CARLTON FIELDS

Impact Investing: Keys to a Responsible Exit

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Impact investing has been gaining new prominence recently to respond to the environmental and social challenges that the traditional frameworks of philanthropy alone could not address. Impact investors generally seek to generate a double or multiple bottom-line, meaning achieving positive social and/or environmental change in addition to securing a financial return. Some examples of impact investors include development finance institutions, banks, impact investing firms, family offices, public charities, and private foundations. These entities usually invest in ventures aligned with their mission, priorities, or sustainable goals (e.g., clean energy, health, education, financial services, sustainable agriculture, gender equality). Many examples of successful impact investments and ventures exist. One such success story is the Patagonia venture fund launched in 2013, known as Tin Shed Ventures, which invests in "innovations that overcome systemic barriers to regenerative agriculture adoption on land and water," with outcomes including the reduction of waste and the environmental impacts of agriculture. Innovation in the field of impact investing has translated into creative legal innovation including the evolution of new financing tools, such as the B corporation, revenue-based financing, and recoverable grant and social bond structures. The impact investing industry is also using innovative blended finance structures to more adequately balance impact and financial objectives. The effectiveness of impact investing implies considering the long-term lasting impact of an investment, including after liquidation. For that reason, achieving a "responsible exit" when divesting is crucial. Exits need to be structured at the outset to ensure that the liquidation of the impact investment is accountable to the communities being served and intentional about continuing the positive impact for society. **I. Considerations at the Time and During the Life of the Investment** Planning for a responsible exit should start long before an actual divestment. To accommodate a responsible exit, when investing, an impact investor can seek to invest in mission-driven founders and should understand the founders' plans for growth and possible exit scenarios. As a condition to investment, and then during the investment, impact investors should look to design ways to influence policies and achieve certain impact metrics. When considering attracting additional investors, impact investors can also undertake proper due diligence to ensure alignment of any co-investors with the company's mission, and they should provide for contractual

mechanisms to protect the mission of the investment. *Mission-driven leadership.* Impact investing also means investing in a team that will embed the mission in the company and its operations. Selecting a founder of the venture and a management team who are aligned with the impact investor's objectives and deeply committed to the mission is often the best way to create a lasting impact. Founders likely will want to retain a degree of control over the venture company's mission (e.g., by creating separate classes of voting stock and vesting in the founders certain voting or veto rights over identified decisions affecting the mission). *Effective policies*. Impact investors can also lay the groundwork for responsible exits during the life of their investment. The investor can promote effective policies related to Environmental, Social, and Governance ("ESG") and related issues, and it can make sure those policies are implemented by systematizing reporting requirements, compliance, and audit checks. Good governance and policy implementation should be a key focus of impact investing, and it should never be underestimated when exploring and negotiating the investment. Embedding certain ethical principles and instilling ESG and equivalent policies and practices into the business is essential to a responsible investment, and should be factored into the investment strategy. Depending on the industry, investors can even take additional steps by seeking to ensure that their investments obtain the highest level of third-party certification available in that industry (e.g., B Corp certification, or, in the case of financial institutions, client protection certification from bodies approved by Cerise+SPTF, which provides confidence that a financial service provider adequately follows client protection principles). *Investor alignment and legal protection mechanisms*. Structuring the investment with investors sharing a similar philosophy can also influence whether an investment will be able to grow sustainably while also subsequently achieving a responsible exit. Mechanisms should be incorporated in a shareholder's agreement (or equivalent document) to enshrine the mission consistent with the objectives described above. The impact investor can require that certain impact metrics (such as the number of lives impacted, the progress on gender equality and women and girls' empowerment, or the alignment with certain United Nations' Sustainable Development Goals) are met in connection with their investment. A supermajority vote or founder consent may be required for any amendment to the mission statement for mergers, reorganizations, or stock transfer as discussed above. Put option or redemption rights may be available, and in fact, are often requested by impact investors as mechanisms to withdraw from the investment under the occurrence of certain triggering events (e.g., if the company fails to meet or maintain certain impact objectives or results). Such provisions are also used by impact investors to protect against reputational risk if, for example, the company's activities become misaligned with the investor's mission, priorities, policies, or regulations. **II. Considerations at the Time of Exit** When it is time to divest, the ability to achieve a responsible exit may be challenged by several factors. The exiting impact investor and the prospective ideal buyer may not always have the same time horizon, resulting in the need to compromise, depending on availability of adequate buyers. In addition, finding the perfect buyer with an aligned mission can prove to be difficult in some markets. Finally, enshrining mission preservation principles in the legal documentation at exit is at best difficult and at worst impossible. *Timing the exit*. In the impact investing space (similar to other types of investments), timing an exit may depend on several factors.

The investors may have decided that their mission or impact objectives have been accomplished, and now they need to deploy their capital elsewhere. Additional capital may also be required to further the mission, capital that the current investors may not be willing or able to provide. Scarcity of aligned buyers is another factor in determining the timing and conditions of an exit. For instance, an aligned buyer may want to invest at a specific time when no other aligned buyers are available at that time. This, in turn, forces the divesting impact investors to be more accommodating from a financial (i.e., pricing) perspective if they believe long-term impact may be created. Being flexible in terms of timing may also allow for better, more responsible exits. *Buyer selection and mission alignment*. Identifying buyers aligned with the company's mission is generally the best guarantee that such mission and related impact will be continued. Impact investors should perform a thorough due diligence on the buyer to increase the likelihood of continued impact after exit. In addition to the traditional Know Your Customer searches on the buyer, impact investors should understand the industry reputation of the buyer, along with the prospective buyer's track record of achieving impact objectives. The buyer should also have the financial capacity to carry the mission forward. One complicating factor, though, is that the impact investors may not have multiple buyers available at a time when they are under financial constraint. Identifying and vetting the right buyer and preserving the financial situation of the investment will also, at times, require a balancing act. *Legal documentation protections*. Legally enshrining the mission preservation in the legal documents at the time of exit through various covenants is often challenging and may be subject to difficult negotiations. At the core of preserving the mission is ensuring that the employees of the divested company are protected. Employees who decide to work in impact investing often have made the choice consciously and care deeply about their company's mission. Once the impact investor has divested, these employees are needed to help carry the mission forward and thus realize its objectives. Hence, protecting the employees at the time of exit should be part of the negotiations both at the time of investment and upon exit. This is particularly important given that covenants in the sales closing documentation requiring new owners to preserve impact post-closing are often difficult to negotiate and most of the time ineffective. It would generally be very difficult for impact investors to ensure compliance post-closing with these conditions, and the likelihood of exited impact investors suing a buyer to enforce these covenants is unlikely in practice. **Conclusion** When companies reach a level of maturity such that a new strategic investor is needed, or when a reallocation of resources is necessary, impact investors may decide to exit responsibly to mitigate any mission drift, and in the hope that their investment will have a lasting impact. Despite its challenges (e.g., lack of appropriate buyers, difficulties in enforcing impact-related covenants), trying to achieve a responsible exit is paramount for impact investors. Put simply, it means caring about the population served and wanting to leave them in a better, more lasting position with new investors who share similar values. Not exiting responsibly can also have severe reputational consequences, which may result in an impact investor being unable to raise future capital or source deals. In some industries, selling to the wrong buyer can also have dire consequences (e.g., in the case of microfinance, selling a company to a predatory lender means negatively impacting the population the impact investor seeks to serve). Careful exit planning throughout the investment, nevertheless,

can achieve a responsible and sustainable investment aligned with the original mission.

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Authored By

Thomas F. Morante

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