LEGAL INNOVATION IN IMPACT INVESTING

MORRISON FOERSTER

IMPACT CAPITAL MANAGERS

Thoughtful legal advice is core to effective investing for any impact fund manager. From the formation of a new impact fund and throughout the investment lifecycle—from sourcing, to diligence, to negotiation, value creation, and, in most cases, exit—legal tools are an integral part of the investment process. Increasingly those tools are being developed and applied in ways to help all investment stakeholders create and protect not only their financial interests, but their impact objectives as well.

Legal innovation could not come at a more opportune time for the private capital impact investing ecosystem. First, there is the sheer growth in the number of new impact funds, characterized not just by many emerging "pure play" impact funds but also by impact initiatives launched by traditional private equity platforms. Second, since there is a growing interest in alternative impact fund structures, such as evergreen funds and holding entities, many new funds-in-formation are not looking to use traditional models or playbooks for fund structure. Third, there is the need for all these new funds, regardless of structure, asset class, or impact theme, to maintain a credible commitment to impact management. As they balance fiduciary duty with what some have called "impact fidelity," funds must communicate a consistent commitment to all stakeholders and structure incentives to prioritize positive impact and financial returns.

Finally, and particularly over the last year, there has been an overdue reckoning for impact investors to examine racial equity and representation on their teams, in their investment processes, and in their portfolio companies. Here too, legal tools and mechanisms have a critical role to play in achieving meaningful change.

At Impact Capital Managers—a nonprofit membership association for North America-based private capital funds investing for positive impact and seeking superior returns, representing over $12 billion in assets under management—we are working to accelerate the performance of our members and scale the impact investing marketplace with integrity and authenticity. It is our hope that this new study on legal innovations in private capital impact investing will contribute to a deeper understanding of how legal tools are being used today and provide practical guidance to founders, funds, allocators, and the law firms that partner with them.

We appreciate the fund managers who, by participating in this study, have furthered the industry's knowledge and practice. And we extend special thanks to ICM Fellow Daniel Irvin of Stanford Law School and to Suz Mac Cormac and Kaela Colwell of Morrison & Foerster, LLP for their guidance and partnership.

Sincerely,

Marieke Spence
Executive Director
Impact Capital Managers

As of January 2021, there were over 5,380[1] private funds active globally, with nearly $8.5 trillion[2] in aggregate assets under management. While still in the minority, the proportion of funds pursuing impact alongside financial returns has been steadily increasing since the early 2000s. By way of example, the number of investors that have signed on to the United Nations' Principles for Responsible Investment—a set of six responsible investing concepts, including the incorporation of Environmental, Social, and Governance (ESG) principles into investment analysis and decision-making—has increased from 100 to over 3,000 since the principles were launched in 2006, and these investors have come to represent over $1 trillion in assets under management.[3] Of 150 fund general partners surveyed in 2020, 88% indicated that they expect to increase their focus on ESG over the next 12 to 24 months, and 80% of the top 100 limited partners "list ESG as criteria in their investment policies, adhere to ESG investing, or have assets dedicated specifically to ESG."[4]

Although the increasing interest in impact investing is encouraging, concerns regarding "greenwashing" remain. For this reason, it is important that general partners and limited partners alike give careful thought as to which tools will best support their impact objectives and align incentives.

Of the variety of legal and operational tools available to impact investors, there is no one-size-fits-all. While a general partner focused on investing in companies with Black and Latinx founders may be able to meet its impact goals within the standard 10-year closed-ended fund term, a general partner focused on sustainable agriculture investments may be better served by the opportunity to hold onto assets indefinitely under an evergreen fund or permanent asset vehicle structure. The combination of tools that a particular impact fund should utilize to best accomplish its goals will depend, among other things, on the sector in which it invests, its definition of impact, and the risk tolerances of its investors.

The problems facing our world today—climate change, hunger, economic inequality, racism, and more—can't be solved with philanthropic capital alone. The volume of private capital being applied to these issues must continue to increase. If integrated into an investor's strategy appropriately, a focus on impact can both reduce long-term risk and provide an opportunity for above-market returns.

The Social Enterprise + Impact Investing Group at Morrison & Foerster LLP was formed with this in mind. We understand that, as investors continue to develop and refine their strategies for achieving impact, the legal and operational resources available to them must also evolve. We are grateful for the opportunity to work with Impact Capital Managers and Daniel Irvin on this study and the insights gained from participating ICM members.

Sincerely,

Susan Mac Cormac, Partner
Kaela Colwell, Associate

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

This report contributes to the field of impact investing by sharing examples and best practices from venture capital ("VC") and private equity ("PE") investors currently active in the field. Data for this report was collected by Impact Capital Managers ("ICM") and Morrison & Foerster LLP ("Morrison Foerster"), who surveyed ICM's membership and interviewed select members and other impact investors to gather more information on the impact-protecting tools that these investors are using.

The report also contains a discussion, informed by experts in the field, of the distinguishing features of various "alternative corporate forms," such as benefit corporations, public benefit corporations, low-profit limited liability companies ("L3Cs"), and others and when impact funds might want to use them.

The headline takeaway of this report is that impact investors are pursuing a wide variety of strategies to substantiate their impact goals and using a wide variety of impact provisions to support these goals. Alongside more commonly used devices, impact investors are deploying innovative and frontier-pushing legal tools, including:

1

structuring carried interest and other forms of compensation to be contingent on impact performance,

2

providing options for extending a fund's term if needed to meet impact goals, and

3

building in features to attract philanthropic capital without sacrificing the market-returns orientation of the fund.

The following table summarizes results from the ICM member survey, showing how common various impact provisions are among ICM members.

>50%	15-50%	<15%
Commonly Used (Greater than 50% of Respondents)	**Somewhat Common (Between 15% and 50% of Respondents)**	**Used by Some Funds (Fewer than 15% of Respondents)**
Include impact orientation in fund purpose section or investment objective	Target companies that have corporate forms intended to protect impact	Tie management compensation to achievement of impact goals
Require impact reporting from fund to LPs[1]	Subject impact reporting to third party audits or other independent verification	Tie LP remedies to fund's adherence to impact goals
Require impact reporting from portfolio companies to fund	Include impact terms on issues other than impact reporting in initial investments (e.g., adopting standards for employee compensation)	Impose financial penalties if the fund GP[2] fails to meet impact reporting requirements
Enter into LP side letters addressing impact considerations	Negotiate mechanisms for protecting for impact upon exit (e.g., keeping a sustainability mission board)	
	Adopt formal tools for assisting companies dealing with the pandemic (e.g., helping companies apply for PPP loans)	
	Work with portfolio companies to adopt corporate forms or certifications intended to protect impact	

1 As used herein, "LP" refers to a passive fund investor, including, e.g., limited partners of funds formed as limited partnerships and members of funds formed as limited liability companies.
2 As used herein, "GP" refers to an active manager of a fund with general liability, including, e.g., general partners of funds formed as limited partnerships and managers or managing members of funds formed as limited liability companies.

INTRODUCTION

As impact investing has grown in size and scope, the need for legal tools tailored to meet impact goals has grown as well. This report focuses on PE and VC impact investing funds that are seeking market-rate financial returns alongside impact. For purposes of this report, “impact” means one or more positive social and/or environmental outcomes. “Impact investors” are investors who, through investment activities, intentionally seek to generate impact in addition to financial returns.

The data for the report is drawn from two sources: a survey of ICM’s members (each survey participant, a “Respondent”) and in-depth interviews with select members and impact investors (each such person interviewed, an “Interviewee”). For the survey, we asked Respondents to answer questions on a broad range of topics for one fund managed by their firm. The underlying funds of the 20 Respondents range from VC funds focused on seed funding to PE funds focused on leveraged buyouts of mature companies, and the target LP commitments of these funds range from $50 million to $600 million. Most funds are relatively young, having held their initial closing within the last three years. To supplement the survey, we also interviewed 10 investors for more in-depth conversations about the legal tools their funds have implemented. All Respondents and Interviewees pursue market-rate returns alongside impact goals.

Why might impact PE and VC funds need legal terms that differ from standard market terms? The most basic answer is that standard market terms have been developed to achieve the economic goals of investors without much consideration for impact. But there are many different paths investors and companies can take to achieve their economic goals. The point of an impact-protecting legal device is to push all parties into choosing the path that protects impact without detracting from financial returns. The real question is: what kind of legal tools are effective and desirable for any given impact investor? An impact investor whose impact goal is the reduction of carbon emissions through deployment of sustainable energy will likely need different provisions than an investor whose primary impact goal is the creation of high-quality jobs in a particular geographic region. The goal of this report is to identify terms, conditions, and structures that promote and protect impact (referred to as the “impact provisions”) and that have been employed in the field and explain when they might be valuable for any particular investor.

Where relevant, we identify potential impact provisions that are not being used in the field and discuss barriers to their use, as well as any advantages we might anticipate from their use.

This report divides impact provisions available to investors into two sections. The **first section** covers how the fund structure itself can be designed to further impact, including in terms of duration, economics, LP participation, and other key features. The **second section** explores how to deploy capital in a manner that maximizes impact—from the initial investment into a company, to management of the company while in the fund portfolio, to sale of the company.

Both sections propose a wide variety of mechanisms and approaches that can be useful to investors seeking to further and protect impact. We categorize these approaches on a spectrum based on the formality of the approach. An approach is informal if it involves a non-binding strategy that does not impose enforceable requirements on parties. This includes practices like developing trust between parties or the reputation of a party.[3] For example, one strategy impact investors can pursue to protect impact upon sale of a company is to communicate to the buyer that the company's value derives from its brand reputation as a mission-oriented company.

There is no questioning the importance of trust between parties at all stages of the impact investing process and a strong reputation as a mission-oriented company or investor. As is the case for most business goals, impact goals are unlikely to be met in reliance on informal mechanisms alone. Using impact-focused provisions to impose binding requirements on parties, including remedies if those requirements are not met, are most often essential to achieving impact.

It should be noted that stronger or more formal terms do not equate to "better" terms for the purposes of impact investors. Not every tool makes sense in every situation. The goal of this report is to describe the approaches currently being implemented in the marketplace so that fund managers and investors can be better informed about options for designing their impact funds and investments.

3 See generally, Jeffrey Dyer and Wujin Chu, *The Role of Trustworthiness in Reducing Transaction Costs and Improving Performance: Empirical Evidence from the United States, Japan, and Korea*, 14 Organization Sci. 57, (2003); Ranjay Gulati, *Social Structure and Alliance Formation Patterns: A Longitudinal Analysis*, 40 Admin. Sci. Q. 619, (1995).

DESIGNING FUND STRUCTURES FOR IMPACT

This section covers legal tools that are relevant for the capital aggregation phase of a fund's life, i.e., the design of the fund and its relationships with LPs.

Categorizing tools for designing fund structures for impact

Informal/Non-binding	Strong/Enforceable	Stronger/Enforceable
• Firm has a strong reputation due to delivering upon impact in previous funds	• Historic impact reporting documents are provided as part of diligence process	• Suspension of fees if GP fails to meet impact reporting requirements
• Trust between firm and key LPs based on successful previous funds	• Mandatory impact reporting to LPs	• Mechanism for GP removal if it fails to follow impact mandate
• Value alignment between LPs and GP	• Side letters on impact issues but without remedies in event of deviation	• Side letters on impact issues provide remedies in event of deviation
• Voluntary impact reporting	• Term extensions if needed to meet impact goals	• Compensation of GP is tied to achievement of impact goals
• Employees and other team members care about impact	• Description of impact mission in fund's purpose section	• Employee bonuses are tied to impact metrics
	• Management company is certified as a B Corp	• Nonprofit with ownership stake and voice in the management company
	• Firm voluntarily donates portion of profits to nonprofits	• GP or management company is formed as a PBLLC

LP Relations

Survey Results	Other Tools Used by Investors
A **majority** of funds are required to report on impact to LPs	Historic impact reporting is provided as part of initial diligence
Of funds that are required to report on impact, **one third** are required to subject underlying metrics to third-party audits and independent verification	Side letters that give exit rights in case of poor impact performance
Ten percent of Respondents provided for specific remedies in the event of failure by the GP to adhere to reporting requirements, such as fee suspensions	Side letter commitments to adhere to Community Reinvestment Act place-based investing requirements
More than half of Respondents use side letters with LPs to cover impact-related concerns	

Given that VC and PE funds are vehicles for aggregating private capital from various sources, a crucial element in designing a fund structure for impact is the LP base. The identity of a fund's investors, including the constraints such investors face, can have a major influence on fund structure. In many cases, impact-focused funds attract a mix of investors, some of which are solely returns-focused, some who care about impact but not at the risk of returns, and some who prioritize impact. Balancing these various interests in a way that maximizes both returns and impact can be a difficult task.

Track Record and Impact Reporting

One of the most important informal mechanisms for impact investors is the reputation of a fund's management team. Several Interviewees noted that a key selling point of their current fund was a track record of success in delivering upon both impact and financial returns in previous funds. Additionally, many LPs in their current fund had invested in previous funds, and so a strong level of trust exists between the parties.

Where a prior relationship does not exist, funds can commit to providing data on historical impact performance and related information as part of the initial diligence process. This demonstrates the firm's commitment to impact and can build trust with new LPs. By setting an expected baseline for impact performance, reporting on adherence to impact management ("impact reporting") helps indirectly set goals for future investments and funds. It also demonstrates the relative importance of impact by showing the fund cares enough to rigorously track its efforts and publicize its successes (or failures) to its investor base. A majority (65%) of Respondents reported that their fund requires impact reporting to LPs. As discussed in subsequent sections, reporting on impact at various stages of the investment process (fund to LP, company to fund, etc.) is one of the more common purely impact-related requirements that investors are using. The type of reporting that funds undertake currently varies widely, including in terms of what is reported, how metrics are measured, how benchmarking is conducted, and how information is reported.

For funds that are required to report on the social or environmental impact of their investments to LPs, about a third reported that the underlying metrics were subject to a third-party audit or independent verification. There are several reasons why third-party audits are worth considering for any impact investor. They reduce the risk of bias in measurement. To the extent that third-party evaluators use similar tools, they can increase the uniformity by which impact is measured across funds and help the impact sector develop standardized tools for tracking impact. Consistent third-party evaluations would facilitate the aggregation and comparison of data across funds. Finally, third-party evaluations encourage better measurement and tracking by fund management, as third-party auditors have quality and depth standards in terms of the information needed to conduct their assessments.

Some funds take matters a step further by providing for a specific remedy in the event the GP fails to meet impact reporting requirements. Several Respondents reported that financial penalties or fee suspensions could be imposed if the GP does not meet impact reporting requirements. To the extent expedient or regular performance of certain duties is important, such as issuing an annual impact report to LPs, the possibility of delaying carried interest payments to the GP in the event these duties are not completed as required will incentivize compliance.

Another option for monitoring a GP's impact performance is to provide the fund's LP advisory committee ("LPAC") with certain enforcement rights. Interestingly, none of the Respondents reported that the purview of their LPAC had been expanded to include specific impact-related mandates. This is a sign that, at least for now, the LPAC is generally viewed as best suited for the traditional roles of resolving conflicts of interest and weighing in on matters when requested by the GP. Given that a majority of Respondents reported having a prohibition on investments outside of their fund's impact thesis, many LPACs may inevitably serve as guardians against investing outside of a fund's impact thesis through their determination not to waive such investments.

Side Letters and Transfer Rights

A majority of Respondents reported that they have entered into a side letter with one or more LPs to address specific impact considerations, though the total proportion of Respondents reported having side letters with less than 25% of their LPs in most cases. Most Respondents indicated that a mix of investors were making these requests. Some investor types that were specifically highlighted included banks subject to the Community Reinvestment Act ("CRA") and foundations.

The CRA requires that banks make certain investments in low- to middle-income communities. Participating as an LP in an impact investment fund that invests in companies that serve these communities can be a qualifying investment. Many banks seek side letters requiring the fund to consider investments in a region where the bank investor is eligible to receive CRA credit. This might involve place-based investing requirements.

As tax-exempt organizations, foundations making program-related investments ("PRIs") must ensure that their investments are made primarily for the advancement of one or more of their charitable purposes, not a profit. Foundations therefore might need stronger assurances that a fund will make a positive social impact than the typical LP and special exit rights if the fund fails to do so. One Interviewee provided the example of a foundation that wanted a redemption right if the fund failed to meet a certain key impact metric. The fund did not want to grant such a right, as it would create a special class of LPs that would receive downside protection if the fund performed badly both financially and on impact. The LP would be able to receive the full value of its investment back, while the rest of the LPs would receive cents on the dollar. Instead, the fund granted the foundation a side letter right to sell its interest in the fund if the fund failed on the relevant impact metric. In parallel, the fund entered a side letter with a second non-foundation LP providing that, if the foundation wanted to sell its interest because of an impact failure, the second LP would put forth a good faith bid to buy the foundation's interest in the fund. The foundation could either accept the bid, find another buyer, or decide to live with a non-mission-aligned investment. This type of parallel side letter structure has proven useful for several ICM members.

Another major category of impact side letter requests is reporting requirements. Some LPs have specific reporting needs that differ from the general LP base. For example, institutional investors may have policies that mandate reporting on impact-related topics, such as gender diversity. One downside of using side letters to cover reporting requirements is that the administrative burden of providing different information to different LPs in varying formats can be immense. This administrative burden should be balanced with the needs and requirements of LPs.

The Growth of Interest in Impact Investing

One important trend in the domain of LP relations is the explosive growth of LP interest in impact investing. Paraphrasing one Interviewee: *In 2014, when we were raising our first fund, impact was the second-to-last slide in our pitch deck and no one wanted to talk about it. Now it is our second slide, and everyone is asking us questions*. The growing global focus on impact investing has attracted new categories of LPs, such as institutional investors, to VC and PE firms whose past funds were primarily made up of family office and individual LPs. This growth in variety does bring challenges. For example, new investors often try to push impact funds to adopt more "traditional" terms in place of terms specifically designed to further impact. Some of this pushback can be attributed to investor-side legal counsel and other advisors who have been trained to believe one of their value-adds is bringing fund terms closer to market. Even if a fund successfully demonstrates the value of its non-standard approach, implementation of it can require protracted and painful negotiations with LPs. Often these negotiations are largely left to investors' legal and compliance teams who may not understand the strategic rationale for the different terms and tend to be less supportive of innovation than an investor's commercial team.

On the whole, the greater demand for impact investing products in recent years has been a positive. One Interviewee had, at inception, wanted to form an evergreen fund, as the management team believed a perpetual vehicle provided the clearest path to achieving the fund's impact and return goals. But the firm was unsuccessful in bringing this strategy to fruition in its initial years of operation because the market was not willing to accept an indefinite fund term at the time. Now that the firm has a robust track record of success in the impact investing space and in achieving market returns, it has been able to find a group of aligned investors. The firm is currently in the process of converting its older funds into a single evergreen fund.

Compensation Mechanics

Survey Results

Ten percent of Respondents provided for specific remedies in the event of failure by the GP to adhere to reporting requirements, such as fee suspensions

Example Approaches

GP's eligibility to receive carried interest distributions from the fund is tied to impact metrics

Investment personnel's eligibility to receive carry and/or bonus compensation from the GP or management company are tied to impact metrics

Other firm employees' performance reviews and non-carry compensation are tied to impact metrics

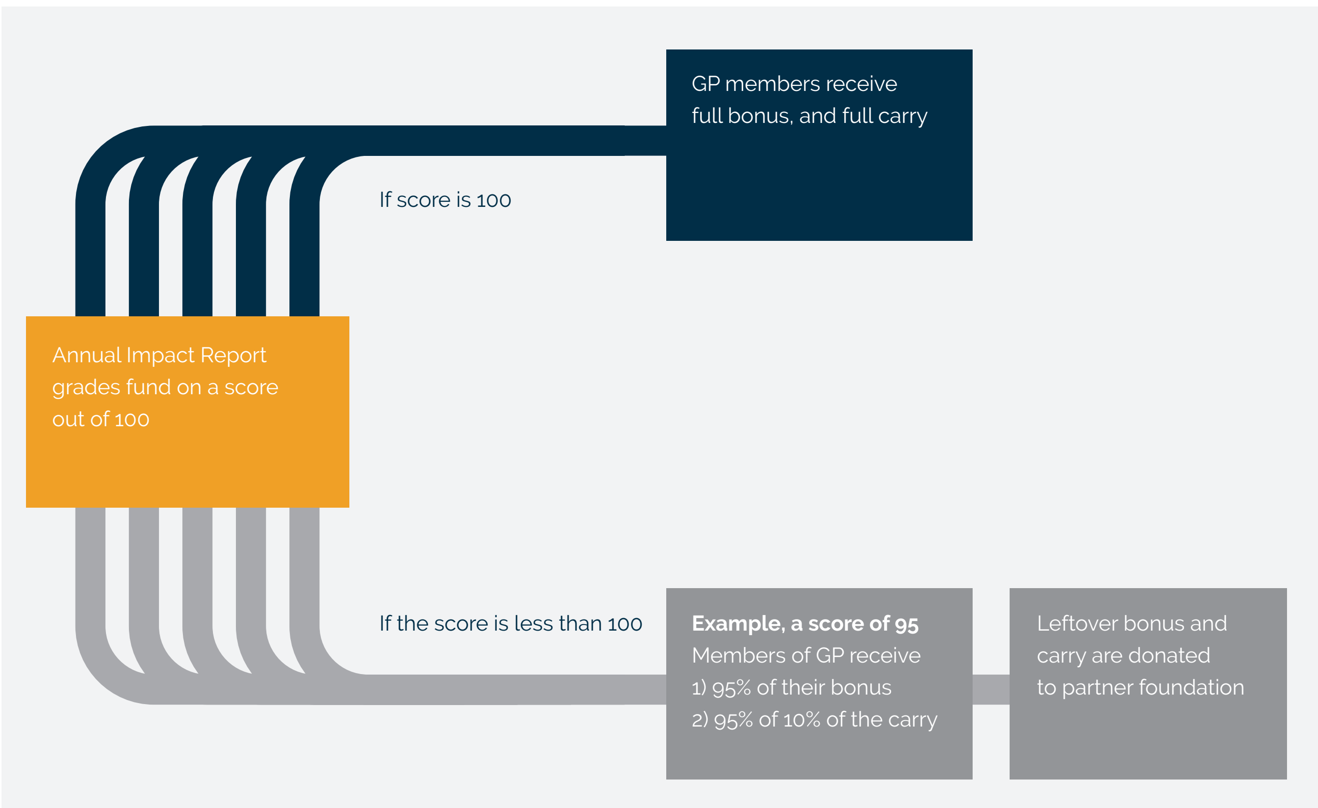
The compensation of fund management can be a powerful tool for incentivizing behavior. A basic principle that underlies the very structure of capitalism is that people will respond to financial incentives, either by taking action to earn a financial reward or avoiding actions that incur financial penalties. Impact investors can take advantage of this principle by finding ways to tie compensation of various actors to their ability to deliver on impact goals. This issue is of great interest to many impact investors. As one Interviewee argued, the best way to maximize impact and return is to compensate for impact at each stage of the investment process. This aligns incentives at all levels, from the source of capital to the fund manager to the companies themselves. The impact calculus must be factored into the economic incentives that each of these institutions, and the actors within them, face.

Several Respondents reported that they tie the right to receive carried interest to impact. Some funds have implemented this tool at the fund level, meaning that some or all of the GP's right to receive carried interest distributions is contingent on the achievement of certain impact goals. The second approach is to tie the allocation of carried interest received by the GP amongst the GP's members and other fund personnel to impact. In either case, implementation requires answering the basic question of "where does unpaid compensation go if not to fund management?" One approach is to give that portion of the fund's profits to LPs instead of the GP. The issue here is that, from a financial perspective, it incentivizes LPs to accept the GP's failure to achieve impact to the extent such failure will result in reallocation of the carried interest to the LP base. For this reason, funds have determined that carried interest received but not payable to fund management due to impact shortfalls should be allocated to a third party relatively uninvolved with management of the fund, such as in the form of a donation to a partner nonprofit whose mission aligns with the impact goals of the fund.

From these basic parameters, there are a wide variety of possible structures. One VC fund Interviewee issues an annual impact report. This report grades the impact of portfolio companies and grades the fund itself on how well it is advocating for the incorporation of impact into each company's operations and processes. Each individual company score is then rolled up in an overall score that grades the fund on how well it is doing at investing in companies that have a positive impact. The report is graded by an external committee.

This score affects two aspects of compensation. First, 10% of the carry allocable to key fund personnel is contingent upon the impact score. Second, in years where the management fee is greater than the cost of operations, partners are entitled to the remaining portion of the fee as a bonus. This bonus is also tied to the impact score. For example, if the impact score for a given year is 95%, each partner in the GP would receive 95% of the 10% of the carry that is reserved for this impact score and 95% of the bonus from the management fee. Any unpaid portion of the carry or bonuses are donated to a charity.

Visualization of Compensation Mechanics



Another firm has a similar compensation mechanic focused on individual employees of the firm. The quarterly and annual performance reviews for the firm employees have impact metrics built into them. In order to achieve its non-carry compensation and bonus, an employee must achieve certain goals related to those impact metrics. When designing mechanisms like this, it is important that the employees actually have the ability to affect the chosen metrics. After all, it is difficult to incentivize someone to do something they do not have the power to do.

Fund Duration

Survey Results

10

Nearly all Respondents reported a fund term of 10 years with two possibilities for extension

Approaches Used by Investors

Extensions beyond year 12 permitted if needed to meet impact goals, with approval of (i) 75% in interest of the LPs if economic goals have not been met or (ii) 50% in interest of LPs if economic goals are met

Evergreen fund/Permanent asset vehicle

As is common amongst VC and PE funds more generally, many impact funds have an initial term of 10 years, with opportunities for one or two extensions in the discretion of the GP or with the consent of LPs. Nearly all Respondents reported that their initial term is 10 years. Similarly, most funds have two opportunities for extending the term an additional year. Several funds have three opportunities for extensions but with all the extensions requiring LPAC approval.

Despite the prevalence of this structure and its track record as a proven model for VC and PE funds, there are several reasons why the 10 years plus two extensions model might not meet the need of impact investors in every circumstance. The first reason is that a fund's impact goals can cause it to take longer to reach that fund's financial goals. For example, an early-stage climate-tech company might need a longer runway to prove viable than a typical venture-backed software company.

A useful distinction for impact investors is the distinction proposed by one Interviewee between "front stage" and "backstage" impact. Front stage impact (also known as the "what" of a company) refers to the impact embedded in a company's product or service—the carbon mitigation potential of a startup's technology or the improvement in educational outcomes from the services of an education company. Backstage impact (also known as the "how" of a company) refers to the social or environmental performance of the company's operations and how their product or service is brought to market. While not every company has front stage impact, all companies can have backstage impact, since almost all companies have employees and a supply chain. The value proposition behind impact investing is that there is no tradeoff between values and value: Improving both front stage and backstage impact will unlock value for investors.

However, backstage impact in particular might need a longer time horizon before that value is unlocked. Because it concerns logistical and operational aspects of a company, it is likely that value-driven operations will not result in an immediate payoff. For example, a series of programs to improve employee treatment and pay might not immediately result in increased sales or revenues. But over the long term, a happy and satisfied workforce will be more productive and less likely to leave for new opportunities. Similarly, working with suppliers to improve their environmental, social, and governance ("ESG") performance can result in a more resilient supply chain. But this superiority will not be apparent until a shock to the system puts it to the test. Thus, for impact investors for whom backstage value is part of both their impact and financial value proposition, a longer duration fund might make sense.

The third benefit of a longer duration fund in impact investing is that it can delay or avoid one of the thorniest issues faced in impact investing: how to ensure impact is protected upon sale of a portfolio company. Given the nature of traditional corporate structures, it is difficult to guarantee a future owner of a company will support the company's continued focus on impact. One way to resolve this is to delay exit or avoid it entirely.

Impact investors have started to explore different approaches to the issue of fund duration. A first-order issue when designing a mechanism for extending a fund's lifespan is who should have the power to extend. Should it be at the GP's discretion or only by LP consent? The argument for GP discretion is that the GP knows the fund's portfolio companies best, including whether holding onto the fund's investment in a particular company is needed to advance impact. However, LPs tend to push back on complete GP discretion over term extensions out of fear that the GP will extend the fund's term out. Along with providing for a step down of the management fee if the fund's term is extended, one of the Interviewees indicated that it had gained LP acceptance of an extension provision under which only 50% of the LPs needed to approve an extension beyond year 12 if the fund's economic goals had been met at such time, but that approval of 75% of LPs would be needed for extension if these economic goals had not yet been met.

Long-duration Vehicles

While this report is focused on PE and VC funds, it is worth highlighting that some impact investors who previously operated within these structures have switched to investment vehicles with perpetual duration. These investors believe that a long-term model is needed to substantiate their impact goals. Examples of this perpetual duration investment vehicles include evergreen funds, hedge funds, and permanent asset vehicles (holding vehicles).

	Evergreen or Hedge Fund	Holding Company
Typical Legal Form	Pass-through vehicle (e.g., limited partnership or limited liability company	Corporation
Third-party Investors	LPs/Members	Shareholders
Investor Liquidity	Typically, transfers or redemptions permitted at predetermined intervals (e.g., every four years)	Transfers or redemptions permitted as specified in shareholder agreements and state corporate law
Governance	GP/Contractual manager	Board of directors

Evergreen Model

Evergreen funds are typically structured as pass-through vehicles with reoccurring investment (such as three to four years) and offering periods (every three to five years). Investors can opt in or opt out of new investment periods, though the precise rules will vary from fund to fund. If they opt in, distributions from previous cycles are rolled over to the new fund cycle. The advantage to this structure is that it reduces the cost of multiple vintage funds, simplifies the offering process, and can reduce (though not eliminate) conflicts of investing in later rounds of an earlier fund's portfolio companies. On the impact side, it allows the fund to hold onto a company or asset indefinitely, allowing the fund to capture long-term economic value and avoid the difficulty of identifying an optimal exit.

Permanent Asset Vehicle

Permanent asset vehicles have increased in popularity in recent years and are typically structured as corporations instead of pass-through vehicles. One Interviewee utilizing this model initially raised capital from a small group of investors specifically interested in long-term investments and impact. Now, in addition to the option of issuing new equity, the firm is able to utilize free cash flow from existing operating companies to fund additional acquisitions. The board of directors, which is comprised of independent shareholders, plays a critical role in the impact work of the firm. It has a sustainability committee to which managers report on their environmental and social value creation.

There can also be direct capital benefits from a permanent vehicle model. Another Interviewee believes that its corporate structure has enabled it to see a lower cost of capital and a superior risk-adjusted return than it would have seen had it adopted a limited-term fund structure.

Other Key Fund Terms

	Survey Results	Approaches Used by Investors
85%	**Eighty-five percent** of Respondents include their impact orientation in their investment vehicle's purpose clause or investment objective	Allocated stakes in the GP or management company to a foundation or public charity
20%	**Twenty percent** of Respondents allow for some investments outside of the impact thesis	Provide for GP removal if it fails to invest in impact sectors

Impact Thesis

A fundamental feature of any PE or VC fund is its investment objective: how is it actually going to produce returns for its LPs? Impact funds are no different, but they have the added element of also needing to explain to prospective LPs and portfolio companies what kind of impact they hope to make and how they plan on delivering on that impact. In addition to communicating these details to outside parties, including a fund's social purpose or mission in its purpose gives its impact objectives legal enforceability. Almost every Respondent reported integrating its fund's impact objectives into the fund's purpose clause or investment objective. This makes sense, as the most basic distinction between impact funds and non-impact funds is the former's intentional orientation towards impact. One important practice in designing a purpose clause is to strike a balance between specificity (which allows for meaningful measurement and reporting) and generality (which allows the GP to adapt its strategy when market conditions change). The exact balance will likely vary from fund to fund and depend on both the impact mission of a fund and expected volatility of the targeted markets.

Even where a fund has a formal declaration of its impact thesis, it is common to build in some flexibility for the GP to deviate. About a quarter of Respondents reported that the GP is allowed to make investments that fall outside of the purview of the fund's impact thesis. To ensure that this power is not abused, GPs should cap the proportion of investments that may be made outside of a fund's investment thesis, among other forms of protection.

Impact investment theses should be accompanied by remedies for material deviations as well as parameters for making the determination that a deviation has occurred. One option is to provide LPs with the ability to remove the GP if it fails to follow the fund's impact thesis, such as by failing to invest in the specific impact sectors provided therein. Like with many drastic remedies, the expectation with this remedy is that it will serve as a guardrail against major deviations but only in rare cases will be used. As discussed in the "LP Relations" section above, the LPAC's traditional role of determining whether to waive investment restrictions at the GP's request means it will inevitably serve as a guardian in defense of the impact thesis.

Alternative Corporate Forms

On top of choosing between a pass-through entity and entity taxable as a corporation, impact investors face the additional decision of whether to utilize alternative forms in the design of their investment fund or other structure, such as a Delaware Public Benefit limited liability company (PB LLC) or public benefit corporation. Such an option might be worth considering for several reasons. First, use of these corporate forms can signal to prospective LPs the depth of a fund's commitment to impact. Second, these forms provide additional protection for impact by, in the case of the Delaware PB LLC, giving fund managers a duty to balance the fund's impact goals with its monetary goals. This can provide more freedom and discretion to fund managers as they think about the best way to maximize both returns and impact. While no Respondents reported incorporating alternative fund entities as a PB LLC into their investment structures, we are aware of several funds not a part of this study that have done so.

Tax-exempt Organizations and Fund Design

By partnering with an exempt 501(c)(3) public charity, a fund can strengthen its impact by holding itself accountable for ensuring its operations are consistent with one or more of the tax-exempt's charitable purposes and validate this impact through evaluation by the tax-exempt partner. One of the Respondents has done just that by providing an ownership stake and voting rights in the management company to a public charity whose mission aligns with its fund's impact goals. The charity has the equivalent of a golden share, where it is able to block changes to the impact mission of the company through the exercise of veto power over an outside investor's attempt to purchase the company. The charity's need to protect against revocation of its 501(c)(3) and or state tax-exempt status incentivizes it to play a mission lock role: it will not approve any action it does not believe to be mission-aligned. Partners at the firm who manage this fund have committed to give 10% of their profits to the charity, which has allowed it to fund adjacent work, such as seeding impact-first funds, creating a hardship fund for employees in transition after a portfolio company went bankrupt, and funding impact management work. Partnering with a tax-exempt organization has allowed the firm to increase its impact in a way that complements the work of its funds. This has been accomplished with both direct charitable work and by helping to build the capacity of the impact investing community. The charity also benefits from this partnership, as partnering with the fund has resulted in greater capital deployment in furtherance of its mission than it would have been able to achieve on its own.

Other funds have included a nonprofit organization as a member of the GP. To avoid unrelated business income tax and better protect its tax-exempt status, it is common for the charity to hold its interest in the GP through a blocker corporation. The nonprofit can help ensure that fund investments align with its mission through participation on the investment committee or a technical advisory committee. A fund may also choose to partner with a charity through a joint venture in which the charity can provide services to a fund in furtherance of the fund's impact objectives. In both joint ventures and equity ownership models, care must be taken to ensure that the public charity is not providing an impermissible gift to the fund, i.e., it must be documented that the for-profit must pay fair value for any services or IP.

A final way that impact funds can partner with nonprofits is by using philanthropic capital as first-loss capital. Where a fund's potential for achieving high impact exceeds its potential for achieving market financial returns, first loss capital makes it more likely that the fund will be in a position to make distributions to market-rate seeking LPs—and thus attract their capital—as making distributions to these LPs would take priority over returning money, if any, to philanthropic investors. Another way to de-risk impact investing for market return-seeking investors is for philanthropic investors to guarantee investments made by the fund. This does not require the philanthropic capital-provider to participate in the fund and so may be viable for a broader range of charities as compared to direct involvement in a fund.

DEPLOYING CAPITAL FOR IMPACT

This section covers tools available to impact investors in the capital deployment stage of the fund's life—from initial investment to exit. Some of the discussion in this section will have different implications for VC and PE funds, as there are different considerations for minority investors versus investors that purchase controlling interests in companies.

Informal	Strong/Enforceable	Stronger/Enforceable
• Fund invests in companies whose business models are compatible with fund's impact objectives	• Impact analysis incorporated into due diligence process	• Term sheets require companies to report on impact
• Mission alignment between company management and fund	• Term sheets commit prospective portfolio companies to impact	• Term sheets require companies to meet certain ESG or impact goals
• As a board member, fund supports company against non-impact oriented investors	• Companies are encouraged to become B Corp certified	• Covenants in debt terms around impact that make deviation from mission an event of default
• Exit company by selling to value-aligned new buyers	• Impact committees are established and preserved before and after sales	• Protective preferred equity provisions like separate stock classes for mission aligned investors and founders
• Advises founders on whether potential acquirers are mission aligned	• Rollover equity for founders or mission-aligned investors	• Companies are converted to alternative corporate forms like PBCs
		• Acceleration of payments if acquirer deviates from mission

Initial Investment

Survey Results

75%

Seventy-five percent of Respondents include impact related terms in structuring their investment

Approaches Used by Investors

- Incorporate impact analysis into initial financial analysis for holistic view of a company
- Use a side letter to address impact-related terms, with authorization for side letter embedded in primary agreement
- Require commitment to, e.g., further with fund's impact goals, comply with impact reporting requirements, and meet certain standards
- Negotiate protective provisions related to exit
- Include terms required for B Corp certification in company formation documents

The initial investment into a portfolio company is a key point for maximizing the impact of the company. For maximizing both financial returns and impact, investors must be able to successfully source, assess, and value potential investments based on the potential to achieve both. A fund's impact orientation can make it an attractive investor to prospective targets.[4] Funds can further improve their appeal to social enterprise targets by including impact-related protections in term sheets to demonstrate mission alignment.

4 Amy Bell, John Griffith, and Ben Thornley, The Alpha in Impact (see Driver #3 on page 13)

A best practice for impact funds is to incorporate impact analysis into their overall financial analysis during due diligence. This ensures that the fund gets a holistic look at the company and can confirm it conforms with the investment thesis of an impact and returns investor. Identifying critical weaknesses or opportunities in companies from an impact lens will reveal issues that are relevant to financial returns. One Respondent explained that its sustainability-focused PE fund relies on three key indicators in determining what is a sustainable business:

1

Whether the company's current earnings borrow away from future earnings

2

What the company does (does it provide goods and services that are consistent with a low-carbon, healthy, fair, and safe society?)

3

How the company does what it does (its sustainability practices, products, and services, how they drive revenues, profitability, and competitive positioning)

These indicators then become "part of what the investment analyst looks at to determine [] the quality[] of the management and the quality of the business," as they provide a holistic look at the health of the business and the potential avenues for creating both economic value and impact.

According to several Interviewees, mission alignment between their funds and prospective portfolio companies is an important consideration in making an investment decision. It is desirable to source companies whose business models are already aligned with the impact objectives of the fund. Even if the company (and its employees and management) does not think of itself as a social enterprise, it may still align with the impact mission of the fund if its business model furthers that mission.

About 75% of Respondents reported that they include impact provisions in structuring their investments. For investors that do use impact provisions in their investments, this is often accomplished by adding a provision in the main investment document that commits the parties to adhering to a side letter including the desired impact requirements.

Respondents reported including terms requiring companies to, among other impact-related matters:

- **Commit to the impact goals of the fund and adhere to its impact thesis**
- **Adopt hiring practices intended to promote diversity and inclusion**
- **Commit to meet certain impact metrics (such as carbon reduction)**
- **Adopt certain standards for employee compensation**
- **Provide data or impact metrics**

Reporting Requirements

Almost all Respondents indicated that they require companies to comply with impact-specific reporting requirements. It is important to ensure that reporting metrics used are appropriately tailored to measure the targeted impact. They should not be so broad as to capture irrelevant results nor so narrow as to miss important impacts. This means that chosen metrics can vary from company to company, and so a fund is unlikely to be able to capture all relevant data using the same reporting form for every company. To deal with this issue, one Interviewee uses a standard sustainability side letter and then adds to the letter specific metrics tailored to the particular company.

One PE fund includes an impact section in its letters of intent with companies emphasizing that it is a mission-driven investor interested in the company because the company is also mission driven. The fund also highlights in this section that it intends to manage the company in accordance with impact management practices like the Global Impact Investing Rating System (GIIRS).[5] This helps lay the groundwork for the future of the relationship between the fund and the company, setting out the fund's goals and demonstrating its interest in the company's mission. Similarly, another Interviewee meets with the founders or CEO of potential portfolio company acquirers to explain how central impact is the company's mission and how it is a way to unlock financial value. With one company, the fund helped pass a board resolution stating that the company is committed to a process for continuous improvement on impact-related issues.

One consideration that funds should be aware of when tracking metrics is the privacy of portfolio company employees. Especially with diversity and inclusion metrics, the process of tracking and reporting personal information should be designed to minimize the risk of exposing such information. From a regulatory perspective, this concern is particularly prominent for public companies (of which corporate VCs are often a part of) that face SEC disclosure requirements. But the legal and reputational risks of data breaches and inadvertent disclosures exist for all funds.

5 GIIRS is a rating system that assesses the impact performance of companies and is intended to provide comparable and verifiable impact performance data for investors and companies. It is affiliated with the B Labs Initiative. Beth Richardson, *Sparking Impact Investing through GIIRS*, Stanford Social Innovation Review, (Oct. 24, 2012).

Impact Terms Related to Future Changes

Another Interviewee, a VC fund, uses the initial investment as a time to build in certain protective provisions related to exit. For example, the fund adds in terms that give it a say in the timing and method of exit, which helps steer sales towards mission-aligned buyers. Similarly looking towards the future, one PE fund ensures that the legal documents of each new company in which it invests contain the provisions required for B Corp[6] certification. Even though this fund does not require companies to become B Corps, several of its investees have taken the B Corp certification test and became excited at the prospect of achieving that certification.

B Corp certification requires certain terms to be present in formation documents. The first time the fund determined to help certify one of its portfolio companies as a B Corp, it had to amend the formation documents of the company, incurring additional legal fees. Because of this experience, the fund now includes all necessary terms in the original formation documents of new companies. This makes any future attempts to achieve B Corp certification much less painful. While directly relevant for any fund who might seek B Corp certification for its portfolio companies, this experience also applies to any changes to a company requiring alternation of its formation documents, as including them from the start can save money and time.

One potential concern with seeking to include impact-related provisions in an acquisition transaction is that it could make an investor less competitive. If the existing owners and managers of the company targeted for acquisition are interested in the mission of the company, then impact provisions may actually strengthen the bid, as the prospect of protecting and building upon the social impact of the company would be seen as a positive to such individuals.

6 To be a “B Corps” means that a company has been certified by B Labs Initiative (a private nonprofit), that the company meets certain impact performance standards, as well as meets standards of “public transparency and legal accountability.” Interested companies can take the B Impact Assessment, and, if they pass, they can be awarded B Corps Certification. *See About B Corps*, B Corporation.Net, https://bcorporation.net/about-b-corps (last visited Nov. 30, 2020).

Managing Portfolio Companies

Survey Results

50%	**Half** of Respondents have worked with portfolio companies to adopt corporate forms intended to protect impact
33%	About **one third** say that they have a preference for investing in alternative corporate forms like the Delaware PBC

Approaches Used by Investors

Provide financial and logistical support to companies to assist with their impact reporting efforts

Investors have employed a diversity of approaches to protecting and maximizing the impact of portfolio companies. The approach they take is determined in part by whether they have a controlling interest in the company. Those that do not have a controlling interest must deal with the added dimension of other potential non-impact-oriented investors and founders who still control the company. For both groups, one of the key tasks is working with companies to implement impact management programs to assess and improve upon the impact of the company and to inform the fund's annual report to LPs. Recognizing that tracking impact metrics can be a burden (especially for smaller companies), some funds more directly support their portfolio companies in their impact management efforts. One venture capital fund grades itself on how effective it is at advocating for impact within its portfolio companies, such as by encouraging companies to bring other stakeholders to the table. The goal for many venture capital investors at this stage is to be more of a supporting stockholder and board member. As one investor put it, his fund views its job as advocating not just for social impact but for "long-term greediness" instead of the short-term mindset that other investors in the company might have. One frontier proposed by some practitioners but unexplored by any of the Respondents is to tie compensation of employees at portfolio companies to their impact scores, such as through bonus mechanisms.

Alternative Corporate Forms

About half of Respondents reported that they have worked with portfolio companies to adopt corporate forms intended to protect impact. These protections could range from adding a few protective provisions to the certificate of incorporation to the conversion of the company to a new corporate form like the public benefit corporation (PBC), the social purpose corporation (SPC), the public benefit LLC, and others.

The development of these alternative forms has provoked a great deal of discussion, both in the impact PE and VC world and the broader impact investing community. While there is much excitement over these forms (and about a third of Respondents reported that they had a preference for investing in these forms), we also heard uncertainty and hesitation from a few Respondents. With any new corporate form, a lack of case law interpreting the governing statutes will give investors pause. Moreover, the introduction of new fiduciary duties and enforcement mechanisms seem to increase the risk of legal liability. Inertia and a desire to not be off-market can play a role as well—companies seeking capital from traditional investment sources tend to incorporate as Delaware corporations because that is "what everyone else does." Deviating from that expected form can increase costs or decrease stockholder value. Finally, there is the issue that perception can equal reality: even if a particular investor does not think there are real downsides to incorporating as something other than a C corporation, if other investors disagree, the value of a company could be adjusted downwards. Insofar as these concerns are accurate, alternative corporate forms are not created equally—each one is slightly different from the rest. It is worth highlighting some of the key types of forms and their similarities and differences.

Comparison of the New Corporate Forms (and One Non-Form)

Terms	Type of Organization	State of Formation (as of December 2020)
Low-profit Limited Liability Company (L3C)	LLC (hybrid)	Eleven states
Public Benefit LLC	LLC	Delaware
Benefit Corporation	Corporation	Thirty-five states (in varying forms)
B Corp	Not a corporation, just a certification	
Social Purpose Corporation (SPC)	Corporation	Three states, including California
Public Benefit Corporation (PBC)	Corporation	Delaware

The **low-profit limited liability company** (L3C) is a type of limited liability company that may be formed in 11 states.[7] It is intended to be a hybrid form that combines attributes of traditional nonprofits and the LLC form. The form was designed to be able to attract program-related investments (PRIs) alongside non-philanthropic capital. As such, the L3C must have a primary charitable mission and a secondary profit concern.[8]

Another variation on the LLC form is the Delaware **public benefit limited liability company** (PB LLC). This is a relatively recent form (adopted in 2018). A PB LLC must identify a specific benefit to be promoted in its certificate of incorporation and be managed in a manner that balances such benefit, the interests of those affected by the PB LLC's conduct, and the members' economic interests. The company must report biennially to its members on its promotion of the specified public benefit, and members can bring a derivative suit to enforce the obligation to balance the three interests identified above.

The utility of both the L3C and the PB LLC are somewhat limited due to the fact that the traditional LLC form has tremendous contractual flexibility. For example, the operating agreements for Delaware LLCs can waive all fiduciary duties that would be otherwise owed from members to the LLC or to each other. Depending on the state, it is likely that impact investors can form traditional LLCs that include their desired impact provisions. The primary relevance of these forms to PE and VC investors tends to be on the fund structure side, not on the capital deployment side.

The **benefit corporation** is a type of corporation in many U.S. states. The promoters of the form have created a model statute, which has been implemented in widely varying forms across states.[9] The model version requires adherence to a general public benefit (defined as a positive impact on society and the environment), as well as specific public benefits that can be selected from a statutorily defined list. To enforce these requirements, shareholders can sue directors and managers under a "benefit enforcement proceeding." This proceeding can provide injunctive relief, not damages. The corporation must also appoint an independent "Benefit Director." Finally, the corporation must issue an annual benefit report, which must be certified by a third party.

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7 Madeleine Monson-Rosen, *Companies with Purpose: The L3C Option in the US*, MissonBox, (June 6, 2019) https://www.missionbox.com/article/401/companies-with-purpose-the-l3c-option-in-the-us.

8 Joseph P. Glackin, *What Exactly is a L3C?*, BCLaw Lab, http://bclawlab.org/eicblog/2017/3/21/what-exactly-is-a-l3c#:~:text=L3C%20stands%20for%20a%20low,socially%20beneficial%20objective.%5B2%5D (last visited Nov. 30, 2020).

9 *Social Enterprise – the Use of Corporate Forms to Promote Impact*, Morrison Foerster https://www.mofo.com/special-content/impact-investing/social-enterprise.html (last visited Nov. 30, 2020).

Confusingly, "**B Corp**" is not a shorthand for **benefit corporation** and is not a corporate form at all. Instead, it is a certification regime that assesses the impact of a business and awards the B Corp certifications to companies (of any form) that meet B Lab's (the certifying organization) standards. Aside from the name, B Corps may be confused with benefit corporations or other types of corporate forms given that achieving B Corp certification requires that (where allowed) companies adopt certain provisions into their governing documents.[10] In practice, this often means converting to one of the alternative corporate forms in jurisdictions that have them.[11] Additionally, the B Impact Assessment required to be completed by B Corps can be the method by which benefit corporations meet the requirement to have ongoing, third party assessments.[12]

The **social purpose corporation** (SPC) is a type of corporation available in less than a handful of states, including California. The corporations must select a social purpose from the categories enumerated in the section 501(c)(3) of the Internal Revenue Code. The management and board of the SPC must consider this social purpose (in addition to shareholder maximization) when making decisions and are shielded from liability when doing so. But, unlike the benefit corporation, there is no benefit enforcement proceeding, though an annual impact report must be delivered to shareholders and publicly disclosed.

The **Delaware public benefit corporation** (PBC) is the most relevant of these alternative corporate forms for both PE and VC funds. The enabling law specifically applicable to the PBC is contained in seven subsections (subsections 361-368 of the General Corporate Code).[13] To the extent a particular matter is not specifically covered in this subchapter, the rules governing Delaware C corporations apply to a PBC.[14] This means that, for the vast majority of issues a PBC might face, the well-developed body of Delaware jurisprudence covering corporations will apply.

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10 *About B Corps*, B Corporation.Net, https://bcorporation.net/about-b-corps (last visited Nov. 30, 2020) ("what's the difference between a certified b corp and a benefit corporation").
11 *Benefit Corporations & Certified B Corps*, BenefitCorp https://benefitcorp.net/businesses/benefit-corporations-and-certified-b-corps?_ga=2.186297257.1227147289.1601884825-1751259940.1601884825 (last visited Nov. 30, 2020).
12 *Id.*
13 8. Del. Code Ann. §§ 361-368.
14 See 8. Del. Code Ann. § 361 (stating that PBCs are subject to the rules of the chapter [governing corporations], unless this subchapter imposes different or additional requirements).

The four ways in which PBCs are different from standard Delaware Corporations:

1

A PBC must be organized to promote one or more specific public benefits (and include such benefits in its certificate of incorporation).[15]

2

A PBC must be managed in a manner that balances the financial interests of stockholders, the best interests of those materially affected by the corporation's conduct, and the public benefits identified in its certificate (the "balancing requirement").[16]

3

Only PBC stockholders meeting certain requirements may bring a derivative suit to enforce the balancing requirement.[17] Any decision that implicates the balancing requirement will be deemed to satisfy the directors' fiduciary duties if it is "both informed and disinterested and not such that no person of ordinary, sound judgment would approve."[18]

4

A PBC is subject to mandatory reporting requirements to stockholders covering its promotion of the public benefits. PBCs can include a provision requiring third party certification of the reporting, but it is not required.[19]

15 8. Del. Code Ann. § 362(a)(1).
16 8. Del. Code Ann. § 365.
17 8. Del. Code Ann. § 367.
18 8. Del. Code Ann. § 365(b). Note that the 2020 amendments to the statute will clarify that a director's ownership of stock or other interests in the PBC shall not alone create a conflict of interest for the purpose of the balancing requirement (except to the extent that there would be a conflict of interest if the PBC were a standard corporation). House Bill 341, § 18.
19 8. Del. Code Ann. § 366(b)-(c).

Though the PBC, SPC, and benefit corporation[20] share similarities (and for that reason are often confused with one another), there are material differences that should be taken into consideration, beyond the fact that the forms are available in different states. The SPC arguably has more robust reporting requirements than the PBC.[21] A crucial difference between the benefit corporation and the PBC is the high degree of discretion afforded to boards and officers in the PBC. PBC stockholders have the same tools to enforce both the mission and stockholder value: they can vote to remove directors or sue for breach of fiduciary duty. As indicated above, the threshold for satisfying fiduciary duties is relatively low, similar to traditional corporate fiduciary duties. In contrast, the benefit corporation form requires an independent benefit director and creates a new cause of action for enforcing its mission requirement. It is not clear yet what kind of actions (or inactions) by boards would give rise to liability in a benefit enforcement proceeding. The model statute does specify a standard of conduct for directors, requiring them to consider the effects of any action/inaction upon seven different factors, including shareholders, employees, customers, the community, the environment, the short-term and long-term interests of the benefit corporation, and the ability of the corporation to accomplish its general or specific benefits.[22] While it does not require directors to prioritize one interest over others, directors need to be able show that they considered all seven of them in making decisions.

20 Note that all comparisons in this section are to the benefit corporation model statute. Each state that adopts the statute can modify the model statute to suit their needs, and so the differences discussed here may not apply to every state.
21 *Social Enterprise – the Use of Corporate Forms to Promote Impact*, Morrison Foerster https://www.mofo.com/special-content/impact-investing/social-enterprise.html (last visited Nov. 30, 2020).
22 Model Benefit Corporation Legislation § 301(a).

Other differences between Benefit Corporations and PBCs:

	Benefit Corporation	PBC
Type of benefit it must pursue	General public benefit; one or more specific benefits selected from a list in the statute	Specific benefit (no required list to choose from)
Enforcement mechanism	Benefit enforcement proceeding	Derivative lawsuit enforcing fiduciary duties
Type of relief	Injunctive (no money damages)	Injunctive (no money damages)
Third-party certification of impact report	Required	Not required, but corporations can elect to do so
Timing of report	Annual	Biennial

The benefit of the PBC form is that it converts a "may" into a "shall." That is, under the business judgment rule, the directors of a standard corporation may consider social goals so long as they can argue some kind of connection to long-term stockholder value. But they are not required to consider such goals, and in certain sale contexts they can only consider short-term stockholder value. With the PBC, the directors shall consider social goals.

The impact of PBCs and other alternative corporate forms on valuation is uncertain, but there are three publicly traded PBCs:	Laureate Education	Lemonade	Vital Farms
	An owner and operator of higher education institutions.[23]	A property and casualty insurance company.[24]	A provider of eggs and dairy from humanely and pastured raised animals.[25]

All three of these have successfully completed IPOs as PBCs, with Lemonade's and Vital Farms' occurring recently (July 2020) and Laureate's occurring in early 2017.[26]

23 *Capital Markets Embrace a Novel Corporate Form*, Morrison Foerster, https://www.mofo.com/resources/insights/200903 novel-corporate-form.html (last visited Nov. 30, 2020).
24 *Id.*
25 *Id.*
26 *Id.*

Exit

Survey Results	Approaches Used by Investors
One third of Respondents have included some form of impact protection on their funds' exit of a portfolio company	Highlight impact orientation of company in information memo to filter for buyers interested in impact mission
	Insist a buyer agree to keep a sustainability mission board active as part of a company after acquisition
	Create a special purpose vehicle to extend a fund's hold in a company
	Implement protective provisions that let minority owners have a say in the timing of a sale

Protecting a company's impact upon exit is one of the more difficult tasks impact investors face, as it requires creative mechanisms designed to increase the chances that the missions of companies will be protected when they no longer have a voice in those companies. In many cases, the highest bidder for a company is also the preferred acquirer from an impact perspective. However, when this is not true, a fund can be stuck with making a difficult decision.

The relevance of this concern might vary from company to company. For a company whose impact value proposition lies in its main product or service (e.g., a company that makes direct air capture facilities for carbon removal) it seems fairly likely that any future owner would have reason to protect that impact. After all, deviating from the social mission of the company would entail completely changing the business. In contrast, backstage impact might be more vulnerable to non-impact-focused owners. Even if a company's strong labor protections and sustainable operations are crucial to its economic value proposition, a particularly short-term-minded owner might see labor and operations costs as good places to cut spending.

Even for a company where it would be foolish for any owner to immediately deviate from its impact mission, without protections for impact, the long-term growth of the company might move in a contrary direction, i.e., mission drift. For example, suppose an impact investor owned a company that made certain components for electric vehicles. If it sells the company to a non-impact investor, it might not feel the need to negotiate special impact protections for the company's front stage impact, as the chances of the buyer immediately converting the company into one that operates in the gas-powered SUV market would seem low. This might be accurate, but it fails to consider how the company may evolve in the coming years. If the company continues to do well and seeks to diversify its operations, it might consider acquiring companies that operate in markets that are contrary to the impact investor's mission. For any investor who plans on selling its portfolio companies, the issue of mission drift upon exit has at least some relevance.

To deal with this issue, about a third of Respondents reported that they have included some form of impact protection upon exiting an investment. One of the most basic ways that investors can protect impact is by finding mission-aligned buyers to hand the company off to. As one Interviewee described, the goal in its fund's sale process is to put the impact dimension for the company front and center—it does not want to make impact companies obscure. By doing so, the fund is able to attract buyers who believe what the fund believes about the value of a company. This goes back to the relationship between impact and returns. If it is true that a company's economic value is a product of its social values, then it will be easier to find buyers who wish to protect the values of the company. Following a similar model, another Interviewee noted that its fund emphasizes a company's impact metrics in the information memo for a sale. The goal is to filter for value-aligned buyers and encourage them to discuss how they will protect impact in their bids. For this fund, the strategy has worked as in one of its recent exits, the highest bidder was also the buyer the fund was most confident in from an impact protection perspective. The Interviewee also noted how important finding a value-aligned buyer was for this company's employees and for management, who advocated strongly for finding a buyer that cared about impact. The desire from the employees to see impact protected, again demonstrates that impact provisions should not be viewed as a handcuff for reluctant companies. Impact provisions have the potential and often do improve the ability of funds to source deals and create value. The process for seeking mission-aligned buyers often takes the form of "reverse diligence,"[27] i.e., the seller can send due diligence requests to potential acquirers, asking questions about their ESG practices, and any quantitative measures they have demonstrating their commitment to impact.[28]

27 Susan Mac Cormac, Lee Johnston, and Shai Kalansky, *Maintaining Impact Through M&A*, Morrison Foerster, (May 29, 2020 https://impact.mofo.com/measuring/maintaining-impact-through-ma/.
28 *Id.*

Other funds have implemented mechanisms to enforce a buyer's commitment to keeping certain impact protections post-closing. One fund had a portfolio company with a sustainability board, which was in charge of overseeing the mission of the company. The acquirer agreed to keep the mission board active as part of the company after acquisition. Even if a mission board does not exist already for a company, a seller could propose the formation of such a board as part of the acquisition. Another approach is to create special purpose vehicles to extend the fund's ownership in particular companies if needed to protect the company's impact.

Investors without controlling interests face a special difficulty in exits given that they do not have final say in how or when a company will be sold. For this reason, one of the Interviewees ensures that its VC fund builds in protective provisions around exit as part of its initial investment. The fund tries to add in provisions that let it have a say in certain matters, such as the timing of a sale. Here, VC fund personnel's role as adviser to the founders of a company is also crucial. It can help ensure that an eventual sale is only to a mission-aligned buyer. VC funds can also be proactive and try to point a company towards buyers known to be mission-aligned.

In addition, some have proposed viewing the PBC form as a "sweet pill" in the sale context, as[29] it allows for the board to look at other issues besides maximizing stockholder value.[30] While the owners could eventually convert the PBC to a standard corporation if they desired, it could at least provide some initial layer of protection. This could be particularly useful in the IPO context, where finding a single mission aligned buyer is not an available option. As discussed in the previous section, as of [December] 2020, three PBCs are publicly traded.[31]

29 *Id.*
30 *Id.*
31 *Capital Markets Embrace a Novel Corporate Form*, Morrison Foerster, https://www.mofo.com/resources/insights/200903-novel-corporate-form.html (last visited Nov. 30, 2020).

CONNECTION TO CURRENT EVENTS

This study was conducted during the COVID-19 pandemic and at a time when the ongoing issue of racial justice in the United States was brought to the forefront following the murder of George Floyd and subsequent protests across the United States. Several Respondents and Interviewees have taken steps to address these matters as part of their investment management activities.

Racial Justice

How can VC and PE funds play a role in advancing racial justice? Several Respondents described how they have used term sheets to require both diversity and inclusion reporting and a commitment to certain diversity and inclusion goals from portfolio companies. Numerous Respondents reported requests for commitments from LPs on diversity issues, including institutional investors.

For one venture capital fund who has worked on diversity and inclusion issues for many years, integrating these concerns into all aspects of investing is key. The fund has a “front and center commitment to remedying historical inequities.” It has made a conscious decision to start investing earlier in companies, as this is more likely to lead to investments in black-owned companies in the current startup climate. Making an effort to have a more diverse pool of candidates for CEO searches has produced positive results for fund and the companies in which it invests, as it has yielded CEOs who would not have been included in the search process otherwise.

An underlying idea that accompanies impact investing is that there is an alpha in paying attention to things that other investors are not. In this case, it means looking at people and communities whose assets and abilities have been historically underappreciated and dismissed as a result of racial prejudice and both conscious and unconscious bias. The most successful businesses are the ones that deeply understand their customers, which requires institutionalizing empathy. Working to become fully conscious of all biases, including biases outside of race, is a critical step in building this empathy.

COVID-19

Impact VC and PE funds have tried to support portfolio companies in surviving the economic impacts of the COVID-19 pandemic. About a quarter of Respondents reported that they have used legal tools intended to specifically respond to the pandemic and resulting economic pressures, including:

Setting up employee assistance funds for portfolio company employees;

Helping portfolio companies apply for PPP[32] loans;

Developing support programs for portfolio company workers; and

Engaging with portfolio companies on social issues.

One of the drivers of financial value for many impact investors is the ability to increase resilience by paying attention to environmental and social risks. The economic downturn resulting from the pandemic makes the efforts of VC and PE investors to increase resilience even more crucial in the coming years.

32 PPP refers to the Payment Protection Program, in which the Federal Small Business Authority provided loans to businesses to keep their workforce employed during the early stages of COVID-19. This investor helped portfolio companies apply for such loans. For more information on the PPP, *see Paycheck Protection Program*, SBA, sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program (last visited Nov. 30, 2020).

DISCUSSION OF THE IMPACT LABEL

One big picture issue that arose during the course of this study is the use of the "impact" label. Several Interviewees expressed concern that the word "impact" has negative connotations and potentially held the field back. Specifically, these Interviewees believe that many prospective LPs and partners associate this label with concessionary investing, i.e., that impact investing requires the forfeiture of financial returns. As a result, some investors eschew the impact label.

As one Interviewee pointed out, there are unapologetically concessionary investors who label themselves impact investors. How can impact investors who invest for returns and impact address these concerns? The ability to show that, regardless of label, the financial returns on impact investing are as good or better than the financial returns of comparable non-impact funds. Those impact investors who have proved the strength of investment models through one or more successful impact funds tend not to regard the impact label as a particular impediment.

These perspectives on the impact label point to a broader issue that will likely face the impact investing community as the field continues to grow: In the long run, should the distinction between market rate financial return seeking impact and non-impact funds continue, or should the goal be to eventually transition away from distinguishing between impact funds and more traditional funds? As one Interviewee pointed out, the term "impact" has become very broad, which can be both helpful and diluting. There are now subsets of categories within impact, and this trend will continue as the field grows. Even as the goal might be to encourage all investors to consider the ESG implications of their investments, there will still be room for impact investors to push the frontier of using capital to address deep social problems.

CONCLUSION

The data analyzed in this report demonstrates that there is no single blueprint for an impact fund. Instead, different approaches are necessary for achieving different impact goals, and each fund will have to decide for itself which approach best suits it and how to measure success. As the marketplace develops, these approaches and tools will continue to be honed and improved upon, advancing the field further.

Example Fund Type	Sample Qualities (Terms and Tools)
The Informal Protector Focuses on informal protections for impact	• Ensures value alignment between LPs, fund, fund employees, and portfolio companies • Builds strong brand reputation for fund and portfolio companies as mission-oriented • Sources portfolio companies whose business model meets impact criteria • Reports on impact but reporting is minimal or unsystematized • Sources buyers for portfolio companies that understand value of mission
The Messenger Has binding impact provisions on issues related to impact management and reporting	• Describes impact mission in fund's purpose section • Mandates impact reporting to LPs • Includes provisions in term sheets requiring impact reporting from portfolio companies or implements reporting systems after acquisitions • Provides historic impact reporting to LPs as part of standard diligence process • Integrates ESG factors into company diligence; holistic analysis that places impact on the same level as financial analysis
The Flexible Uses an on-market structure but builds in flexible impact protections	• Targets impact-first LPs like foundations and enters into side letters to ensure that impact-first capital can be used • Provides for term extensions beyond typical 10 plus two if needed for impact, with mechanisms to ensure LPs don't incur excess fees as a result • Commits in LPA to meet certain impact goals • Considers nonprofit ownership stake in GP or management company
The Reformer Works with portfolio companies to setup binding impact requirements	• Encourages portfolio companies to become B Corp certified • Provides for rollover equity for founders or mission-aligned investors upon exit • Obtains commitment from acquirer to keep certain impact protections upon exit
The All-in Provides binding enforcement mechanisms to incentivize and lock in impact mission and performance at the fund and portfolio company levels	• Provides for removal of GP if it fails to follow impact mandate • Ties compensation of GP, senior leadership, and employees to ability to deliver on impact • Provides LPs with remedies for fund's deviation from impact mission • Ties compensation of portfolio company leadership to impact • Requires companies to meet certain impact standards • Seeks equity or debt instruments that build in impact protective provisions • Converts portfolio companies to PBCs to protect impact upon exit; builds protective provisions into sale agreements to guard against mission deviation

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