

Resolving Impact Investment Disputes: When Doing Good Goes Bad

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“The world is on the brink of a revolution in how we solve society’s toughest problems. The force capable of driving this revolution is ‘social impact investing,’ which harnesses entrepreneurship, innovation and capital to power social improvement.”

—*Report of the independent Social Impact Investment Taskforce, established under the United Kingdom’s presidency of the G8 (September 15, 2014)*¹

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1. SOCIAL IMPACT INVESTMENT TASKFORCE, *IMPACT INVESTMENT: THE INVISIBLE HEART OF MARKETS 1* (2014) [hereinafter *THE INVISIBLE HEART OF MARKETS*]. The Social Impact Investment Taskforce was launched during the summer of 2013 as an independent task force under the United Kingdom’s presidency of the G8. Government and sector experts from the G7 countries, the European Commission, and Australia collaborated to report on “catalysing a global market in impact investment.” *Id.* The G8 Impact Taskforce Report is one of several papers and reports that were issued under this mandate. *See also* SOCIAL IMPACT INVESTMENT TASKFORCE, *POLICY LEVERS AND OBJECTIVES* (2014); SOCIAL IMPACT INVESTMENT TASKFORCE, *MEASURING IMPACT* (2014); SOCIAL IMPACT INVESTMENT TASKFORCE, *ALLOCATING FOR IMPACT* (2014); SOCIAL IMPACT INVESTMENT TASKFORCE, *PROFIT-WITH-PURPOSE BUSINESSES* (2014); SOCIAL IMPACT INVESTMENT TASKFORCE, *INTERNATIONAL DEVELOPMENT* (2014); *Social Impact Investment Taskforce*, GOV.UK, (Oct 19, 2014), available at <https://www.gov.uk/government/groups/social-impact-investment-taskforce> (listing eight National Advisory Board Reports—Australia, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—notably absent is Russia).

“One might with justification say that [impact investing] brings the invisible heart of markets to guide their invisible hand.”

—*Sir Ronald Cohen, Chair of the Social Impact Taskforce, Letter to Leaders of Taskforce Governments*²

“This is ground zero of a big deal.”

—*Former US Secretary of the Treasury, Lawrence Summers (May 2014)*³

INTRODUCTION

A “revolution,” the “invisible heart of markets,” “ground zero of a big deal”—these are powerful metaphors for characterizing the promise of a new approach to investing money called “impact investing.”⁴ But can all impact investments deliver on these expectations?

Most will deliver, but some may not. Accordingly, a challenge to growing a robust impact investment market is to make sure that the deals that fail to meet investors’ expectations don’t erode investor confidence in the impact investment market more generally.⁵ One

2. THE INVISIBLE HEART OF MARKETS, *supra* note 1.

3. See THE INVISIBLE HEART OF MARKETS, *supra* note 1, at 39 (Summers is quoted after investing in a new social finance innovation—the social impact bond). See also Burand, *infra* note 31 and accompanying text for further discussion of social impact bonds.

4. Even Pope Francis is promoting impact investing. In June 2014, he issued a call to action to world leaders, saying “[i]t is urgent that governments throughout the world commit themselves to developing an international framework capable of promoting a market of high impact investments and thus to combating an economy which excludes and discards.” THE INVISIBLE HEART OF MARKETS, *supra* note 1, at 39.

5. This Article focuses on how to respond to impact investments that do not meet investors’ expectations, that is impact investments that have “gone bad.” Most of the examples cited in this Article focus on impact investments that have failed to meet investors’ financial expectations, rather than those that have failed to meet investors’ social expectations.

Yet, in the impact investing market, investment disputes also can arise when there is financial or operational “over” performance by the impact investment, such that financial rewards are likely to overwhelm or distract managers’ attention from achieving social impact objectives. For example, the financial performance of a social enterprise may attract commercial investors that have little interest in the social mission of the enterprise. In some cases, notable financial success may make the social enterprise a target for acquisition by a larger commercial enterprise. Or, as happened in the microfinance sector, the financial rewards of conducting a lucrative initial public offering of a social enterprise may cause consternation among those who worry about subsequent mission drift. See, e.g., Muhammad Yunus,

way to ensure that this nascent market stays healthy as a whole, even if individual impact investments struggle, is to develop innovative and value-aligned approaches to dispute resolution that mirror the innovations and value alignment found in impact investment deal structures.

This Article describes the state of impact investing today. In doing so, it examines trends in impact investment deal structures and documentation that distinguishes impact investments from more commercial investments. It also identifies unique challenges that may arise in disputes concerning weak or failing impact investments. To inform this discussion, this Article considers the responses of socially conscious investors to problems with their investments in troubled microfinance institutions shortly after the 2008 global recession. Finally, this Article considers the appropriateness of using international arbitration as a dispute resolution mechanism in cross-border, impact investments. This Article concludes with several suggestions for dispute resolution mechanisms that are capable of resolving disputes arising from impact investments gone bad.

I. WHAT IS IMPACT INVESTING?

While investing to advance societal goals is not a new idea, a market that self-identifies as impact investing only recently has emerged.⁶ The meaning of the term “impact investment” is not universally agreed upon. A growing consensus, however, recognizes that impact investing is more than investing with good intentions.⁷

Sacrificing Microcredit for Megaprofits, N.Y. TIMES (Jan. 14, 2011), http://www.nytimes.com/2011/01/15/opinion/15yunus.html?_r=1 (Professor Yunus, the founder of Grameen Bank and 2006 winner of the Nobel Peace Prize for his contributions to creating the microfinance sector, criticizes the commercialization of microfinance and argues that “[p]overty should be eradicated, not seen as a money-making opportunity”).

6. The term “impact investing” was first coined in 2007 at a conference convened by the Rockefeller Foundation in Bellagio, Italy. The use of financial investments to advance social goals has a much longer history, however. Some observers trace impact investing’s roots in the United States to 1950, when the United States started selling political risk insurance to US companies investing abroad. See U.S. NATIONAL ADVISORY BOARD ON IMPACT INVESTING, PRIVATE CAPITAL, PUBLIC GOOD: HOW SMART FEDERAL POLICY CAN GALVANIZE IMPACT INVESTING—AND WHY IT’S URGENT 12 (2014).

7. Paul Brest & Kelly Born, *When Can Impact Investing Create Real Impact?*, STAN. SOC. INNOV. REV. (Fall 2013) at 22 (with commentary by Audrey Choi, Morgan Stanley;

Intentions matter, of course; but so does measurement of progress toward achieving those intentions. According to the G8's Social Impact Investment Taskforce (the "Taskforce"), "the defining characteristic of impact investment is that the goal of generating financial returns is unequivocally pursued within the context of setting impact objectives and measuring their achievement."⁸

This Article adopts the definition of impact investment used by the Global Impact Investment Network (GIIN) in its 2013 survey of 125 impact investors:⁹ "[i]mpact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances."¹⁰

II. HOW BIG IS THE IMPACT INVESTING MARKET TODAY AND WHAT ARE ITS PROSPECTS FOR CONTINUED GROWTH?

As the quotes that introduced this Article indicate, some champions of impact investing see its potential power as nothing short of transformative, capable of mobilizing entrepreneurship, innovation, and capital to solve some of society's most challenging

Sterling Speirn, W.K. Kellogg Foundation; Alvaro Rodriguez Arregui & Michael Chu, IGNIA); see also *OPIC In Action*, OPIC, <http://www.opic.gov/opic-action/impact-investing> (last visited Oct. 19, 2014) (OPIC identifies deals as "impact investments" when its partners ". . . design their very business models with an explicit and inherent intent at startup to address environmental or social issues, as well as a business model with a structure dedicated to achieving both impact and financial returns").

8. See *THE INVISIBLE HEART OF MARKETS*, *supra* note 1, at 18 (in contrast, an "investment that results in impact that is marginal to a business's main activity is not impact investment, though it might be viewed as 'investment with impact'").

9. Yasemin Saltuk et al., *Spotlight on the Market: The Impact Investor Survey*, GLOBAL SOCIAL FINANCE (May 2, 2014), 1, 13 available at <http://www.thegiin.org/binary-data/2014MarketSpotlight.PDF> (this survey gathered the responses of 125 impact investors at end of 2013). Because this Article examines key findings of the GIIN survey, it adopts the GIIN definition of impact investing.

10. *Id.* at 13; see also *About Impact Investing*, GLOBAL IMPACT INVESTING NETWORK (GIIN) (2014), <http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html>. GIIN identifies four core characteristics of impact investing: (1) intentionality, (2) investment with return expectations, (3) range of return expectations and asset classes, and (4) impact measurement. *Id.*

problems.¹¹ Whether impact investing can live up to its promise, however, is likely to turn on whether impact investments actually deliver on their multiple bottom lines—that is, their ability to deliver financial returns alongside measurable progress toward desired social and environmental impacts.¹²

Many market observers are betting that impact investments will do just that, as shown by the fast growth rate of capital investment in the impact investing market. A recent survey of 125 impact investors found that these investors managed approximately \$46 billion in impact investment assets as of the end of 2013.¹³ Survey respondents also reported that they planned to invest another \$12.7 billion in 2014, while increasing the number of impact investment transactions executed in 2014 by 31 percent.¹⁴

Whether this pace of growth can and will continue is debatable. Current impact investors point to the following challenges to growing their portfolios of impact investments:

1. Shortage of high quality investment opportunities with track records
2. Lack of appropriate capital across the risk/return spectrum
3. Difficulty exiting impact investments

11. See THE INVISIBLE HEART OF MARKETS, *supra* note 1, at 1 (“By bringing a third dimension, impact, to the 20th century capital market dimensions of risk and return, impact investing has the potential to transform our ability to build a better society for all”).

12. John Elkington coined the term “triple bottom line” when describing the financial, social and environmental bottom lines of companies. See, e.g., JOHN ELKINGTON, CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS (1997).

13. See Saltuk et al., *supra* note 9, at 5–6 (surveyed respondents providing numerical data for 2013 and 2012 experienced 10 percent growth in capital committed between 2012 and 2013 and 20 percent growth in the number of deals executed).

Impact investing is taking place across a range of sectors, but the majority of impact investing is currently concentrated in the financial services sector, including both microfinance (21 percent) and other types of financial services (21 percent). See Saltuk et al., *supra* note 9, at 7. This sectoral allocation may start to shift. A number of survey respondents indicated that they plan to increase their sector exposure to food and agriculture and to healthcare. *Id.*

14. *Id.* at 12–13 (surveyed respondents committed \$10.6 billion and executed 4,914 deals in 2013. In 2014, they expect to invest another \$12.7 billion and execute another 6,419 deals).

4. Lack of innovative deal/fund structures to accommodate investors' or portfolio companies' needs

5. Lack of common way to talk about impact investing¹⁵

These are significant concerns that deserve attention and creative solutions, but it should be noted that these are the concerns of a relatively small number of investors (125) that are already active in the impact investment market.

The real challenge here is convincing a much larger class of investors to enter the impact investment market, namely those 1,276 investment managers that currently manage more than \$45 trillion in assets and have committed to incorporate social, environmental, and governance factors into their investment decisions.¹⁶ To convince these investment managers to direct some portion of the assets under their management to the impact investing market, work needs to be done to ensure that any weak or failing impact investments are dealt with efficiently and effectively. Otherwise, disappointments over the performance of a handful of impact investments may spill over and taint these investment managers' view of the quality of the rest of the impact investing market.

III. WHAT KINDS OF DEALS ARE BEING DONE IN IMPACT INVESTING AND HOW ARE THESE TRANSACTIONS DIFFERENT FROM MORE TRADITIONAL COMMERCIAL INVESTMENTS?

Currently, more than two-thirds of impact investing deal flow takes place in emerging markets outside the United States. Much of that deal flow is in the form of debt financing.¹⁷ Therefore, as a

15. *Id.* at 17.

16. See THE INVISIBLE HEART OF MARKETS, *supra* note 1, at 18.

17. See Saltuk et al., *supra* note 9, at 6–7, 23 (debt financing accounts for 62 percent of the impact investment assets currently under management, and private equity investments amount to 24 percent).

This current preference for debt financing may reflect one of the concerns identified by impact investors in the Impact Investor Survey—namely, it is difficult to exit an impact investment. *Id.* at 6, tbl.4 (difficulty of exiting investments ranked in the top three of perceived challenges to the growth of the impact investing market). The lack of exit options, in turn, can place additional pressure on parties trying to resolve an impact investment dispute since it is

general matter, the documentation of an impact investment will look very familiar to those experienced in structuring more traditional, cross-border commercial investments, particularly international debt financings.

Some impact investors, however, have developed new forms of documentation and deal structures that attempt to align their capital to the business models, including financial and social objectives, of their investees. As one impact investor has commented, “[t]he bottom line is that impact is being generated by the underlying operating entity. As investors, our job is to understand the underlying business model and determine whether we are prepared to align our capital to support it.”¹⁸

A recent study of the innovative deal structures currently used in impact investments observed that both debt and equity investors¹⁹ are modifying and adapting traditional deal structures to align the timing and amount of financial returns with the business models of their borrowers/investees.²⁰ Some lenders offer borrowers more flexible

unlikely that a disgruntled investor can walk away from a dispute by simply selling its impact investment to another party.

18. *Id.* at 13.

19. Grant funders also are experimenting with new hybrid structures. For example, some donors are developing “repayable grant” facilities that, upon the occurrence of certain agreed milestones (often operational or financial targets), convert their grants into loans that the grant recipient is expected to repay to the donor. This structure may appear counterintuitive as it effectively penalizes high-achieving grant recipients by introducing a financial liability to replace what originally was “free” money. This structure could also introduce an element of moral hazard such that grant recipients have a financial incentive not to meet the agreed milestones. The donors proposing these structures, however, appear willing to accept the risks inherent in this misalignment of incentives. Some critics might argue that grant recipients that meet certain operational or financial threshold indicators of success can afford to return the grant funding. Recycling these donor funds back to the donors, they argue, benefits all impact investment stakeholders, since relatively scarce grant resources can then be made available to other grant recipients. Examples of repayable grants are available in the author’s clinic files; see also “conditionally repayable contributions” offered by the Canadian government to small businesses (conditions for these repayable contributions are described at <http://www.canada.govtmentgrants.org/conditionally-repayable-contribution.php>); repayable grants also are offered by the Global Water Foundation to small and medium enterprises and local entrepreneurs. See *Grant Guidelines*, GLOBAL WATER FOUND. <http://www.globalwaterfoundation.org/index.php?page=grant> (last visited June 10, 2015).

20. Diana Propper de Callejon et al., *Innovative Deal Structures for Impact Investments* (2014) (report) (on file with author). This study, *Innovative Deal Structures for Impact Investments*, is based on interviews with nearly one hundred impact investors, enterprises, legal experts, and advisors from around the world. Its key findings, which were released in

repayment schedules. For example, they are creating variable payment structures that are triggered when (and in some cases, only if) the borrower meets certain thresholds of revenues or cash flows. Therefore, the timing and amount of debt repayments are contingent on the borrower's financial performance rather than a traditional, fixed payment schedule.²¹ Other lenders are providing for principal amortization schedules that go for as long as ten years or grace periods of eighteen to twenty-four months or more; some lenders are agreeing to forego prepayment penalties or, in a few cases, offer prepayment discounts.²²

Equity investors also are attempting to align the timing and amount of dividend payments and redemption rights with the business models of their investees. In doing so, they stage dividend payments and redemption-based exits, and, in some cases, link these payments to the investee's revenues or amount of cash on hand.²³

Beyond aligning impact investors' financial return expectations to the investee's business model, some impact investors also attempt to embed social impact goals directly into the contractual provisions of their investments. These provisions could aim to protect against

September 2014, focus on privately held, early-stage businesses. The lead researchers were Diana Propper de Callejon and Bruce Campbell, with support from Gabi Blumberg. *Id.*

21. *See id.* One variable payment structure used by impact investors is called the "demand dividend." The demand dividend structure, it should be noted, does not offer dividends to its investors. Rather, the demand dividend is a variation on debt royalty structures and often includes the following features: (1) a payment schedule that is tied to the cash flow of the borrower, (2) a honeymoon period (grace period) where repayment obligations are deferred, (3) a fixed payment obligation that is calculated as a multiple of the amount lent to the borrower, and (4) covenants focused on ensuring that the borrower reaches a positive cash flow. *See* SANTA CLARA UNIV., DEMAND DIVIDEND: CREATING RELIABLE RETURNS IN IMPACT INVESTING 3 (June 2013), available at <http://www.scu.edu/socialbenefit/impact-capital/upload/Demand-Dividend-Description.pdf>.

22. *See* Propper de Callejon, *supra* note 20, at 3.

23. *See id.* at 2.

unintended and undesirable social impacts or,²⁴ conversely, to spur and measure desired social impacts.²⁵

Other impact investors, however, do not appear to rely (or at least not as much) on contractual provisions in their investment documentation to ensure mission compliance.²⁶ Instead, these

24. SARAH FORSTER ET AL., IMPLEMENTING THE CONSUMER PROTECTION PRINCIPLES: A TECHNICAL GUIDE FOR INVESTORS 15–16 (Nov. 2010). The German-owned, development finance institution, KfW, uses a contractual provision when making loans to microfinance institutions that aims to minimize adverse impacts on the end-users of its funding. More specifically, this contractual provision attempts to ensure that the microfinance institutions receiving loans from KfW adopt adequate customer protections for the micro-entrepreneurs that they serve. It states:

The Borrower [microfinance institution] shall fully comply with all existing and future national laws and regulations on consumer protection especially in the area of financial services. The Borrower shall in particular provide its customers with clear and comprehensive information on the main characteristics of the financial services the customers [micro-entrepreneurs] seek. The Borrower shall, for example, have thoroughly informed its customers in good time before the signing of a loan agreement on the terms and conditions of the loan in a way easily understandable for the customer.

These loan agreements shall further contain such information and shall be drafted in a manner the customers are able to understand. Furthermore, the Borrower shall critically review the customer's repayment capacities before signing a loan agreement and shall refrain from any form of unfair or even harmful debt collection practices.

Id. at 16. While some investors have included clauses like the above that require financial institutions to assess the repayment capacity of micro-entrepreneurs in both their loan and equity documentation, other investors have opted not to include such clauses in their investment documentation, and, instead, are focusing efforts on working with investees to improve client protection practices. *See id.* at 15–16.

25. Typically these contractual provisions are put in the form of reporting covenants, which require the investee to report to its funders on the social impact of its operations and activities. In the microfinance context, where financial inclusion is the desired social impact, these covenants can take the form of reporting provisions relating to the number of poor clients in rural areas or the number of female micro-entrepreneurs being served, for example. *See generally* Richard Rosenberg, *Measuring Results of Microfinance Institutions: Minimum Indicators That Donors and Investors Should Track*, CGAP, (June 2009), available at <http://www.cgap.org/sites/default/files/CGAP-Technical-Guide-Measuring-Results-of-Micro-finance-Institutions-Minimum-Indicators-That-Donors-and-Investors-Should-Track-Jul-2009.pdf>.

26. In 2013/2014, students of the ITC conducted a survey of impact investors to determine the extent to which impact investors are using contractual provisions in their investment documentation to ensure compliance with social mission goals. Christina M. Culver & Feihong Xu, University of Michigan International Transactions Clinic, *Reinforcing Social Mission Through Redemption Clauses: A Survey of Industry Standards* (2014) (unpublished survey) (on file with author) [hereinafter *Reinforcing Social Mission Survey*]. More specifically, students interviewed half a dozen impact investors with active equity investments to find out whether these impact investors used contractual provisions, such as redemption clauses, to encourage

investors use the pre-investment, due diligence process to assess the seriousness of the potential investee's commitment to achieving targeted social objectives. Once the investment is made, these impact investors rely on investees' governance structures to police the monitoring of, and compliance with, their investees' social mission goals.²⁷

Another factor that some impact investors leverage to shape investee behavior is the prospect, or lack thereof, of future funding. Some impact investors have indicated that they are unlikely to contribute future, additional funding to any investees that materially deviate from their stated social missions.²⁸ The effectiveness of such a threat to withhold future investments is likely to turn on the extent to which other sources of attractive capital present themselves to the investee.

Other ways that impact is being embedded in deal structures and investment documentation include the following:

1. A social mission definition is included in the deal documentation;²⁹
2. The use of proceeds of the investment are restricted to financing those business operations that are driving social impact outcomes;³⁰
3. The investee's governance structure includes the appointment of a board member with the responsibility to oversee the investee's social impact;³¹

investees' compliance with stated social mission goals. *Id.* at 2. Among the surveyed impact investors, only a few expressly tied social mission compliance to redemption rights. *Id.* at 2. Furthermore, rarely (if ever) are such redemption rights actually used to accelerate an exit. *Id.* at 2. Rather, those surveyed investors that link social mission to redemption rights appear to be using such rights as leverage to bring the investees to the negotiating table, while also signaling to investees (as well as to other investors, presumably) that social mission compliance is a priority. *Id.* at 3.

27. *Id.* at 4.

28. *Id.* at 2–3.

29. See Propper de Callejon, *supra* note 19, at 3.

30. *Id.*

31. *Id.*

4. Financial returns are correlated to social impact outcomes actually achieved by the investee—either directly (the higher the social impact, the higher the expected financial return)³² or inversely (a lower financial return is required if a higher social impact return is achieved); or
5. Investors are seeking to preserve the social mission objectives of their investees, even at exit.³³

In this author's opinion, this last issue presents some of the thorniest, and perhaps most controversial, deal structures and clauses in impact investing. A variety of methods have attempted to preserve social mission, a goal sometimes called "mission lock," beyond the contractual terms of the impact investment. In some cases, the investee's founders—presumably the people and/or institutions most concerned with maintaining control of the investee's social mission—are granted veto power to block investor exits that conflict with that mission.³⁴

In other cases, mission lock is being attempted through the investee's choice of legal form and/or charter provisions. Several relatively new legal forms of corporate entities are emerging in the United States and elsewhere that can be utilized by organizations seeking to generate financial returns as well as positive social and/or environmental benefits.³⁵ Organizations' motivations for choosing

32. *Id.* In the case of a new social finance innovation, social impact bonds (SIBs), financial and social returns are correlated positively so that financial returns increase when targeted social outcomes are met or exceeded. *See generally* Deborah Burand, *Globalizing Social Finance: How Social Impact Bonds and Social Impact Performance Guarantees Can Scale Development*, 9 N.Y.U. J.L. & BUS. 447 (2013) (describing two of the first SIB structures).

33. *See* Propper de Callejon, *supra* note 20, at 3.

34. *Id.* The termination of valuable licenses or hikes in the royalties/fees to be paid for such licenses also are reportedly being used by some to deter social mission drift (or at the very least, make such a drift more "painful").

35. One new legal form in the United States is the "benefit corporation." Adopted first in Maryland in 2010, twenty-seven states have enacted benefit corporation legislation to date. Notably, among these states, Delaware enacted public benefit corporation legislation in 2013. Alicia Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In?*, 14 U.C. DAVIS BUS. L.J. 247, 248 (2014).

Delaware Supreme Court Chief Justice Leo E. Strine, Jr. recently offered an analysis of the potential implications of Delaware's decision to adopt public benefit corporation legislation. In his opinion, Delaware's decision to permit a new legal form of company—the public benefit

one of these legal forms can be mixed. In some cases, it appears that this legal formation decision is being made by the founders. In other cases, impact investors also may be pushing the organization to incorporate as one of these new legal forms.

One's choice of legal entity, however, is not the only way to achieve mission lock. Some organizations are including mission locks in their charter documents.³⁶ It remains to be seen whether

corporation—is of particular significance because Delaware is the state of incorporation for the majority of American public companies and the preferred domicile for American companies seeking to go public. Consequently, he predicts that benefit corporations that hope to go public are likely to domicile in Delaware. Relatedly, Chief Justice Strine observes that one of the most important consequences of Delaware's public benefit corporation legislation is that the *Revlon* doctrine is not applicable to public benefit corporations. Consequently, the board's duty in a sale of control is fundamentally changed: namely, the board of a public benefit corporation cannot simply sell the corporation to highest bidder, but must use its own judgment to choose the best offer after considering all corporate constituencies. Leo E. Strine, Jr., *Making It Easier for Directors to "Do the Right Thing"?*, 4 HARV. BUS. L. REV. 235, 243–45 (2014).

In addition to benefit corporation legislation, some states have enacted laws that allow other legal forms of enterprises that expressly contemplate a social mission, such as "flexible purpose" or "social purpose" corporations (California and Washington, respectively), and "low profit, limited liability companies" (L3Cs). See generally J. Haskell Murray, *Corporate Forms of Social Enterprise: Comparing the State Statutes* (Jan. 15, 2015), available at <http://ssrn.com/abstract=1988556>. Nine states have enacted L3C legislation, but North Carolina repealed its L3C legislation effective January 2014. As of August 24, 2014, over one thousand L3Cs have been formed in the United States. *Latest L3 Tally*, INTERSECTOR PARTNERS L3C, http://www.intersectorl3c.com/l3c_tally.html (last visited Oct. 26, 2014).

This is happening outside the United States too. For example, the "community interest company" is a relatively new legal form in the United Kingdom. Introduced in 2005, community interest companies now number over ten thousand. See generally THE OFFICE OF THE REGULATOR OF COMMUNITY INTEREST COMPANIES, OPERATIONAL REPORT: SECOND QUARTER 2014–2015, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/365907/CIC-14-1163-community-interest-companies-operational-report-second-quarter-2014-15.pdf.

36. In 2013 the ITC provided pro bono legal support to help a L3C convert into a more traditional C Corporation at the request of an investor, but expressly included a broad social purpose in the Articles of Incorporation similar to that found in the Model Benefit Corporation Legislation ("Model Legislation") (originally drafted by Bill Clark of Drinker, Biddle, & Reath LLP, the Model Legislation has evolved. A current version (June 2014) of the Model Legislation can be found at <http://benefitcorp.net/attorneys/model-legislation>).

More specifically, the Articles include a provision stating:

The purpose or purposes for which the corporation is formed are to engage in any activity within the purposes for which corporations may be formed under the Michigan Business Corporation Act, including, without limitation, creating a (i) general public benefit, meaning a material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of the corporation, and (ii) the specific public benefits of improving human health and

these mission locks will prove effective.³⁷ Similarly, it remains to be seen whether those investors that achieve an effective mission lock will be satisfied in the long term with the social performance of their investee, particularly if the mission lock limits the investee's ability to innovate or attract additional capital needed to scale its operations.

IV. WHAT RISKS DO IMPACT INVESTMENTS PRESENT AND HOW ARE THEY CURRENTLY PERFORMING? WHAT HAPPENS WHEN AN IMPACT INVESTMENT GOES BAD?

For the second year in a row, “[b]usiness model execution [and] management risk” top the list of impact investors’ concerns as to the most significant contributors to risk in their impact investment

providing low-income or underserved individuals or communities with beneficial products or services.

See Design Innovations for Infants and Mothers Everywhere (DIIME), Articles of Incorporation (Apr. 23, 2013) (on file with author).

Some companies are including provisions in their charter documents that specify what they will *not* do to make profits. A notable and recent example is Ello.co, an ad-free social media network that converted to a Delaware public benefit corporation in the fall of 2014. Its new charter states, in part, that:

Ello shall *not* for pecuniary gain:

1. Sell user-specific data to a third party;
2. Enter into an agreement to display paid advertising on behalf of a third party; and
3. In the event of an acquisition or asset transfer, the Company shall require any acquiring entity to adopt these requirements with respect to the operations of Ello or its assets.

Jonathan Shieber, *Ello Raises \$5.5 Million, Legally Files As Public Benefit Corp. Meaning No Ads Ever*, TECH CRUNCH (Oct. 23, 2014), <http://techcrunch.com/2014/10/23/ello-raises-5-5-million-legally-files-as-public-benefit-corp-meaning-no-ads-ever/> (emphasis added) (reproducing Oct. 20, 2014 memorandum executed by founders and current investors of Ello).

37. One practical but not particularly easy way that charter provisions of benefit corporations can be “unlocked” is through a vote of the requisite number of shareholders/members. For example, under the model benefit corporation legislation, shareholders can vote to terminate benefit corporation status by a two-thirds supermajority vote. Model Benefit Corp. Legislation § 105(a) (2013); *see, e.g.*, DEL. CODE ANN. tit. 8 § 363(c)(1) (dilution or change of public benefit corporation’s commitment to pursue a public benefit must be approved by two-thirds of outstanding shares); *see also* DEL. CODE ANN. tit. 8 § 363(c)(2) (public benefit corporation cannot merge or consolidate with another entity if, as result of such merger or consolidation, the surviving corporation’s certificate of incorporation lacks identical provisions identifying public benefit, unless the merger or consolidation transaction received approval of two-thirds of outstanding shares of the public benefit corporation).

portfolios.³⁸ To combat this concern, most impact investment capital (89 percent) has gone to companies that are in a post-venture stage, and hence have a proven track record of performance.³⁹ A much smaller amount of impact investment capital (11 percent) has been invested to date in seed, start-up, or venture stage enterprises.⁴⁰ As impact investors start to invest in less proven enterprises, the chances of underperformance—both in terms of social impact and financial expectations—are likely to increase.⁴¹

38. Saltuk et al., *supra* note 9, at 34 (other contributors to the risk of impact investment portfolios, in descending order of concern to surveyed impact investors, include: liquidity and exit risk; market demand and competition risk; country and currency risk; macroeconomic risk; financing risk; and perception and reputational risk); *see also* Paul Brest & Kelly Born, *supra* note 7, at 29 (according to Alvaro Rodriguez Arregui and Michael Chu, impact investors have a higher tolerance for risk than do traditional investors).

39. Saltuk et al., *supra* note 9, at 7 (35 percent growth stage, 44 percent mature and privately held, and 10 percent mature and publicly traded).

40. *Id.*

41. *See, e.g.*, David Bank, *E+Co Avoids Litigation—Barely—and Emerges Persistent*, HUFFINGTON POST BLOG (Oct. 3, 2012), http://www.huffingtonpost.com/david-bank/eco-avoids-liquidation-ba_b_1932503.html. This was, at least in part, a challenge faced by the now defunct E+Co, which provided capital and technical assistance to sustainable energy entrepreneurs in Central America, Southeast Asia, and Sub-Saharan Africa. According to co-founder Christine Eibs Singer, E+Co's portfolio of investments faced challenges due to a mismatch between the increasing amount of capital that E+Co could tap to finance small and growing businesses and the diminishing amount of grants and other funding available to E+Co to provide technical assistance to those same investees. She is quoted in the press, saying, "[t]he portfolio had grown in volume, but it was a lot of startup entrepreneurs and they needed hand-holding. The challenge is how do you fund the technical assistance to de-risk these investments?" *Id.*

In 2012, E+Co faced a restructuring of its investment portfolio and winding up of operations. Nearly half of the E+Co portfolio was written off or down. The remaining portfolio was transferred to private equity funds in debt-for-equity exchanges. *Id.*; *see also* Scott Anderson, *Weekly Roundup: E+Co's Slow Burn and What it Means for Impact Investing*, NEXT BILLION (Oct. 13, 2012), <http://nextbillion.net/blogspot.aspx?blogid=2977>. According to Anderson, E+Co's experience "raises questions beyond management, governance, due diligence, and investment squabbles." *Id.* Given that E+Co was viewed as a trailblazer and, prior to its demise, a success story in impact investing, Anderson asks what is an appropriate fund model for impact investing, how many boards/investors understand the risks to their capital when they invest in impact investment funds, and "how many truly understand (and are comfortable with) what patient capital means in practice?" *Id.*

Over two years later, the wind-up of E+Co is still discussed within the impact investing community as observers look for lessons to take away from this experience. In May 2014, Scott Anderson returned to this story in an interview with Christopher Aidun, CEO and Managing Director of Persistent Energy Partners, the company that acquired E+Co's Africa portfolio of investments as part of E+Co's restructuring plan. Prior to his current leadership roles at Persistent Energy Partners, Mr. Aidun served as the managing director of E+Co. At E+Co, Mr.

Most impact investors, however, report that their impact investment portfolios currently perform in line with their social impact and financial return expectations.⁴² What is more, a sizeable number of impact investments are exceeding their investors' expectations.⁴³ Where there have been disappointing results, these are

Aidun helped negotiate the debt restructuring plan with key E+Co creditors, which led to E+Co's asset transfer of its African portfolio to Persistent Energy Partners, the for-profit company co-founded by Mr. Aidun. Scott Anderson, *A Renewable Proposition (Part 1): Formerly E+Co, Persistent Energy Partners Looks to Solar Horizon*, NEXT BILLION (May 20, 2014), <http://nextbillion.net/blogpost.aspx?blogid=3885>. According to Mr. Aidun, the reason that E+Co's business model did not work was due to the number and size of the deals it was making:

Managing a large number of small investments [most of E+Co's investments ranged from \$200,000 to \$250,000] requires at least as much attention as managing a large number of large investments. In fact, investing in small entrepreneurs in developing markets means that even greater investment management effort is required per investment. E+Co didn't earn enough in management fees and grants to support the size of investment staff needed to manage its portfolio. So even with all the sophistication of a private equity fund, E+Co was doomed.

Id. Audrey Desiderato, co-founder and COO of SunFunder, a solar finance company, draws different lessons from the E+Co experience. After disclosing that one of the founders of E+Co was an important mentor of hers, Ms. Desiderato identifies five lessons to be gleaned from E+Co's demise: (1) start with a for-profit model; (2) create investment products and processes and harness technologies aimed at dealing with the fact that many of the target portfolio companies for investment cannot furnish investors ideal levels of financial and customer data; (3) stay in physical proximity to investments to observe their operations; (4) create a financial eco-system that graduates target portfolio companies from one source of capital to another and fosters investor coordination (rather than competition); and (5) match funding sources' expectations to target portfolio companies' risk profiles; match the skills and talents of board, staff, and advisors to the investing entity's business model; and ensure that all involved understand mission goals. Audrey Desiderato, *What Can SunFunder Learn from E+Co*, SUNFINDER (July 24, 2014), <http://blog.sunfunder.com/post/92753292356/what-can-sunfunder-learn-from-e-co>.

42. Saltuk et al., *supra* note 9, at 31. Note that while the return expectations of impact investors can vary greatly, most impact investors expect some amount of a financial return. *Id.* at 13 (80 percent of surveyed investors think it is "essential" that impact investments generate financial returns). Some impact investors are "financial first" oriented, meaning that they seek to optimize financial returns provided a base threshold of social returns is met. Others are "impact first" investors; they seek to optimize social returns provided a base threshold of financial returns is met. Others fall somewhere in between. JESSICA FREIREICH & KATHERINE FULTON, *INVESTING FOR SOCIAL AND ENVIRONMENTAL IMPACT: A DESIGN FOR CATALYZING AN EMERGING INDUSTRY* 31–32 (2009) (identifies categories of impact investors based on the investors' primary investment motivations).

43. Of this group, 20 percent report that their investments are outperforming against their social impact expectations, and 16 percent report outperformance against their financial return expectations. Saltuk et al., *supra* note 9, at 31.

more often due to financial underperformance than to social impact underperformance.⁴⁴

This is not to suggest, however, that impact investing is immune to performance problems, financial or otherwise.⁴⁵ The most notable example of what can go wrong in impact investing can be found in the microfinance sector, which currently accounts for slightly more than one-fifth of the impact investment market.⁴⁶ The microfinance sector faced serious refinancing challenges when the 2008 financial downturn constrained liquidity on a global scale. While the number of microfinance institutions that defaulted as a result of this liquidity crunch was not as large as some (including this author) feared,⁴⁷ some microfinance investors unhappily found themselves in the middle of negotiating and structuring debt workouts for troubled microfinance institutions.⁴⁸

A 2009–2010 study of seventeen microfinance debt workouts (sixteen microfinance institutions and one regional microfinance investment fund) found a variety of reasons for the failures that led to these workouts.⁴⁹ In most cases, microcredit portfolio deterioration was the proximate cause of the problem. Other factors, however, such as weak management and governance within the microfinance institutions, adverse macroeconomic conditions, and difficult political environments also contributed to performance problems.⁵⁰ In two cases, investors identified fraud in the microfinance institutions.⁵¹ Of particular relevance to this discussion, however, is how these

44. Only 1 percent reported underperformance on social impact, while 9 percent reported financial underperformance relative to expectations. *Id.*

45. *See, e.g., supra* note 38 and accompanying text.

46. *See supra* note 12.

47. *See* Deborah Burand, *Deleveraging Microfinance: Principles for Managing Voluntary Debt Workouts of Microfinance Institutions*, 27 J.L. & COM. 193, 199–200 (2009).

48. *See, e.g.,* INTERNAT'L ASSOC. OF MICROFIN. INVESTORS, MICROFIN. LENDERS WORKING GROUP, AND MORGAN STANLEY, CHARTING THE COURSE: BEST PRACTICES AND TOOLS FOR VOLUNTARY DEBT RESTRUCTURINGS IN MICROFINANCE (2011), available at <http://www.morganstanley.com/globalcitizen/pdf/IAMFI.pdf> [hereinafter INTERNAT'L ASSOC. OF MICROFIN. INVESTORS] (approximately six percent of the loans made by microfinance investment intermediaries required restructuring during this period).

49. *Id.* at 5 (approximately 6 percent of the loans made by microfinance investment intermediaries required restructuring during this period).

50. *Id.*

51. *Id.*

microfinance investors behaved toward the troubled investee, and toward each other, when confronted with investments going bad.

One key finding is that the diversity of lenders to these microfinance institutions made debt workouts especially challenging. Microfinance, like much of impact investing, has attracted investors with a wide range of investment motivations and return expectations.⁵² The sheer number of lenders with loans outstanding to a single microfinance institution complicated some of these workouts.⁵³ Additionally, the lenders often were quite diverse with respect to their risk tolerances, sources of funding, legal mandates (e.g., some were not legally authorized to receive equity stakes in return for troubled debt assets), and deliberative processes.⁵⁴ Taken together, this diversity slowed the workouts, sometimes to the detriment of the troubled microfinance institution that needed a fast resolution of its debt problems.

The microfinance institutions, however, were not the only ones who suffered from the diverse range of interests evidenced by the lenders. Some intercreditor relationships suffered as well. As one representative of a microfinance investment fund tellingly observed: “To those who take the money and run . . . people don’t forget. Behavior comes back to haunt you.”⁵⁵ Another key finding was that, while social objectives mattered, investors’ perceived fiduciary responsibilities to their own sources of capital sometimes led them to prioritize capital protection over advancement of the investee’s social mission.⁵⁶ One representative of a microfinance investment intermediary framed this tension as follows: “We are continuing to

52. See discussion of varying investor expectation *supra* note 42.

53. One representative of a microfinance investment fund observed that organizing a large group of lenders was like “herding cats.” INTERNAT’L ASSOC. OF MICROFIN. INVESTORS, *supra* note 48, at 7.

54. *Id.* at 7–8.

55. *Id.* at 7.

56. *Id.* at 7–8. Socially-motivated lenders noted that, like more commercial lenders, they too had fiduciary responsibilities to their stakeholders and that the repayment of their outstanding loans to microfinance institutions was necessary to support the financing of future investments. As a result, in some cases, some socially-motivated lenders soundly rejected any workout scenario that would have provided them with restructuring terms that were less favorable from a financial standpoint than those offered to more commercially-oriented co-lenders.

learn as a social investor what the balance is in protecting investors' capital and being patient capital."⁵⁷

A third, perhaps not surprising, finding is that investors that have gone through a workout are changed as a result of that experience and may approach new investments and potential co-lenders with more caution and suspicion. For example, some investors that participated in microfinance debt workouts subsequently decided to engage more rigorous due diligence processes in hopes of avoiding another workout situation.⁵⁸ Others concluded that their standard loan agreements contained flaws that weakened investor claims on the borrower, particularly vis-à-vis other lenders. These investors, therefore, decided to take steps to improve their loan documentation and processes, including making better (or, for some, any) use of local counsel to enforce legal claims on borrowers' assets.⁵⁹ Still others considered adding new covenants to their loan agreements that would attempt to shape a troubled borrower's behavior toward its investors⁶⁰ and penalize or forestall any preferential treatment by the borrower of some lenders over others.⁶¹

57. *Id.* at 7.

58. *Id.* at 17 (Microfinance investors determined to strengthen "their due diligence, loan documentation, monitoring and restructuring capabilities.").

59. *Id.* at 9, 17.

60. *Id.* at 39. For example, some lenders determined that, in the future if a borrowing microfinance institution became distressed, they would propose that all lenders to that microfinance institution should amend their loan documentation so as to standardize the timing and content of the reports and notices required of the borrower. This would ensure that information was shared equally among all lenders and no lender would benefit from getting borrower information faster than others. This standardization also would make it easier for the troubled MFI since it would no longer bear the administrative burden of meeting multiple reporting requirements.

61. *Id.* at 33–39. For example, some lenders involved in these microfinance workouts later proposed adding a negative covenant to their loan documentation that would prohibit any early redemption or prepayment by a troubled microfinance institution of its debt obligations. This covenant was intended in part to preserve the microfinance's net cash flow. It was also intended to protect lenders who had provided borrower-friendly financial terms and conditions from being disadvantaged should the borrower try to first prepay its more onerous debt obligations to others. *Id.* at 39. The irony here is that some borrowers with limited cash on hand paid down their more expensive commercial debt obligations at the expense of servicing cheaper debt obligations to more socially-motivated lenders. While a wholly rational decision from the point of view of the borrower, this practice did not sit well with disadvantaged lenders. More specifically, some "social impact first" lenders made it clear that they were "unwilling to

A fourth finding is that investors were likely to try, at least at the outset, managing disputes in a coordinated and consensual fashion outside of more formal mechanisms such as litigation or bankruptcy proceedings.⁶² Lenders, however, often were slow to form intercreditor committees to engage collectively with the troubled borrower,⁶³ and, as a result, lost valuable time that could have been spent responding to the weakening financial positions of the microfinance institution.⁶⁴ In part, these delays may have been due to the relative inexperience in managing debt workouts of some of the individuals involved.⁶⁵

assume a *de facto* subordinated position or outcome relative to other [more commercially-oriented] investors.” *Id.* at 7–8.

62. *Id.* at 10. Because of concerns about the lack of clear-cut bankruptcy laws in the emerging markets where these troubled MFIs were operating, and worries that forced liquidation strategies could backfire “given the challenge in servicing microloans and the likelihood that client repayment [would] plummet once an MFI’s imminent closure [became] public,” lenders involved in these microfinance workouts generally preferred to pursue voluntary restructurings.

63. *Id.* at 7. In nearly all cases, lenders formed intercreditor committees to engage with the troubled microfinance institution; but, there were numerous instances where lenders did not respond with sufficient urgency or had problems forming a lender group that was able to negotiate collectively and present a unified position in negotiations with the borrower.

64. *Id.* Only a small number of the creditor committees entered into formal intercreditor or standstill agreements. *Id.* at 7.

65. *Id.* at 8 (microfinance investment intermediaries involved in these workouts had “almost no staff members in their microfinance investment departments with prior debt workout experience”).

To respond to this challenge and help the microfinance sector as a whole learn from these voluntary debt workout experiences, a working group of investors in microfinance (organized under the auspices of IAMFI) secured the pro bono services of the ITC during the 2009–2010 academic year to produce four tools to facilitate smoother debt workouts of microfinance institutions in the future.

One product was the development of Microfinance Voluntary Debt Workout Principles (“Microfinance Workout Principles”). The Microfinance Workout Principles were informed by guidelines applied to negotiations of commercially-oriented, cross-border debt workouts in the financial sector, such as those developed by the International Federation of Insolvency Professionals (INSOL). *See, e.g.*, INSOL, STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO MULTI-CREDITOR WORKOUTS (2000), available at <http://www.insol.org/pdf/Lenders.pdf>. The Microfinance Workout Principles draw on these guidelines, but then were adapted to respond to the unique characteristics of microfinance and investors in microfinance. *See* INTERNAT’L ASSOC. OF MICROFIN. INVESTORS, *supra* note 48, at 21–24.

Another product was the development of an Intercreditor Agreement Template to guide investors in creating ex post intercreditor agreements. *See id.* app. 5, at 25–31.

So, what can the microfinance experience teach the impact investing market more generally about dispute resolution? One obvious lesson from these microfinance debt workouts, which may hold true for other types of troubled impact investments, is that an impact investor's commitment to achieving both a financial and a social return will be tested when an impact investment begins to underperform financially. It is likely that financial considerations ultimately will guide investors' responses—even more socially-motivated investors.⁶⁶ Furthermore, the wide variety of investors attracted to impact investing can slow and complicate the resolution of a troubled impact investment, should a workout become necessary. Coordinating investors likely will become still more challenging when the multiple investors that are party to a dispute have opted for different mechanisms to resolve disputes, and, in some cases, have chosen the laws of different jurisdictions to govern their investment documentation.

If this microfinance experience is indicative of how other disputes might play out in impact investing, investors are likely, at least initially, to attempt to resolve impact investment disputes on a consensual and informal basis outside of more formal mechanisms. Furthermore, given that so much of impact investing today is in the form of debt investments, debt workouts likely will be accomplished through the establishment of intercreditor committees, and ex post intercreditor agreements or standstill agreements.

A third product was the creation of a debt restructuring menu of options, outlining various alternatives available to investors to encourage lender participation in voluntary debt workouts. *See id.* app. 6, at 32.

The last product was a Microfinance Loan Covenant Review. To complete this review, students in the ITC researched loan agreements in commercial and microfinance contexts and reviewed, confidentially, two mainstream and four microfinance loan agreements. The review identified covenants that lenders might incorporate into their future loan documentation to microfinance institutions to further mitigate risk, such as restrictions on the borrower's ability to make distributions to shareholders; restrictions on consolidations and mergers; insurance coverage requirements; and compliance with anti-corruption, anti-terrorism and anti-money laundering laws. The review also identified variations in definitions and calculation methods of common covenant items that could benefit from harmonization in the future. *See id.* app. 7, at 33–39.

66. *See, e.g.,* INTERNAT'L ASSOC. OF MICROFIN. INVESTORS, *supra* note 48, at 7 (quoting a microfinance investor who noted that "All of us want to get our money back. This is no different from the 'world.'").

Finally, it is likely that the contractual provisions currently included in impact investment documentation will shift in content and grow in importance as the impact investment market gains more experience dealing with conflicts that may arise from these investments. One other likely result is that some of the complexity being built into the structures of impact investments may give way to simpler transactions—particularly for low-value transactions where the cost of enforcing a complex payment provision or complex deal structure threatens to overwhelm the amounts in dispute.

V. HOW ARE IMPACT INVESTMENTS PLANNING TO RESOLVE DISPUTES? WHAT CONSIDERATIONS ARE RELEVANT? HOW CAN WE CREATE MORE EFFECTIVE MECHANISMS TO RESOLVE DISPUTES ARISING FROM IMPACT INVESTMENTS GONE BAD?

Impact investors appear to be taking a variety of approaches to mitigate or avoid the possible risks of impact investing. In many cases, the most effective and practical approach to managing these risks may be to look beyond the four corners of the investment documentation. Yet, the underlying investment documentation still will need to include some form of dispute resolution mechanism. Furthermore, while investors and investees may not be inclined to ask (or pay) their lawyers to tailor dispute resolution provisions to the idiosyncrasies that shape their particular impact investment transactions, the act of merely dropping boilerplate dispute provisions from commercially-oriented agreements into impact investment agreements is hardly appropriate—particularly in impact investments where great care has been taken to introduce novel structures or terms to reflect the transacting parties' social motivations.

Given the nascent stage of impact investing, the current body of research about which dispute resolution processes are most appropriate for particular types of disputes has not yet extended to disputes arising out of impact investments, especially disputes arising out of the social impact goals of the investment. To the extent that impact investment disputes arise from social mission-oriented expectations, it is worth considering, even if just hypothetically, which dispute resolution mechanisms are most appropriate to respond to such disputes and to explore what modifications or improvements

could be made to enhance the effectiveness of these mechanisms when applied to impact investments.

Arbitration is currently the preferred method of resolving international commercial disputes.⁶⁷ As such, it should not be surprising that many impact investors also opt to resolve cross-border investment disputes through international arbitration.⁶⁸ In part, impact investors' preference for arbitration may be due to the fact that most impact investments are taking place in emerging markets, where the efficiency and impartiality of judicial systems may be viewed with skepticism by foreign investors.⁶⁹ In the commercial context, however, international arbitration is not only preferred by those who worry that the opposing party is coming from a country with an inefficient or unreliable judicial system. Often, international arbitration is favored over litigation by parties seeking a quicker, more private proceeding that is subject to more limited discovery rules. Alternatively, the parties may want to ensure that the dispute is presided over by a specialist who is knowledgeable in the field from which the dispute arises.⁷⁰ Another important benefit of international

67. See, e.g., GARY B. BORN, *INTERNATIONAL COMMERCIAL ARBITRATION* 94 (2d ed. 2014); see also S.I. Strong, *Beyond International Commercial Arbitration? The Promise of International Commercial Mediation*, 45 WASH. U. J.L. & POL'Y 11, 11–12, 27 (2014).

68. In 2012–2013, a legal working group of in-house lawyers for impact investors and social enterprises from the Aspen Network of Development Entrepreneurs (ANDE) noted the growing use of arbitration clauses in impact investment documentation and asked the ITC to create a guide for drafting arbitration clauses for cross-border investment transactions in social enterprises. See DEBORAH BURAND, WHITNEY SCHNEIDER—WHITE & JAY SPRINGER, ASPEN NETWORK OF DEV. ENTREPRENEURS, *Guide to Drafting Arbitration Clauses for Cross-Border Investment Transactions in Social Enterprises: Annotated Model Arbitration Clause and Annotated Model Multi-Tier Dispute Resolution Clause* 5 (2013) (on file with author) [hereinafter ANDE Arbitration Guide].

69. In many developing countries, even if there is a functioning and reputable judicial branch, courts may experience significant backlogs, which can add to lengthy delays in resolving disputes. For example, one commentator has noted that there are “habitual delays of up to 15 years” in litigating commercial disputes in India. Ramon Gosh, *Commercial Disputes in India*, Vol 9, Issue 3. Investigative Intelligence (2011), available at http://www.kroll.com/media/pdf/articles/Asian-Mena_Counsel_Ramon_Ghosh_May2011.pdf; see also India—*Doing business in*, Chambers & Partners Legal Practice Guide, Litigation 2014–2015, available at <http://www.chambersandpartners.com/guide/practice-guides/location/241/6600/1028-0>.

70. See generally WHITE & CASE & QUEEN MARY UNIVERSITY OF LONDON, 2010 *INTERNATIONAL ARBITRATION SURVEY: CHOICES IN INTERNATIONAL ARBITRATION* 2–3 (2010) (stating that arbitration is widely used to resolve international disputes because of its flexibility). Parties can choose governing law, place of arbitration, arbitration institution (if

arbitration is the relatively easy enforcement of arbitral awards as a result of international treaties created to promote the recognition and enforcement of arbitral awards.⁷¹

Presumably, impact investors (and, possibly, their investees) share similar perceptions of the advantages of arbitration for resolving disputes arising in cross-border impact investments. But is arbitration well suited for resolving disputes between an impact investor and its investee, or among impact investors that have co-invested in the same investee? Put differently, are the perceived benefits of arbitration likely to be realized in an impact investment dispute?

For the purpose of this analysis, this Article focuses on four considerations that are likely to be important when fashioning an effective dispute resolution mechanism for impact investing:

- (1) knowledge/skills of decision-makers charged with resolving the dispute;
- (2) speed of proceedings;
- (3) adversarial/private nature of proceedings; and
- (4) cost of proceedings.

A. Knowledge/Skills of Decision-Makers

One perceived benefit of arbitration is that parties can control who will resolve their dispute. In theory, parties can pick an arbitrator who understands their business goals, and the context in which the dispute arises, yet is also impartial.⁷² On the face of it, this sounds like a

used), and arbitrators, among others. *See also* William S. Fiske, *Should Small and Medium-Size American Businesses "Going Global" Use International Commercial Arbitration?*, 18 *TRANSNAT'L LAW* 455, 481 (2005) ("Before opting out of litigation and, instead, into arbitration, American-based transborder businesses should consider three simple variables: (a) the nature of the transaction at issue; (b) the legal tradition of their trade partner's country; and (c) the local judiciary's expertise with the relevant commercial issue").

71. Strong, *supra* note 67, at 27–28.

72. Susan D. Franck, *A Survival Guide for Small Businesses: Avoiding the Pitfalls in International Dispute Resolution*, 3 *MINN. J. BUS. L. & ENTREPRENEURSHIP* 19, 28 (2004). Franck points out that it may be at the negotiation stage to gauge what disputes, if any, will arise in connection with the transaction. *Id.* She notes that parties may be better situated looking for an arbitrator with a helpful background *after* a dispute arises and facts/issues have crystallized. *Id.* She also cautions against defining too narrowly the required attributes of an

good idea for impact investment disputes too, particularly given the very limited experience that sitting judges (and possibly juries) may have in considering impact investment disputes. In today's world, however, where are the arbitrators who are skilled and knowledgeable about social enterprises and impact investing?

A lack of arbitrator expertise in impact investing raises the likelihood of unpredictable dispute resolution processes and outcomes, which in turn can significantly undermine investor confidence. As a result, new investors may delay their entry into, or existing investors may hasten their exit from, the impact investing market. Accordingly, unless initiatives are launched to develop impact investment arbitrators or to educate existing arbitrators about the distinguishing features of impact investing, today's arbitrators are no more likely to bring specialized knowledge to impact investing than their judicial counterparts.

One possible solution is to establish arbitral tribunals that use arbitrators with specialized expertise in impact investing.⁷³ While the idea of creating an "impact investing tribunal" could be useful in the future as the impact investing market matures and deal flows increase, the establishment of a niche tribunal for the impact investing market does not adequately solve today's problem—namely, the current lack of arbitrators who are knowledgeable about impact investing. Happily, however, the answer to that problem just might reside in the impact investing market itself.

Currently, the world of international arbitrators is populated for the most part by lawyers and judges, but that has not always been the case.⁷⁴ There is no legal requirement that arbitrators must be

arbitrator, as overly "prescribing attributes for arbitrators at the contractual stage does a disservice to a business' commercial objective to have a flexible and enforceable dispute resolution mechanism." *Id.*

73. See Fiske, *supra* note 70, at 477–78 (describing, for example, the emergence of niche arbitral tribunals, such as the American Arbitration Association's E-Commerce Dispute Management Protocol, which is technology focused dispute resolution service for b2b internet transactions; the Grain and Feed Trade Association's arbitrations for commercial disputes over sales of grain and herds; and the World Intellectual Property Organization's (WIPO's) arbitrations focusing on domain name dispute resolution).

74. See Thomas J. Stipanowich & Zachary P. Ulrich, *Arbitration in Evolution: Current Practices and Perspectives of Experienced Commercial Arbitrators* 43–44 (Legal Studies Research Paper Series, Paper No. 2014/30, 2014), available at <http://papers.ssrn.com/sol3/>

members of the bar.⁷⁵ One possible solution to the lack of qualified arbitrators with impact investment experience is to seek potential arbitrators from within the growing ranks of impact investing professionals.

Another, perhaps more practical, approach is to introduce expert testimony from impact investing professionals in arbitration. Indeed, some commentators argue that, given that arbitration's evidentiary rules and discovery requirements are less onerous than those found in litigation, arbitration is better suited than litigation to using expert evidence effectively.⁷⁶ Dispute panels involving experts from various disciplines have long been used in construction and securities/brokerage disputes.⁷⁷ There is no reason why impact investing should not do so too. Furthermore, impact-investing experts may be particularly useful in helping arbitrators craft appropriate remedies for an impact investment dispute. This may be particularly true where the issue at stake is not purely monetary.

B. Speed of Proceedings

Speed is another reason that parties sometimes choose arbitration. In the resource-constrained world of small and medium-sized enterprises, a fast decision or resolution of a dispute often is valued more highly than a favorable outcome.⁷⁸ The rapid resolution of disputes may be critical to keep fundamentally strong impact investments on track toward achieving their financial and social objectives, and also to build and maintain the confidence of new and existing impact investors, so they will be inclined to make additional

papers.cfm?abstract_id=2519196 (citing antecedents of modern arbitration practice, which included merchant and professional guilds to resolve disputes of their members).

75. *Id.* at 10.

76. See George Ruttiger & Joe Meadows, *Using Experts in Arbitration*, 62 DISP. RESOL. J. 46, 47–48 (2007) (stating that arbitration offers more opportunities for using and presenting expert testimony than litigation).

77. Stipanowich & Ulrich, *supra* note 74, at 44.

78. According to a survey of small and medium enterprise (SME) respondents, the top requirement of a dispute resolution mechanism was speed; the second ranked requirement was a favorable outcome. See ROB VAN DER HORST, RENATE DE VREE, & PAUL VAN DER ZEIJDEN, EIM BUSINESS & POLICY RESEARCH, SME ACCESS TO ALTERNATIVE DISPUTE RESOLUTION SYSTEMS 67 (2006).

impact investments. Unfortunately, in practice, arbitration is not always faster than litigation.⁷⁹

On the other hand, steps are being taken to establish expedited or fast track procedures for commercial arbitration.⁸⁰ According to a recent survey of arbitrators, expedited procedures are most likely to be used in commercial arbitrations with relatively low-value amounts in dispute.⁸¹ Given that most impact investments are also relatively small,⁸² use of expedited or fast track procedures may be necessary to increase the efficiency of arbitration as a dispute resolution mechanism for impact investment disputes.

79. Strong, *supra* note 6758, at 26 (internal citations omitted) (noting current discontent with international arbitration arising from perception that arbitral processes have become “too slow, expensive and legalistic”).

80. *See, e.g.*, INTERNATIONAL CENTER FOR DISPUTE RESOLUTION, INTERNATIONAL DISPUTE RESOLUTION PROCEDURES, INTERNATIONAL EXPEDITED PROCEDURES 8 (2014).

81. Stipanowich & Ulrich, *supra* note 74, at 39 (Chart FF). In a survey of arbitrators’ experience with streamlined or fast track arbitration procedures, Stipanowich and Ulrich found that fast track procedures in arbitration were used most prevalently in low value disputes. In response to the question, “have you served as an arbitrator in a case under streamlined or fast track procedures involving disputes” of certain dollar amounts, survey respondents answered “yes” at the following rates:

- Under \$100,000: 88 percent
- From \$100,000 to \$499,000: 43 percent
- From \$500,000 to \$999,000, 21 percent
- From \$1 million to \$4.99 million: 17 percent responded yes
- From \$5 million to \$9.99 million: 2 percent
- From \$10 million to \$49.9 million, 2 percent
- \$50 million or more: 2 percent

Id.

82. *See supra* note 14.

C. Adversarial/Private Nature of Proceedings

Parties sometimes choose arbitration over litigation because of the perception that litigation is more polarizing and can cause already challenged relationships among the parties to deteriorate further, particularly if grievances are aired in a public courtroom. At first blush, a less polarizing, dispute resolution mechanism than litigation sounds like a good idea for impact investment disputes too, particularly given that so much of impact investing is based on aligning the values and return expectations of investors and investees. But is arbitration any friendlier than litigation? And, perhaps even more important, is the privacy afforded most arbitral decisions healthy for the impact investing market?

One can argue that the impact investing market needs its missteps to be widely shared so that the learnings gleaned from those missteps can prevent others from making the same mistakes.⁸³ Moreover, important public policy consequences may arise from a failed impact investment. To resolve such disputes in secret could have damaging implications that go far beyond the impact investing market, particularly when impact investment transactions are grounded in private/public partnerships to address a thorny societal problem.⁸⁴ Accordingly, parties considering impact investment arbitration may decide that it is not only in the impact investing market's broader interest to forego the confidentiality that often accompanies commercial arbitration, but that it also is in the broader societal interest to bring their impact investment dispute proceedings out into

83. For example, Jeffrey Liebman points to the need for "high value learning" to emerge from the experimentation taking place with social impact bond structures so that lessons from these transactions can be shared broadly and quickly with others putting together new deals. JEFFREY B. LIEBMAN, CENTER FOR AMERICAN PROGRESS "SOCIAL IMPACT BONDS: A PROMISING NEW FINANCING MODEL TO ACCELERATE SOCIAL INNOVATION AND IMPROVE GOVERNMENT PERFORMANCE" 20 (2011).

84. Social impact bonds and other government-sponsored "pay for success" financings are examples of impact investments that deliberately align private and public interests in a financial transaction. See generally *Center for American Progress Fact Sheet: Social Impact Bonds*, CNTR. FOR AMERICAN PROGRESS, available at <https://www.americanprogress.org/issues/economy/report/2014/02/12/84003/fact-sheet-social-impact-bonds-in-the-united-states/>.

the open.⁸⁵ This is most likely to be relevant for those impact investments where significant public policy considerations are at stake.

D. Costs of Proceedings

Even if knowledgeable arbitrators can speedily reach decisions in the international arbitration of impact investment disputes, while preserving some semblance of amicable and transparent proceedings, costs remain a problem. In short, the costs involved in arbitrating an impact investment dispute may overwhelm the sums in question.⁸⁶ Managing costs in dispute resolution is not a problem unique to impact investments, of course. Small and medium enterprises have

85. The idea of opening arbitration proceedings to the public when public interests are involved is not as radical as it might first appear. A significant step was taken recently in this regard by the United Nations Commission on International Trade (UNCITRAL) in 2013, which adopted a set of rules aimed at opening these types of dispute proceedings to the public (the “Transparency Rules”). UNITED NATIONALS COMMISSION ON INTERNATIONAL TRADE LAW, UNCITRAL RULES ON TRANSPARENCY IN TREATY-BASED INVESTOR-STATE ARBITRATION, 6 (2014), available at <http://www.uncitral.org/pdf/english/texts/arbitration/rules-on-transparency/Rules-on-Transparency-E.pdf>. The Transparency Rules came into effect on April 1, 2014. TRANSPARENCY REGISTRY (A REPOSITORY FOR THE PUBLICATION OF INFORMATION AND DOCUMENTS IN TREATY BASED INVESTOR STATE ARBITRATION), *Introduction*, UNCITRAL (2015), <http://www.uncitral.org/transparency-registry/en/introduction.html>.

Subsequently, the Mauritius Convention on Transparency was adopted to ensure application of the Transparency Rules among ratifying governments. The Mauritius Convention on Transparency opened for signature on March 17, 2015. UNIS (United Nations Information Service) Press Release, March 17, 2015, “Signing Ceremony for the United Nations Convention on Transparency in Treaty-based Investor-State Arbitration”, available at <http://www.unis.unvienna.org/unis/en/pressrels/2015/unis1214.html>. This transparency initiative was fuelled by the view that these disputes are likely to involve issues of public interest and uses of taxpayer funds such that confidentiality concerns of the disputing parties should be balanced against the public interests at stake. See generally *FAQ—UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration*, “What is the purpose of the Rules on Transparency?”, UNCITRAL (2014), available at http://www.uncitral.org/uncitral_texts/arbitration/2014Transparency_FAQ.html#purpose.

Related, another potentially useful tool is to create a form of registry for publication of information relevant to impact investment arbitration awards that involve significant public policy considerations and actors. See, e.g., *id.*

86. While the average size of an impact investment transaction in 2013 was approximately \$2 million, impact investment transactions vary in size from thousands of dollars to several millions of dollars. See *supra* note 14, describing the size of capital flows and number of impact investments made with that capital in 2013.

long faced problems of cost when turning to arbitration to resolve cross-border disputes.⁸⁷

One possible cost-saving response is to reconsider the type of legal fee arrangements that are most appropriate for impact investment disputes. How might alternative fee arrangements be structured? Should model agreements or templates be created to demonstrate alternative fee arrangements for impact investment disputes? When, if ever, should pro bono or low bono arrangements be encouraged?

Arbitrators willing to provide pro bono services do exist, but they are rare and more willing to forego fees when disputes involve individuals, rather than companies.⁸⁸ On the other hand, most law firms have been unwilling, to date, to take on international arbitrations at a reduced fee.⁸⁹ In contrast, law school-sponsored clinics may be uniquely situated to provide representation to parties involved in an impact investment dispute, particularly given the social justice and/or economic development motivations that underpin many impact investment transactions.⁹⁰ Just as student attorneys in the International Transactions Clinic (ITC) now represent investors and investees in the creation of impact investments, student attorneys could also represent such clients in impact investment disputes that are of such low value that the private bar is uninterested in representing the disputing parties. Rethinking fee arrangements might be particularly appropriate in those disputes that arise when the impact investor and the investee have agreed to forego some amount of financial return in order to advance social impact goals. This is one place where the lawyers involved in a dispute may want to consider

87. See Horst et al., *supra* note 78, at 67 tbl.41 (among desired requirements of dispute resolution mechanism, low price was ranked as third highest requirement by small enterprises with fifty or fewer employees).

88. See Burand et al., *supra* note 68, at 7.

89. *Id.*

90. See generally Thomas J. Stipanowich, *Reflections on the State and Future of Commercial Arbitration: Challenges, Opportunities, Proposals*, 29 (Columbia American Review of International Arbitration, Vol. 25, 2014; Pepperdine University Legal Studies Research Paper No. 2014/29, available at SSRN: <http://ssrn.com/abstract=2519084>) (describing growing interest in mediation-oriented law clinics in US law schools).

whether their values align well with those of their clients, such that the lawyers might provide their services at reduced rates.

Another cost-saving strategy is to select a location for the arbitration proceedings that is not unduly expensive for the parties. This approach may push parties to opt for local or regional arbitral institutions that are closer to the location of the investment. Or, alternatively, where the dispute involves parties from different jurisdictions, the parties may consider using technology-enabled, dispute resolution processes to reduce the expense of face-to-face proceedings.⁹¹

Perhaps the largest cost-saving strategy is to resolve impact investment parties' concerns before they ripen into a full-blown dispute. Accordingly, parties to an impact investment might include in their investment documentation a pre-arranged, routine mechanism for communicating about concerns that may arise in the course of the investment.⁹²

Parties also may want to including "stepped" dispute resolution clauses into their impact investment documentation.⁹³ A multi-tiered

91. See, e.g., *ICDR Manufacturer/Supplier Online Dispute Resolution Protocol (MSODR)*, INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION (2015), <https://www.icdr.org/icdr/faces/icdrservices/msodr>; see also Bette J. Roth, Randall W. Wulff & Charles A. Cooper, *ADR Rules of the International Chamber of Commerce (ICC)*, 2 ALTERNATIVE DISP. RESOL. PRAC. GUIDE APPENDIX II-25, (2006) (noting that in some countries, e-mediation or online dispute resolution has introduced a promising way to resolve disputes for small and medium-sized enterprises).

92. This is a feature seen in dispute boards that are used in infrastructure project financings. See Cyril Chern & Patricia O. Sulser, *Keeping Public-Private Partnership Infrastructure Projects on Track: The Power of Multistakeholder Partnering Committees and Dispute Boards in Emerging-Market Infrastructure Projects*, 5 THE WORLD BANK L. REV. 21, 36 (2013) (describing use of dispute boards in project financings used by the International Finance Corporation). Another feature of dispute boards that could prove useful in the impact investment context is dispute boards' ability to promote an inclusion agenda, allowing the dispute board to go beyond hearing evidence from the contracting parties to take into consideration, for example, the voices of affected community members. *Id.*

93. Parties always can informally agree to pursue negotiation or mediation. However, there may be some value in expressly stating this expectation at the beginning of the investment relationship and memorializing it in the investment documentation. While there is a risk that parties might take advantage of such provisions, even stall for time to prepare for the eventual arbitration or litigation, this risk can be addressed by including time limits for the negotiation and/or mediation period, after which either party can escalate the dispute and turn to a more formal dispute resolution proceeding such as arbitration or litigation.

or stepped approach requires that the parties engage in negotiation⁹⁴ or mediation⁹⁵ before they turn to arbitration or litigation to resolve disputes. Mediation, in particular, may be useful to impact investments as mediation's more informal and consensus-based procedures can help preserve the parties' relationship beyond the dispute at hand.⁹⁶

CONCLUSION

Impact investments are experimenting with novel deal structures, unusual contractual terms, and untested legal forms of entities—all against the challenging backdrop of conducting cross-border transactions in countries where judicial efficiency and impartiality may be uncertain. This combination of transactional novelty and legal uncertainty presents a dilemma for those who hope to see the impact investment market continue to grow.

To date, much of the attention on impact investing has focused on increasing the deal flow of these impact investment transactions. Yet, if impact investing is to grow into a robust and resilient asset class, attention must also focus on developing effective mechanisms for resolving disputes that will inevitably arise when impact investments fail to meet investor expectations. Consequently, emphasis should be given to building an ecosystem for dispute resolution that best serves the impact investment market.

94. Negotiation as used here means taking attempts to resolve a dispute to higher-level decision-makers (upper management) within the disputing parties' organizations.

95. Mediation as used here means a form of "supervised" negotiation where higher-level decision-makers are in charge of resolving the dispute but they are doing this under the supervision of a neutral third-party, the mediator. Mediation is generally not binding on its own, but parties can agree to memorialize in writing a mediated solution. *See generally*, Edna Sussman & Conna A. Weiner, *Striving for the 'Bullet-Proof' Mediation Settlement Agreement*, 8 NYSBA New York Dispute Resolution Lawyer 22 (Spring 2015) at 25, available at <http://sussmanadr.com/docs/Bullet%20Proofing%20the%20mediation%20agreement%20NYS%20Spring%202015.pdf> (noting that many mediations conclude with only oral agreements, the authors recommend recording the settlement agreement in writing).

96. *See* Strong, *supra* note 67, at 25–26 (observes that consensus-based procedures [as can be found in mediation] offer advantages such as preservation of ongoing relationships, and that "value- or structure-based disputes may derive particular benefits from mediation" as opposed to disputes that "focus primarily on monetary concerns").

This Article suggests that, while the international nature of most impact investments makes international arbitration a more likely choice for dispute resolution than litigation, more work must be done to make international arbitration an efficient and effective dispute resolution mechanism for impact investment disputes. To start, a cadre of arbitrators that understand impact investing should be developed, both to increase the speed with which arbitral decisions are reached and to reduce the costs of arbitration. Furthermore, if arbitration continues to be the preferred mechanism for resolving impact investment disputes, appropriate transparency must be brought to these proceedings and their resulting decisions so market players can learn from each other's mistakes. Similarly, increased transparency may be required in those arbitral proceedings where the disputed impact investment raises significant public policy considerations.

In the meantime, those drafting dispute resolution provisions for impact investment documentation may want to consider including pre-arranged, routine processes for addressing concerns that may arise in the course of the investment so as to avoid the need for implementing a dispute resolution mechanism in the first place. Drafters of impact investment documentation should also consider including a stepped dispute mechanism that directs parties to negotiation and mediation before resorting to international arbitration.

In order to advance this discussion, more thorough research should be done regarding the actual practices of impact investors when confronting weak or failing impact investments, and a larger data set of impact investment documentation must be examined to ascertain what contractual provisions are typically included in impact investment documentation to address disputes. The challenge with this proposal, of course, is that some impact investment market advocates may worry that frank discussions about the likelihood of failed impact investments will dampen the enthusiasm of new entrants to the impact investment market. While that concern is valid, the alternative is far worse; only a few flashy failures may be enough to start a drumbeat of criticisms sounded by skeptics eager to claim that the impact investment market is just smoke and mirrors. The

distrust and suspicion that follows such claims may do irreparable damage to this nascent market.

If impact investing truly is to mature into the “revolution,” “invisible heart of markets,” and “ground zero of a big deal” that its proponents claim, work must start now to ensure that the dispute resolution mechanisms introduced into impact investments are just as innovative and value-aligned as the deal structures attracting investors willing to invest billions, and possibly trillions, of dollars into this new market.