KEYNOTE INTERVIEW

Incorporating impact into deal documentation

The private equity model is well suited to impact investing, but some additional considerations can help funds drive positive outcomes, say Travers Smith's George Weavil and Henriika Hara

SPONSOR
TRAVERS SMITH

Q To what extent does the legal process for investments and disposals differ for impact investors compared with traditional buyout investors?

George Weavil: In many ways, the work that impact investors do is no different to the traditional private equity model, other than the need to select investments and manage them in a way that has the desired positive and measurable impact.

In most cases, particularly where the manager is taking a majority stake, we can use the same documentation with some refinements, such as changing the scope of warranties, for example.

Equity documents in a majority deal are incredibly broad, so they typically work for impact investors too. The things we might do differently include adding impact-driven conduct of business provisions and also tools to help drive behavioural change at the portfolio level – there are some quite interesting innovations appearing on that front, including mechanisms to incentivise management behaviour in the right way. While those incentive schemes are typically based on financial metrics, it is possible to adapt them for an impact context.

From a regulatory perspective, we would also need to approach the due diligence phase more carefully, and the process looks quite different for Article 9 or Article 8-plus funds under the EU Sustainable Finance Disclosure Regulation.

Henriika Hara: Impact investing as a model is well suited to private markets. The active investment approach of private equity suits an impact strategy because PE firms have always put in place

Q Do impact investors require additional information or governance rights relative to other investors?

GW: Information and governance rights are extensive in a traditional buyout deal, giving a fund manager an incredibly broad ability to monitor its investment and, if required, effect change, including by taking control of the board. Similar to how we saw those rights becoming more specific and granular when the UK Bribery Act was introduced, it is likely that we will see further refinements introduced as a result of the increasingly extensive reporting obligations to which impact investors are subject. However, a significant increase in the overall scope of those rights seems unlikely to be necessary.

Where it gets more interesting is where an impact fund takes a minority position, as many do, because then they cannot assume they can take control. Information rights are also more heavily negotiated. In that scenario, managers need to think much more carefully about those rights and aligning them to their own internal KPIs, against which reporting is required by investors and regulators.

Even more challenging is what happens around investment discretion requirements. If you have an Article 9 fund that has a minority position, and therefore does not control the direction of the business, what happens if you start to see that business tripping up and causing harm in some way? Investors have always had default rights to take more control in the event of financial underperformance; impact investors may need to incorporate similar rights based on an impact trigger.

HH: The board structure is a great way for impact investors to have influence and there are lots of mechanisms already built into private equity-style governance rights that allow them to make sure they have levers to pull if things go wrong. Those mechanisms can all be adapted to make sure that, as well as dealing with commercial and financial matters, managers can ensure that impact-related commitments are delivered, so that, in turn, the fund manager can meet its commitments to investors and to regulators.

corporate governance mechanisms that allow them to have a real impact on major operational and strategic decisions at the underlying company level.

Private equity deals are typically private acquisitions, so the buyer can carry out extensive due diligence to identify impact opportunities and develop – and agree with management – a strategy for change. After the deal is done, the investor has access to full information, influence at board level and knows how to incentivise management.

Q Do impact investors have to approach due diligence differently?

HH: Impact investors tend to have their own frameworks to assess companies pre-acquisition to ensure that the investment can generate a positive, measurable social and/or environmental outcome. Those assessments are important for us, as lawyers, to understand when we are conducting due diligence on the assets because it will be important to validate any assumptions being made about the company that are important to generate the impact.

There is also a regulatory aspect to due diligence and market practice that is very much developing as the regulatory framework continues to evolve in Europe. There is still a lack of clarity around what precisely managers need to do in order to invest in an asset that is going into a fund that has been characterised as an Article 9 or an Article 8-plus fund under the EU's SFDR.

An 'impact fund' that has raised money from EU investors recently is most likely to be categorised either as Article 9 or as Article 8-plus. The key difference is that an Article 9 fund can only invest in assets that are defined as 'sustainable investments' by SFDR, whereas Article 8-plus funds must invest at least a specified proportion of their assets in sustainable investments. In both cases, additional due diligence is necessary before making an investment in order to determine whether the asset qualifies as a sustainable

investment for SFDR purposes. That definition remains very much subject to debate, so there will be different approaches in the market, but further clarification is expected soon.

Categorising an investment as sustainable requires not only identifying a social or environmental objective, but also running a detailed 'do no significant harm' (DNSH) test at the level of the portfolio company. That is going to be the most challenging part because managers generally require a lot of data to be satisfied that the investment passes that DNSH test.

Q What tools can help impact investors promote alignment between their impact objectives and those of their management teams?

GW: We have seen interesting new developments here around ESG-linked incentives. Those are not a particularly new idea, in that for quite some time listed companies have had ESG-linked KPIs incorporated into their remuneration schemes for senior managers, but that has now started to filter down into asset management.

The first place we saw it was in lending, in the form of fund-level financing facilities with ESG-linked margin ratchets, and that then dropped down into portfolio-level lending. ESG-linked margin ratchets are now relatively common at that level and they are a useful tool for driving the right sort of behaviours among borrowers.

As part of The Chancery Lane Project – a climate-focused collaboration of legal professionals – Travers Smith has helped develop Bella's Clause. This is an ESG-linked equity ratchet that can transfer value from the investor to the portfolio company management team based on the achievement of ESG-linked KPIs. It is a powerful tool to drive behaviour at that level. We are also seeing that in carried interest structures, so that there is complete alignment all the way down the chain of decision-making.

> *"There are mechanisms that can be built into the sale contract to promote the ongoing impact journey"*
>
> **GEORGE WEAVIL**

These models are not without their challenges, and the magic of making these work lies in the design of the KPIs, which need to be both achievable but also stretching. It is important that they are calibrated appropriately to avoid charges of greenwashing, and all that design must take place against the backdrop of a fast-paced deal environment.

HH: This is a positive development, but it is a tricky area to navigate because, if you are not careful, you can misalign incentives, or cause people to focus on the wrong things, through structuring these in the wrong way. It is important to fully think through any unintended consequences. The design of these ratchets is another area that is still very much in its infancy.

Q Is it possible for impact investors to encourage their portfolio companies to continue their impact journey beyond exit?

GW: There is a lot about the private equity model that is perfectly suited for impact, but if you are just holding an investment for four to five years and then disposing of it, how do you stop all that good work being undone by the next owner? That is a challenge for impact investors, but there are a few fairly simple options available to address this.

First and foremost, there is a question as to whether impact investors should actively seek out the 'safe pair of hands' when selling their assets rather than focusing solely on price and speed of execution. There are also mechanisms that can be built into the sale contract to promote the ongoing impact journey, such as obligations that require the buyer to continue in a particular way. We see examples of this in businesses being sold that are in distressed or turnaround situations, where there might be obligations put in around staff and so on. However, those obligations can be challenging to enforce.

Another drafting solution may be to include a financial penalty or incentive in the documents so that some sort of deferred consideration is payable if the buyer runs the business within a certain set of parameters (or consideration is clawed back in the event of failure to do so).

Perhaps a more interesting option, however, would be turning investments into B Corps, providing certification that the business is meeting the highest standards of performance, accountability and transparency on factors such as employee benefits, charitable giving, supply chain practices and input materials.

That is something we are having more and more conversations about. It is starting to seem like there is a real premium associated with having a B Corp certification, particularly if you are a consumer-facing business. It stands to reason that a business being forced to deregister as a B Corp because it is not meeting the required standard would be likely to have a negative impact on its financial performance. That means turning companies into B Corps ahead of a sale could give some comfort to the seller that the impact journey will continue beyond exit. ■

George Weavil is a corporate partner at Travers Smith and Henriika Hara is senior counsel in the firm's financial services and markets team