

How To Make The Most Of Impact Fund Formation

By **Benjamin Horney**

Law360 (November 28, 2018, 4:03 PM EST) -- As private equity and other investors increasingly consider the effects their investments will have on society, attorneys should spend time becoming familiar with the formation process for so-called impact funds, which aim to contribute to social good, while staying abreast of the unique legal challenges that may arise.

Impact investing — which aims to benefit the greater good by focusing on companies addressing issues such as climate change, education and affordable housing — has historically been thought of throughout the industry as an alternative to seeking the highest possible returns.

The idea was that impact investments could still net solid financial returns while bringing the benefit of societal improvements and bolstering a firm's image, but attorneys with experience in the space say that in today's world, when done correctly, the practice can actually lead to higher returns than those yielded by traditional PE funds.

"It depends on the asset class and type of investment that is being done, but yes, impact funds can result in market or even better-than-market returns," said Luciana Aquino-Hagedorn, a partner at Goodwin Procter LLP and co-leader of the firm's impact and responsible investing practice.

In some cases, the impact aspect can actually be a significant factor leading to stronger returns, she explained.

"For instance, if you're dealing with investors in the forestry space, many of those investors are able to get better returns by pursuing a strategy that addresses climate change, such as conservation easements or carbon credits," she said.

That said, there's more to putting together an impact investing fund than simply adding a few sentences into the framework of a standard PE fund, and the details behind how such funds are formed can be the difference between a client hitting or failing to reach their financial goals, according to Suz Mac Cormac, a partner at Morrison & Foerster LLP and chair of the firm's social and impact investing practice.

"People really need to be thoughtful when advising clients on what the best mechanism is [for putting together an impact investing fund]," Mac Cormac said. "We're seeing a lot of people following the herd, which may be good and may not be good. In the impact investing area, people first need to step backwards and say, 'When a client says they want to have an impact, what does that mean?'"

That's an important question to ask your client right at the start of the process, because the way a fund is formed can differ depending on what they actually mean by "impact." The answer to whether they want to be impact-first, investment-first or catalyst-first investors matters, since it gives lawyers a guide as to what is most important, be it returns, impact or a combination of both.

Regardless of what type of impact investor your client wants to be, there are certain issues that should always be addressed at the forefront. Among the matters that must be addressed early in the process is fiduciary duty, and what responsibilities the general partner will have to the limited partners with regard to returns and impact, since the specifics can vary based upon what the fund's overall goal is going to be.

"If your goal is to maximize profits and also have some kind of impact, then you have to make sure that's understood by investors as part of your disclosure," said Elizabeth Roberts, a partner in Goodwin Procter's private equity and private investment funds practices and co-leader of the firm's impact and responsible investing practice. "That's something that's common across any kind of impact fund."

Another question that is likely to come up in the early stages of putting together an impact fund is how that impact will actually be measured, and although the actual measurement of the impact is not left to the law firm and is instead typically outsourced to third party providers, attorneys will have to write into fund documents some kind of obligation from the general partner to provide a report that measures impact, Roberts explained.

Meanwhile, though the details behind how the impact will be measured is mostly left to entities aside from legal counsel, lawyers do have to be attuned to how those measurements wind up shaking out, because the particulars of the many economic factors that must be written into fund documents can relate to the measurement.

For example, an affordable housing fund could have written into its partnership agreement that part of the carry — which is a share of the profits paid to the general partner — could be dependent on impact, according to Roberts.

"That impact could be the number of affordable housing units they get online in a certain investment, or how many families they put in place closer to a school. It can be measured in different ways."

Another issue that lawyers will be heavily involved with is writing in provisions that lay out how fund managers are going to be incentivized to make sure their investments are focused on impact in addition to financial returns.

There are multiple ways to do that incentivizing, including "impact clawback," according to Roberts, which is a type of provision that can give limited partners the right to require a general partner to return distributions of carried interest if they receive too large a portion of the total profit.

"That's something that we have to put in the documents, because that's how the economics are going to work," Roberts said. "It can be very specific to the client and the fund."

In addition to getting up to speed on the specifics of how to put together the actual fund documents for an impact investment vehicle, it's important that attorneys understand the "breadth and depth" of the types of opportunities that exist in the space, according to Peter Gilman, a corporate partner with Simpson Thacher & Bartlett LLP.

Because there are so many potential areas that a given fund might target — impact funds can focus on everything from water treatment and environmental initiatives to education funding, microfinance, public infrastructure and health care — it's common for experts in the specific field to be brought in to help with both the fund formation process and the actual investments that result.

“Each of these areas requires substantial specialization and expertise, and for that reason, it is common for PE firms and other impact investors to partner with experts in each sector or field to help evaluate opportunities and measure the anticipated long-term impact of their capital in an objective and quantifiable manner,” Gilman said.

These are merely some of the issues that come with setting up an impact investment fund, and it's crucial for those attorneys that are interested in the subject to get up to speed today, because the reality is that the practice is growing in popularity.

The ways that these types of fund are put together will evolve as more private equity players look to make positive societal impacts with their investments, and those lawyers that have been paying attention from the beginning will be better situated to assist clients than those who haven't.

“While the growth in the impact investing space among PE firms has been significant, we believe that it is very much a nascent industry poised for substantial long-term expansion,” Gilman said.

--Editing by Philip Shea and Alanna Weissman.

This is the second in a two-part series on the private equity industry's increasing interest in impact investing and the unique legal work that can be associated with the practice.