Corporate Social Responsibility, Social Impact Investing and Green Bonds

December 2014
Alternative Corporate Forms
Introduction

How can business use *Corporate Form* to help achieve a positive social mission?
The U.S. Entity Toolbox

• Nonprofit Corp
• For-profit Corp
  • “Hybrid” Corp
  • PBC(DE)
  • SPC(CA, WA)
  • Benefit
• General Partnership
• Limited Partnership
• Limited Liability Company
  • L3C
• Unincorporated Association
• Nonprofit Unincorp Association
• Trust
• Cooperative

Traditionally U.S. legal entities have had to focus on shareholder returns as for-profit companies OR pursue social or environmental goals as non-profit 501(c) entities
Advancing Mission: “Hybrids”

- General term for when a non-profit sets up a for-profit subsidiary or vice-versa
- Can refer to a close contractual relationship between the entities
- For-profits set up foundations
- Non-profits set up a for-profit, either majority (over 50%) or minority (20% or less) owned
- Difficult to establish and maintain from both a legal and an operational perspective
  - Contracts between the two entities – *e.g.*, paying for services, use of equipment, license of IP, income from rents and royalties, etc.
  - Issues with employee placement and compensation, as well as board overlap and oversight
FP has Contract-Based Relationship with NP

- Affiliated entities
- Relationship governed by contractual relationships
  - Service or product contracts
  - Resource-sharing agreement (space, equipment)
  - IP license agreements
- No shared employees
- No shared governance
- Relatively straightforward to structure
- Most frequently used structure; although must carefully consider flow of resources and funds from NP to FP to avoid private inurement and related issues
NP as Minority Investor in FP

- NP minority ownership in FP
- Often structured as a Program-Related Investment (PRI) by foundations
- Challenging to structure, particularly if aggregating investment from non-profits and for-profit funds
  - Exit issues for for-profit investors
  - Redemption rights for non-profits
  - Control mechanisms for mission drift
  - Management of conflicts and different incentives between NP and other FP investment
  - Increased importance of independence in governance and management
- Less frequently used form
- UBIT issues
- Carefully consider employee sharing options and issues
FP as Wholly-owned Subsidiary of NP

- **NP**
- **FP**

- FP is 100% owned by NP (public charity)
- Advantage = Governance
  - Oversight by FP ensures tight, mission driven activities by FP
- Fewer conflicts between NP and other investors with different incentives or needs (compare minority investment)
- Relatively straightforward to structure
- However, need contracts for all resources shared between two entities as well as independence at board level of each entity for approval of intercompany agreements
- UBIT issues (dividends excluded)
- Employees may be housed at one entity or both
  - Compensation issues
FP Creates and Controls NP

- Establishes foundation
- Relatively straightforward to structure
- Less frequently used form for social enterprise; often used by large corporation
- Resource and employee sharing
- Review UBIT issues
L3C is statutory variant of the LLC considered in 21 states, and currently adopted in 9

Principally designed to assist for-profit companies that have a *primarily* charitable purpose and hope to obtain program-related investments (PRIs) from foundations

Billed as a simple answer to a complex problem, these entities still have all of the issues of the LLC from an investment perspective and may not make PRI investments any easier

Note the ability to use traditional Delaware LLC to “embed” mission in the corporate structure

Both the L3C and LLC have limited capital market acceptance from institutional investors
Advancing Mission: Benefit Corporation

• Arose from the B Lab “B Corporation” certification process
  • Companies can self-audit their socially responsible practices under B Lab standards and pay a royalty to license the “B Corporation” mark for display
• B Lab co-drafted what became the Benefit Corporation legislation
• Various forms of this statute now exist in 22 states
• Significant variation in Benefit Corp. legislation among the states, and often it is not well integrated with the pre-existing corporate codes
• Most Bar Associates have opposed the legislation in many states on technical and policy grounds
Advancing Mission: Benefit Corporation

- Required to create a general public benefit as a corporate purpose and may also choose to adopt a specific benefit purpose
- Encourages the accountability of directors and officers in achieving these purposes through annual reporting
- Requires an assessment prepared in accordance with an independent third-party standard to measure the corporation’s progress with respect to its purpose or purposes
- Many iterations of the benefit corporation statute require corporations to appoint an independent “benefit” director
- Also includes special “enforcement proceeding” for mission (with risks)
Signed into law by California Governor Brown in October 2011 and effective January 1, 2012 (as the Flexible Purpose Corporation)

Bill was drafted by the Working Group on New Corporate Forms
• Group consisted of 10 corporate lawyers from big and small firms, academia, and members of the Corporations Committee of the State Bar

Requires corporations to pursue an explicitly adopted social or charitable purpose in addition to the other purposes of the corporation

SPC’s articles of incorporation must clearly state the special purpose

Requires boards and management to consider environmental and social factors in addition to shareholder value
Advancing Mission: California SPC (cont’d)

• Protects boards and management from shareholder liability in connection with taking action in furtherance of social/environmental goals

• Creates a new “safe harbor” in addition to the business judgment rule

• SCP must publish annual and current reports measuring its progress with respect to its special purpose

• Designed to function with the rest of the California Corporations Code
  • Many of the structures and obligations that apply to California corporations apply to SPCs, providing a certain level of familiarity for investors
Like the California SPC, but unlike the Benefit Corporation, the Delaware PBC

- Creates a “safe” harbor for the social/environmental purpose
- Does not adopt the third-party standard requirement that is the hallmark of the benefit corporation
- Does not create a “benefit director”
- Does not create fiduciary duties owed to non-shareholder third parties
- Does not create a third-party cause of action against directors
- Does require corporations to agree one or more specific purposes for the charter
More on SPCs and PBCs

- **Social Purpose Corporation (WA)**
  - New corporate form adopted by Washington State last year, which is similar to the California SPC (formerly FPC)

- **Public Benefit Corporation (PBC)**
  - Delaware passed Senate Bill 47 during the summer of 2013
  - Although the proponents of the benefit corporation actively lobbied for Senate Bill 47, the resulting Delaware PBC looks much like the California SPC in terms of form and function
  - Like the California SPC and unlike the benefit corporation, the Delaware PBC empowers shareholders (as opposed to legislators) to determine the social or environmental purposes, and provides flexibility around reporting
Consideration of Mission: Exits

- With traditional corporate form, can mission be considered at time of M&A?
  - Review impact of mission on market value and brand
  - Review identity of purchaser and structure of transaction
  - Review payment mechanism (cash versus stock)
  - Ability for impact/PRI investor to secure different consideration

- Option for conversion of new form (PBC/SPC/Benefit) to traditional form pre-acquisition by shareholder vote

- Primary issue for M&A with new forms is shareholder vote required from target

- No mechanism for preservation of mission post-IPO

- New exit forms to consider (e.g., ESOP)
Accountability: Reporting Mechanisms

• Public Companies – Voluntary reports
  • Sustainability Reporting Guidelines contain recommended performance indicators and management disclosures that organizations may adopt voluntarily
  • Used as the basis for producing voluntary corporate social responsibility (CSR) or sustainability reports
  • GRI is not a rating agency; it doesn’t monitor whether a particular company has correctly applied its guidelines, and doesn’t provide certifications

• Private Companies
  • B Lab is a non-profit company that has established a certification process designed and used primarily by private companies to create “B Corporations”
  • Designed to measure the impact of a company on all of its stakeholders
  • The standards change depending on the size of the company and the sector in which the company operates
Accountability: Reporting Mechanisms

- Impact Reporting and Investment Standards (IRIS)
  - Developed by Global Impact Investing Network (GIIN), a not-for-profit organization dedicated to increasing the effectiveness of impact investing
  - Provides a standard set of performance measures for describing social and environmental performance, including a variety of performance objectives, as well as specialized metrics for a range of industry sectors
  - IRIS is not a rating agency and does not provide certifications

- Sustainable Accounting Standards Board (SASB)
  - The desire for integrated sustainability accounting standards led to the creation of the new SASB, a registered 501(c)(3) non-profit organization, accredited by ANSI
  - Creating industry-specific sustainability accounting standards to disclose ESG (environmental, social, and governmental) factors in standard filings for public companies, such as the Forms S-1, 10-K, 10-Q, and 20-F
Advancing Mission: Equity Instruments

• Use of traditional equity instruments (common and preferred stock) to further mission

• Can be established by founders at time of formation or required by investors

• Rights, preferences privileges
  • Separate class of stock for “mission-aligned” investors and founders whose consent
  • Expansion of protective provisions to include mission with business purpose
  • Either class vote for sale or redemption right
  • Board representation
  • Waterfall Provisions/liquidation preferences
  • Redemption trigger for failure to adhere to mission; can also add contractual remedy (take control of board) if unable to honor redemption
Advancing Mission: Debt Instruments

• Debt Instruments
  • Affirmative and negative covenants regarding mission
  • Default if mission violation
    • Alternative use of higher interest rate in event of mission “creep”
  • Prepayment requirement for mission deviation (alternative to default to avoid cross-default with other debt instruments)
  • Contractual remedies for failure to pre-pay, including take-over of board/control
  • Issues with who determines mission default or “creep”
    • Board representation/approval
    • Can establish special committee for revision of mission (CSR committee) but approach may end up marginalizing mission in comparison with operations

• License Agreements
  • With IP held by related non-profit, may be most effective way to preserve mission in traditional for-profit form
Social Impact Bonds
What is a Social Impact Bond (SIB)?

- A Social Impact Bond is a multi-party, pay-for-performance contract that pays investors financial returns based on impact created by a nonprofit organization.
  
  - Government or private entity contracts to pay for social outcomes that save money or create value.
  
  - Investors fund a nonprofit organization to produce the social outcomes.
  
  - If the social outcomes are achieved, the government or private entity pays investors back their principal investment plus financial returns.

- A Development Impact Bond (DIB) is a SIB in the developing world.
Current Social Impact Bond Model

Pay for Success Financing Tool

INVESTORS
Invest Capital in a Nonprofit Org

NONPROFIT ORGS
Implement Services & Report Impact

PAYERS
Repay Investors Based on Nonprofit Orgs Impact

Intermediaries
Structure Deal & Raise Capital

Independent Assessors Evaluate Impact
Social Impact Bond Example

2013 New York City Recidivism Deal

**INVESTOR**
Goldman Sachs
Invests $9.6M

**PAYER**
City of New York Repays Principal + Return or Bloomberg Philanthropy Guarantees Principal @ 75%

**NONPROFIT ORG**
Recidivism Reduced by +/-10%

Intermediaries Structure Deal & Raise Capital

Independent Assessors Evaluate Impact
Worldwide SIB Applications

Social Impact Bonds have travelled from concept to execution faster than any other social innovation in recent history.*

*SIB Infographic, Rockefeller Foundation, October 2013
## SIB Participant Benefits

<table>
<thead>
<tr>
<th>Participant</th>
<th>Benefits</th>
</tr>
</thead>
</table>
| Investor                         | • Opportunity to invest in the nonprofit sector with the potential to earn both social and financial returns  
                                |   • Improved impact data                                                  |
| Nonprofit Organization/Service Provider | • Access to new capital sources  
                                |   • Reduce reliance on traditional philanthropy  
                                |   • Meritocracy – money follows impact  
                                |   • Streamlined impact reporting  
                                |   • Freedom from overhead constraints                                    |
| Payer                            | • Pay for performance; deferred payment  
                                |   • Higher impact per dollar donated  
                                |   • Government spending reform  
                                |   • Improved impact data  
                                |   • Catalyze new money into the sector  
                                |   • Risk-sharing                                                          |
| Guarantor                        | • Pay for performance  
                                |   • Catalyze new money into the sector                                    |
| Intermediary                     | • New business opportunity                                               |
# SIB Variations

| Cost Saving vs. Value Creation | 
| --- | --- |
| • Originally, SIBs were applied in cases where the intervention saved the government money and the savings was shared with investors in the form of a financial return. For example, reducing recidivism saves the state money and that savings is shared with investors in the form of a financial return. |
| • New applications are being designed where the interventions create value. For example, investing in girls education in the developing world creates value (intellectual capital, future earnings/taxes, etc.) and that value is shared with investors in the form of a financial return. |

| Risk Tolerance | 
| --- | --- |
| • SIBs have various risk sharing structures ranging some of which include guarantors and others that do not. |

| Private Payer vs. Government Payer | 
| --- | --- |
| • Originally, SIBs were applied in cases where the government was the Payer; however, private payers are now emerging as important players, especially in the developing world. For example, Coca Cola is noted as a Payer in a SIB under development in Mozambique for malaria. |
Current SIB Structure

Social Impact Bond ≠ Bond

Limitations

- Private contracts
- Lack of standardization
- Limited accessibility
- Limited liquidity
- Lack of transparency
- Inconsistent reporting
- Lack of market data
New "Impact Security" Model

- A growing number of results-based financing instruments are emerging in the social sector

- If structured appropriately, results-based financing instruments may be considered debt securities ("Impact Securities")

- Impact Securities issued by a government entity and by nonprofit organizations are exempt from SEC registration requirements
  - Nonprofit (501(c)(3)) exemption – Securities Act Section 3(a)(4) exemption
  - Government or municipality exemption – Securities Act Section 3 exemption

- An over-the-counter or interdealer trading market may develop to trade Impact Securities, like the market for muni securities

- Alternatively, an organized market can be established to facilitate trading in Impact Securities
Impact Security Model

INVESTORS
Invest Capital in a Nonprofit Org

PAYERS/DONORS
Repay Investors Based on Nonprofit Orgs Impact

IMPACT SECURITY
ISSUER
501c3 or Government

NONPROFIT ORGS
Implement Services & Report Impact

- Investment
- Donation
- Impact Security
- Payment of principal, returns and/or bonus based on impact
New "Impact Security” Model

• A government entity or a 501(c)(3) organization (foundation or nonprofit organization) (“Issuer”) serves as a conduit connecting investors, foundations/corporations/individuals (“Donors”) and social initiatives in need of capital
• Issuer is self funded and/or receives funding from various sources including foundations, corporations, individuals and government in the form of donations or taxes
• Issuer issues and sells debt instruments to investors in public offering
• Issuer uses offering proceeds to fund specific social initiatives performed by 501c3 nonprofit organizations
• Return to investors contingent on social initiative achieving specified impact results
  • If specified impact results achieved, Issuer pays (i) return to investors, and (ii) “bonus” to successful social initiative (optional feature to align incentives)
  • If specified impact results are not achieved, Issuer does not pay returns or bonus

Restructure the Social Impact Bond model to expand application as well as enable standardization and trading.
New "Impact Security” Model

• By structuring as a “security,” a number of benefits can be achieved:
  • Investors are familiar with offerings of securities
    • Documentation is familiar: a potential investor will receive an offering document and will not be required to review/execute an operating agreement or partnership agreement
    • A security can be more easily held in a brokerage account
  • A security is more readily transferred
    • Transfers would not require assignment of LLC or partnership interests
    • A security may be “traded” on an exchange or through dealers
  • A security may be more readily valued
Building a Successful Market

Expand Beyond Government

Establish Standardized Financial Instrument

Increase Transparency
SIB Principles Goals

• Standardization
• Transparency
• Disclosure
• Foster integrity
• Promote participation
A Case Study: Green Bonds
What are they?

- Green Bonds might be thought of as a form of socially responsible investing (SRI)—aligning investor interest in environmentally-sound projects with their desire to invest in fixed income securities

- There is no uniform definition of a “Green Bond” but it is generally thought of as a debt security the proceeds of which have been earmarked for use in special projects that advance environmentally-friendly objectives
  - Investments in renewable energy, energy efficiency, climate-friendly projects

- From a legal perspective, a “Use of Proceeds” Green Bond is a traditional (usually) senior debt obligation of the issuer that pays a coupon but it is distinguished by the specificity of the use of proceeds
Types of Green Bonds

• Use of Proceeds Bond – traditional debt security the proceeds of which are earmarked for use in advancing certain eligible investments

• Revenue Bond – non-recourse to the issuer; the credit exposure is to pledged cash flows of the revenue stream. Proceeds are ring-fenced or tacked by the issuer and tied to the issuer’s investments in the project

• Project Bond – for single or multiple projects, where the investor has direct exposure to the project

• Asset-Backed Bond – collateralized by one or more specific projects
How has the market developed?

• Beginning in 2007/2008 supranational entities, such as the European Investment Bank and the World Bank, began to issue green bonds wherein the proceeds would be used to fund climate or otherwise environmentally friendly projects.

• There has been an evolution in the market:
  • Issuers have started to come to market with $1 bn-sized transactions instead of $10mm-sized transactions.
  • Now, in addition to supranationals or quasi-governmental issuers (World Bank, EIB, IFC, EDF, KEXIM) corporates have begun to issue green bonds.
How has the market grown?

- There has been significant recent growth
  - 2012 – issuance of nearly $3 billion
  - 2013 – issuance of nearly $12 billion
  - 2014 – expected issuance of between $25 – 40 billion
- Green bonds have been issued in a range of currencies
  - USD and EUR are the most popular currencies
  - Other popular currencies include GBP, SEK, JPY, CAD, AUD
- Ratings: Range from AAA to BBB
- The tenor of benchmark-sized green bonds that have been issued range from 18 months to 10 years
- Privately-placed green bonds are more diverse in currency and tenor
Who invests in green bonds?

• Issuing a green bond allows an issuer to tout its green credentials, raise capital and also to diversify its investor base.

• More and more investors are focused on environmental, social and governance goals.

• The UN articulated Principles for Responsible Investing (PRI)
  • Over 1000 investors have signed on to the PRI, representing over $30 billion in AUM.

• Investor Type
  • Asset Managers
  • Pension Funds
  • Insurance Companies
  • Bank/Corporate Treasuries
  • Ultra High/High Net Worth Individuals
Pricing and Trading of Green Bonds

- **Pricing**: in line with issuer’s outstanding senior bond curves
  - Potentially greater pricing leverage due to more investor participation and diversification

- **Trading**: *pari-passu* with regular bonds and as such trade consistent. Buy and hold nature of the investor base can create technical advantages for holders

- **Liquidity**: consistent with similar sized senior unsecured tranches from the borrower
Green Bond Principles
Promoting disclosure & transparency

• As the market has grown and become more diverse, it has become more important to be able to enhance disclosure and transparency.

• Investors have been calling for more detailed and more transparent disclosures from issuers regarding their sustainability efforts.
Green Bond Principles

• A white paper co-authored by BAML and Citi, the Framework for Green Bonds, formed the basis for the Green Bond Principles

• In January 2014, the Green Bond Principles were agreed in order to promote transparency

• The Principles are not intended to be prescriptive, but rather to be viewed as voluntary best practices intended to provide some guidance for issuers and investors relating to
  • Use of proceeds
  • Project evaluation/selection
  • Management of the proceeds
  • Reporting
Use of Proceeds

• The principal distinguishing factor with a green bond will be the issuer’s intended use of the offering proceeds, therefore, substantial attention is focused on its disclosure
  • Potential eligible categories of investments include:
    • Renewable energy
    • Energy efficiency
    • Sustainable waste management and land use
    • Clean water and water treatment
    • Biodiversity conservation
    • Clean transportation
  • For some specific sub-categories, the Appendix provides resources from environmental experts
Selection Process

- Investors will want to understand how the issuer will approach project selection and how it will measure or assess the impact of projects.
  - A framework for choosing projects may be documented or articulated by the issuer as part of its general sustainability initiatives.
  - Some issuers may publish their framework on their website.
  - Some issuers may obtain a second-party opinion on the framework or the specific uses of proceeds.
Tracking Proceeds

• Issuers have adopted varying practices to track the actual use of proceeds

• The Principles suggest that
  • The issuer clearly disclose the process for tracking the proceeds
    • To this end, proceeds can be ear-marked or even moved to a sub-portfolio
    • For added assurance, the issuer can have the tracked proceeds verified by an independent third party such as the issuer’s auditors
      • “Attestation” or “verification” usually will require issuer to enter into an engagement letter with the auditors pursuant to which the issuer and auditors will agree on the scope of the work, the work product (attestation letter or other), and how that information can be used or shared with third parties
      • The attestation process is distinct from and unrelated to the traditional comfort letter process
      • Auditors may be concerned about the description of their role in the prospectus and any reliance by third parties on their attestation
      • The attestation would not be “expertized” information
Reporting Process

- Investors will seek out periodic reports regarding the issuer’s progress in deploying the proceeds
- The Principles recommend
  - Annual reporting on which projects received proceeds from the Green Bond
  - Where feasible, reporting could include use of quantitative or qualitative performance indicators to measure the impact of specific projects
Second-party Opinions

- Some issuers have engaged outside parties, such as Vigeo (an ESG rating agency) or DNV or CICERO, to write an opinion about the issuer’s “framework”
- Likely that there will be other entrants looking to take part in the market in this way
Evolution of Principles

• A governance process is in place which allows various stakeholders to provide their input on the Principles

• ICMA has been named as third-party Secretariat to facilitate the exchange of information
What’s next

• Indices based on Green Bonds, such as the Solactive index created in partnership with the Climate Bonds Initiative
• Structured securities linked to these indices
• Asset-backed Green Bonds
• Green Project Bonds