	(1) day 0	(2) day 1	(3) day 5	(4) day 20	(5) day 60
β_1	-0.358 (-0.56)	-1.107 (-1.01)	-2.521 (-1.10)	-8.866*** (-2.86)	-13.96*** (-2.80)
β_2	0.18 -0.29	-0.292 (-0.34)	-1.104 (-0.82)	-4.661** (-2.46)	-4.733 (-1.62)
R^2	0.002	0.003	0.005	0.014	0.039
Adj r^2	0.001	0.001	0.004	0.012	0.038
Num obs	140,436	140,436	140,436	140,436	140,436

Panel B: Korea Exchange-listed firms

	(1) day 0	(2) day 1	(3) day 5	(4) day 20	(5) day 60
β_1	0.324 -1.24	0.533 -1.37	1.162* -1.94	0.401 -0.27	1.776 -0.66
β_2	0.336* -1.76	0.126 -0.44	-0.546 (-0.94)	-0.0606 (-0.07)	0.181 -0.09
r^2	0.002	0.003	0.007	0.026	0.064
Adj r^2	0.001	0.003	0.006	0.026	0.063
Num obs	626,618	626,618	626,618	626,618	626,618

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