

A LEGAL SNAPSHOT

# Embedding Impact in Impact Investing



**Wharton**  
UNIVERSITY of PENNSYLVANIA  
SOCIAL IMPACT  
INITIATIVE

# About Wharton Social Impact Initiative

The Wharton Social Impact Initiative (WSII) leads the Wharton School's work in impact finance, social entrepreneurship, impact analytics, and strategic corporate social impact. WSII collaborates with leaders across sectors to apply business strategies to create a better world. WSII's work includes research, consulting, hands-on training, and outreach, and spans many geographic and topical focus areas, including Philadelphia, Africa, women and girls, and others. By leveraging Wharton's hallmark strengths, WSII advances the science and practice of business social impact and develops business leaders who are equipped to lead in an increasingly interconnected and complex world.

To learn more about our work, visit [socialimpact.wharton.upenn.edu](http://socialimpact.wharton.upenn.edu).

# A Legal Research Project

## Exploring the intersection of law and impact investing

In the fall of 2016, Wharton Social Impact Initiative announced a collaborative project with Penn Law's Entrepreneurship Legal Clinic (ELC), and during the 2017 spring semester we welcomed four Penn Law students to continue the work through the Social Impact Fellowship.

Under the supervision of Wharton finance faculty **Dr. David Musto**, Chair of the Wharton Finance Department and **Dr. Christopher Geczy**, WSII's impact investing research launched in 2014 to examine both the financial performance and the social impact of self-identified impact investing private equity funds around the globe.

The research project is ongoing, and has thus far yielded social impact, financial, legal, and demographic information from more than 100 funds. Included in the data are financial source documents, such as annual and quarterly reports, in addition to funds' transactional documents, such as limited partner agreements, private placement memoranda, and investee term sheets.

Wharton Social Impact Initiative published its first impact investing research report, "Great Expectations: Mission Preservation and Financial Performance", in October 2015. The report focused on the performance of impact funds seeking to generate market rate returns for investors, and garnered attention in media outlets such as *The Wall Street Journal*, *The Atlantic*, *Forbes*, and *The Chronicle of Philanthropy*.

WSII continues to develop and expand on this research.

To expand the scope of research, **Anne Tucker**, an associate professor of law at Georgia State University, developed a research framework in collaboration with **Jessica Jeffers**, a PhD candidate within Wharton's Finance Department, to examine inclusion of impact terms in fund transactional documents.

The partnership with Penn Law students allowed WSII to broaden the scope of its research into the funds' transactional documents by collecting specific data points from the documents. Professor Tucker provided oversight for the collaborative effort and continues to be an invaluable resource to the team.

The dispatches in this report detail the Social Impact Fellows' experiences, findings, and insights thus far.

# Applying a Legal Lens to Impact Investing

Ryan Galea

When I joined the Wharton Social Impact Fellowship, I became part of a legal research team collecting data to better understand how impact investing funds, social impact practices, and legal agreements interact.

Our goal was to gather information from the legal documents of numerous impact investing funds, with the purpose of building an understanding of how these funds reflect their social impact agendas in their legal agreements.

The materials I reviewed included limited partnership agreements, private placement agreements and investment term sheets. My role was to read through and “code” these legal documents; The process involved transferring the information contained in the documents to a spreadsheet containing nearly 150 unique fields.

Some of these fields related to information common to all investment funds, such as the terms of the securities to be issued by the fund. However, we also took note of more unique information. This included terms between investment funds and potential portfolio investments regulating the social impact of the portfolio company, such as prohibitions against certain activity. At the fund level, similarly unique information included metrics for tracking portfolio company impact, such as job creation, and various social impact related investment requirements.

Each week of the project, we had a team meeting to discuss our progress and findings from the previous week. For instance, to our surprise, we discovered that there was very little consistency across the funds in terms of how impact was addressed in their legal documents.

**With each of these meetings, I found my understanding and fluency with the impact investing space improving dramatically.**

I also found myself asking increasingly granular questions about the content of our research, many of which would require additional future research to answer. Specifically, questions such as do impact investing funds get more favorable terms with their limited partners given that investment return is not their only focus? Similarly, do impact investing funds have more negotiating leverage with potential portfolio investments than comparatively sized competing funds that are not focused on the social impact angle?

I was curious to learn more about impact investing given my own career interests, and I saw the legal research project as a great way to improve my fluency in reading various financial legal documents. Ultimately, I completed the project satisfying not only these interests, but also learning so much about the current state of impact investing, as well as the challenges and changes the space is undergoing. Although the concept of impact investing is not new, the space is in an exciting period of change that makes now the perfect time to get involved.

*Ryan Galea is a first year in the 3-year Carey JD/MBA program at Penn Law and Wharton. Prior to starting the program, he worked for two years as an associate in private equity at Lindsay Goldberg in New York where he worked closely with the management teams at Odfjell Terminals, Dealer Tire and Federal Way Asset Management. Prior to this, Ryan spent two years as an analyst in the Healthcare investment banking group at Credit Suisse in New York, focused on the healthcare services, pharmaceutical and medical device sectors. Ryan graduated from McGill University in 2012, with a Bachelor of Commerce in Finance and Accounting.*

# What Legal Contracts Can Say About Core Values

Robert Thrasher

After seven years of working in nonprofit homeless services I had experience on the nonprofit and company-level sides of impact but little understanding of the financing side, or impact investing more generally. A research fellowship with the Wharton Social Impact Initiative provided just the opportunity I was looking for.

During this fellowship, I analyzed contracts at the fund and portfolio company level—including deal term sheets, operating agreements, loan agreements, etc.—to gather data on standard impact investing terms.

After many years of leadership experience in the nonprofit industry, I saw how a company's values drove impact through the organization. When values were well considered in relation to the company's mission, and when the company's stakeholders bought into them, they served as terrific fuel and guides for the organization.

As I pored over hundreds of pages of contracts for my research, I began to consider the similar, or at least complementary, role of contract terms.

Consider this term, made up for effect but not altogether different from common investment restrictions I saw during my research:

*"The fund shall not invest in any portfolio company that engages in the production, distribution, or trade of hazardous materials, including trans-boundary or radioactive waste, ozone depleting substances, and harmful pesticides. Nor shall the fund invest in any portfolio company that has not adopted anti-money laundering (AML) policies consistent with widely-accepted international convention."*

While the term may not roll off the tongue in a stump speech or inspire on a glossy poster quite like "Compassion and integrity guard all of our investments," the contract term serves an important role of extending and giving meaning and clarity to the value.

Without the contract term, impact interested investors may not know how a fund or portfolio company actualizes the impact that they market. In this way, the contract term

promotes alignment and confidence between socially minded investors and the funds and portfolio companies that they invest in.

**Clear alignment and confidence are even more important given that impact investing is relatively young.**

Contract terms like the one above serve an important role in demarcating companies or funds willing to legally codify their social impact commitment from those that may go only as far as savvy marketing campaigns.

Clear impact contract terms also can reduce administrative friction along the investing chain of investor, fund board, fund manager, and portfolio company. So here's to the unsung hero of impact investing—the limited partner operating agreement investment restriction contract term!

*Robert Thrasher is a JD/MBA candidate at the University of Pennsylvania Law School and the Wharton School where he is majoring in Accounting and Finance. At Penn, Robert serves on the boards of Penn Law Advocates for the Homeless, Penn Law's One for the World chapter, as well as Wharton Christian Fellowship. Prior to Penn, Robert worked in homeless services, driving best practice innovation as a senior leader at Atlanta Mission, the largest and oldest homeless service provider in Georgia. He also is the Board Chair of Athens PBJs, a nonprofit he co-founded in 2008 that builds community between the homeless and non-homeless populations in Athens, GA. Robert graduated with degrees in Accounting and Economics from the University of Georgia's Terry College of Business.*





There are too few operational, actionable clauses in fund documents binding managers to a specific social impact or outcome compared with the uniform presence of financial clauses that do so.

While benefit corporation standards for portfolio companies doesn't necessarily mean the same standards for funds, the existence of third party standards required by New York PBC statutes would suggest that there could be possible benchmarks to use.

**When investors stop settling for this broad definition, we will likely see clauses with more teeth and specificity, binding managers to a higher standard.**

In the investing space, it is likely that investors have not yet demanded specificity in the fund level documents regarding stated missions. Given the novelty of the impact investing industry, investors are likely just getting used to the idea that their capital can not only provide returns but also target a social benefit. When investors stop settling for a broad definition, we will likely see clauses with more teeth and specificity, binding managers to a higher standard.

*Lacey Nemergut is currently a third year law student at Penn Law and a candidate for the Wharton Certificate in Business Economics and Public Policy. She graduated from Bentley University with a major in Economics-Finance, a liberal studies major in Global Perspectives and a minor in Psychology. Lacey currently serves on the boards of the Youth Advocacy Project and the Urban Ventures Project through*

*the Toll Public Interest Center at Penn Law. She is currently the Symposium Editor for the Journal of Business Law and planned a conference focusing specifically on transactional pro bono and impact investing. Lacey will start work at Freshfields Bruckhaus and Deringer, where she worked as a summer associate after her second year of law school, as a transactional attorney in New York in the fall. She is originally from New Jersey and enjoys traveling and planning trips for time off.*

*Infographic: Map of states with benefit corporation legislation as of Oct. 2015. [Source.](#)*

# Side Letters Vs Limited Partnership Agreements: A Question Of Trust?

Meka Osawamoto Jegede

It's fair to say that, in addition to traditional duties, an impact fund manager must also keep the fund 'on mission' and ensure the particular status (tax, nonprofit etc.) of each investor is not compromised.

Our research revealed that mission protection clauses were fairly common in portfolio level documents via "use of proceeds" clauses, internal and external social impact reporting and/or the powers granted to advisory committees. By contrast, social impact was mentioned only broadly or not at all in Limited Partnership Agreements ("LPAs"). LPAs tended to focus on financial issues rather than mission. Instead, impact investors rely heavily on side letters—a type of collective bargaining agreement—to address these concerns.

The LPA may build the investment vehicle, but it's side letters that give impact investors the opportunity to steer. The tricky part is that no one is quite sure if and how side letters can be enforced, which raises a number of questions.

## What happens if there is tension between the LPA and the side letter?

Another LPA feature is what one could call "no favoured nation" clauses, which allow fund managers to ignore the investors' individual circumstances when making investment decisions.

## Well, then what's the point of executing a side letter if the fund manager can simply ignore it when convenient?

In traditional private equity, the answer is disclosure. In Europe, the Alternative Investments Fund Manager Directive requires pre-investment disclosure of even the possibility of side letters. The SEC has a similar rule based on fiduciary obligations. Where the disclosure box is ticked, the side letter overrides the LPA. For our purposes, these answers raise even more questions.

## Where does an impact fund outside of Europe/US look for guidance? What happens when the side letter imposes non-disclosure clauses on the general partner (gp)?

One answer is that none of this really matters, as it's really all about clout, not contract. The largest LP's side letter always wins. This makes sense: if a major impact investor pulls out, the entire fund may collapse. Another answer (which has popped up in our research) is to include disclaimers in side letters limiting a fund manager's obligations to 'best efforts'.

But this solution leaves the minority investor with two difficult options; gather enough LP support to oust the fund manager or litigation. Litigation brings us back to enforceability, and gathering a consortium [of limited partners/investors?] costs time and effort.

Further, these answers are not entirely compatible with the peculiarity of impact funds. Save for a few big players - large foundations, international investment corporations, impact consortiums- impact investors rarely have a majority stake in impact funds. How then do all these Davids beat Goliath?

Perhaps the dual functions of side letters - mission and



regulatory protection- should simply be captured in the LPA. Investors who are unhappy with this arrangement can still enter into “full” side letters, but this would be at their own risk.

For this approach to succeed, the fund manager must trust its investors not to kick out at the first sign of (necessary) mission deviation, and the investors must trust the fund manager not to unreasonably go off course or renege on the side letter. This is not a huge leap from the current side letter/LPA regime, but could provide greater clarity. Plus, impact investors or fund managers could use due diligence and marketing materials to assemble a consortium with shared or similar mission and regulatory concerns to minimize the moral hazard risk from the very beginning.

The legal status of side letters may be a grey area but perhaps we are understating their normative power in impact investing; in a space where investors are trying to make the world better, perhaps it really is just a matter of trusting your partners to do their best.

*Meka Osawamoto Jegede is a dually qualified barrister in the U.K. and Nigeria. She is currently an LLM and Wharton Business Law Certificate Candidate at Penn Law and the Wharton School. Meka obtained an M.A in Jurisprudence from the University of Oxford in 2007 and was called to the Bar of England and Wales in 2008. From 2008-2009, she interned at UNESCO whilst also studying French at the Sorbonne before returning to London to practice commercial law at Henderson Chambers and 4 New Square. She also earned a BL from the Nigerian Law School and was called to the Nigerian Bar in 2014. Thereafter, she worked as a Senior Associate and In-House Counsel at the Asset Management Corporation of Nigeria. Outside of work, Meka is interested in long distance running, social impact advocacy and travel.*

# Put It In Writing: Contracting Norms In Impact Investments

Prof. Anne Tucker

“Put it in writing” is common business advice. It speaks to framing expectations and accountability. Fund and portfolio company level contracts form the backbone of impact investment deals.

What goes into an impact investment deal? First, a manager forms an impact fund and writes a prospectus—which is half invitation to invest money in the fund and half explanation of why you should invest in the fund and what risks you face if you do.

Interested investors review the prospectus and, if persuaded, sign an agreement investing their money in the impact fund, subject to the terms and conditions stated in the agreement. If enough investors do the same, the manager has raised an impact fund. Now it is time to invest the money in social enterprise companies by building a pipeline of possible portfolio companies. The impact fund and portfolio companies negotiate investment terms and sign a contract.

To collect our data, we read impact investment contracts—at the fund and portfolio company levels—and note the presence (or absence) of standard private equity and venture capital contracting terms. We also note contract provisions unique to impact deals, such as impact measurements.

We further analyze the flagged provisions to understand the beginning, middle and end of an impact contract (whether at the fund or portfolio company level). We review terms like voting rights, ownership percentages, financial rights, fiduciary duties, etc. to understand how the parties’ structured their relationship at the outset of the investment.

We also observe what rights or obligations the parties have regarding ongoing information, monitoring, operational control rights and opportunities for contract renegotiation. The last terms bucket describes the parties’ right when the contract is ending and include investment exit and sale rights, contract termination, and breach rights.

With this data, we explore two simple questions: how are impact deals similar in structure to traditional private equity/venture capital (pe/vc), and how are they different?

Investigating the difference reveals how parties put impact in writing—how purpose gets baked into a deal. Demonstrating impact integration and enforceability addresses a common skepticism in impact investment, namely are impact investments really different or is it just “greenwashing”?

Investigating the similarities sheds light on another common question, are impact investments a good investment, meaning will they earn a competitive return?

The legal documents that create an impact fund—the prospectus, the investment agreement or operating agreement—should protect both profit and purpose. We are specifically interested in the tension or complimentary relationship between contracting for profit and purpose, or at least how inserting a second objective changes contracting dynamics.

For example, the fund manager wants to ensure that it has latitude to invest in social enterprise and won’t face investor ire for not investing in oil or pharmaceutical companies. Investors want these provisions too as assurance against greenwashing or being bamboozled by a wayward manager.

Impact funds also seek to earn a return for investors, so traditional payment terms like drawdowns, waterfall

compensation, carried interest, and liquidation priorities validate the investment (money) side of impact investing.

Investment agreements between the fund and portfolio companies also protect profit and purpose and raise similar questions of balance. The impact fund, as the investor, wants to promote the company's impact so it may negotiate for impact measurements and operational monitoring rights through veto rights or board representation.

The fund also hopes to make money when it exits the portfolio company and may do this by negotiating how and when the fund can sell its investment 5-7 years down the road. The social enterprise wants funding so it can operate, grow, and run the impact-generating business. The portfolio company may negotiate for terms that protect its ability to pursue impact along with profit. It may also want to preserve the managerial influence of the company founders.

## Our data demonstrates the delicate balancing act between contracting for profit and contracting for purpose.

After our initial review, we can identify ways in which impact agreements mirror PE/VC, and ways in which they deviate.

Our next publication will fully explore these similarities and differences, drawing upon prior PE/VC finance literature as a comparison. We are also working on modeling our evolving theory of impact contracting, informed by our research. The growing WSII database

will be a knowledge hub of impact investing and social enterprise serving as a resource for academics, impact investment funds, foundations, and impact-motivated investors.

*Anne Tucker is an Associate Professor of Law at Georgia State University College of Law. Professor Tucker works with WSII fellows and researchers to build the contract terms database. In Pursuit of Good and Gold: Data Observations of Employee Ownership & Impact Investment, 40 Seattle U.L. Rev. 1 (2017) (with Chris Geczy, David Musto, & Jessica Jeffers) is our first publication examining impact investment contract terms.*