Consideration of Contract Terms for Impact Investment Targeting Startups

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1. Introduction

Expectations for impact investment have been increasing in Japan. The promotion of impact investment was established as a clear policy goal in the "Grand Design and Action Plan for a New Form of Capitalism, 2023 Revised Version", published by the Council for Realization of a New Form of Capitalism of the Cabinet Secretariat Council on June 16, 2023. In addition, Japan's Financial Services Agency (FSA) published a report titled "Draft Basic Guidelines for Impact Investing", and is soliciting public comments[1] in order to summarize the basic concept and process of impact investment. In particular, non-listed startups are expected to play key roles in impact investment in Japan, as evidenced by the establishment of "J-Startup Impact" by the Ministry of Economy, Trade and Industry's (METI) and formation of the Impact Startup Association, a general incorporated association comprised of impact startups, as well as the announcement of its collaboration with the New Public Interest Association and Keizai Doyukai.

When examining the contractual concerns raised by impact investment targeting these startups, it is considered necessary to ensure the existence of an investment agreement or loan agreement governing the impact investment and the agreement(s) with existing shareholders, for example, when a limited partnership agreement is used to form an impact investment fund involving venture capital and private equity funds[2].

Although these agreements are similar to ordinary investment agreements, there are several specific points to note when drafting contracts for impact investments. Notably, the objective of impact investing is the realization of an "impact", which differs from other forms of investment, like ESG investing, in which the realization of "impact" is a secondary objective.

In foreign countries, impact investment terms should be tailored to the needs of individual investors and projects, the attributes and objectives of each investor (e.g., whether the investor is an impact-first investor, such as a philanthropic or non-profit organization, the extent to which the investor values returns, and the level of return sought), Maturities of the companies, and the characteristics of the industry. No common practice has been established; however, in recent years, voluntary groups of lawyers and others, mainly from Europe and the United States, have released term sheets containing contract terms for impact investments,

[1] The public comment period was from June 30 to October 10, 2023.

[2] While the focus of this newsletter is investment agreements with issuers and impact investors, it is possible to design LP contracts of impact funds for this purpose also, for disclosing and providing impact reports to LP investors, and determining the success fees for impact funds based on the achievement of impact targets agreed upon in advance with the end investors. For more on structuring on the impact investor side, see Mac Cormac, S. H., Finfrock, J., & Fox, B. (2019). Impact investing. In The Lawyer's Corporate Social Responsibility Deskbook: Practical Guidance for Corporate Counsel and Law Firms (pp. 233-). American Bar Association.

and are beginning to promote and engage in relevant discussions.[3]

Currently, in Japan, it is rare for an impact investor to be a lead investor or to have bargaining power in contract negotiations. There are limited cases in which contract provisions specific to impact investment have been considered and adopted. However, based on the current trends in other countries, and from the perspective of establishing future best practices in Japan, the following sample terms could be included in investment agreements (including side letter agreements) relating to impact investments, assuming equity investments in impact startups, which are expected to play a particularly important role in Japan.

2. Clarification of Purpose and Mission

(1) Common understanding of corporate purpose and mission, and investment objectives

The primary objective of impact investment is realizing the desired impact. Accordingly, it is important to define the purpose and mission of the company (issuer) clearly, and to establish a common understanding of the intended impact, via a review of the basic principles underlying management decisions. In other words, in an impact investment, the issuer seeks to solve a specific social issue through the management of its business, and investors seek to realize the same impact through their investment in the issuer's business. Accordingly, it is important for both parties to share a clear understanding of their common purpose.

In order to ensure clear understanding of the purpose and mission of the company and the purpose of the investment, it is important to state the mechanisms for realizing the desired change (i.e., the process by which the investment is intended to produce social and environmental benefits) in written form. One useful method of organizing this conceptual mechanism is based on the "Theory of Change."[4] Impact investors in Japan also often check for consistency with their own fund's "Theory of Change" when making investments, and there are discussions overseas about requiring sustainable impact funds to disclose their "Theory of Change."[5] As such, it is reasonable to use the "Theory of Change" as common language through which to reach a mutual understanding.

(2) Clarification of corporate purpose and mission

Clarification of a company's purpose and mission generally is implemented prior to negotiation or execution of investment agreements (for example, at the sourcing phase or during the due diligence process), when the parties reach and verify their common understanding. Not only, realization of the desired impact is the primary investment objective of impact-first investors, but also it is necessary to ensure consistency with this purpose in various clauses, including those that address "mission drift," as discussed later. Therefore, it is recommended that the relevant provisions of the investment agreement clearly define the purpose and

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3 For example, Impact Term Sheet 2.0 by LISI (Legal Innovation for Sustainable Investments) and Term Sheets & Case Studies by The Impact Terms Project (https://www.impactterms.org/case-studies-term-sheets/).

4 For more information of "Theory of Change," see the GIIN website (see also https://iris.thegiin.org/glossary/#theory-of-change) and the UN Sustainable Development Group guidance. (See also https://unsdg.un.org/resources/undaf-guidance-theory-change).)

5 For example, the new anti-greenwashing rule (Sustainability Disclosure Requirements), currently being discussed by FCA in the United Kingdom, requires that the Theory of Change be disclosed in sustainable-impact investing.

mission of the investment and the company in which the investment is being made.[6]

Under Japanese law, the inclusion of "purpose clauses" in an investment agreement does not, by itself, immediately give rise to direct rights and obligations of the parties. However, it is important for impact investments to balance the interests of stakeholders with the purpose and mission of the issuer. In addition, Japanese courts interpret the meaning of each phrase in a contract on a rational basis, based on the reasonable intent of the parties. Purpose clauses are important, because they serve as a standard for, and aid to, interpretation of each clause in the agreement.

3. Provision for preventing mission drift

In addition to standardizing the purposes and missions of issuers and investors, it is important to prevent the issuer's corporate management from deviating from the issuer's purpose and mission ("mission drift"). For example, in a situation where the investor is an impact-first investor who invests with emphasis on impact rather than financial return, the parties may agree that a breach of the covenants relating to the purpose and mission of the company constitutes a default under the agreement and that the interest rate may be change or the investor's funds may be withdrawn immediately if this type of default occurs.[7]

Nevertheless, there is a belief among investors that the operation and continuity of the issuer's business, and subsequent financing, should not be affected by the holding or exercise of powerful rights by a particular investor. In addition, in the case of impact investment in particular, investments are often made during the early stages of a business, when it remains easy for businesses to pivot. Therefore, it is important to avoid scenarios in which smooth business operations could be hindered, impeding the sound growth of the issuer. Rather, enterprises should be given some flexibility to manage their business and achieve their respective missions.

Therefore, the following, paragraphs introduce possible provisions and responses to prevent mission drift, although the degree of use of these or similar clauses will vary depending on individual projects and practices.[8]

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6 The purpose clause in an investment agreement could refer to the role of the investor or the intentions of the investor. In recent years, there has been a lot of discussion about regulations on the part of investors who invest in ESG and impact investments. For example, if an investment is included in a sustainable investment portfolio, as defined in the Sustainable Finance Disclosure Regulation (SDFR), it must meet the SFDR definition of "sustainable investment" and comply with the relevant reporting and governance requirements. It may be important for both issuers and investors to determine whether an investment is being made in accordance with these regulations. If investors expect issuers to comply with certain standards, it is possible to clarify those assumptions in the purpose clause of the investment agreement, by stating that the investment is being made in accordance with the relevant regulations. The agreement also may state how responsibility, including responsibility for costs, will be allocated for DD responses and provision of post-investment information necessary to confirm compliance with the relevant regulations (See also: LISI's Regulatory Module Impact Term Sheet 2.0). There may be differences in the required provisions, in terms of satisfaction of relevant requirements, for example, when the intention is to make investments that are eligible for tax incentives, such as program-related investment, which is a form of impact investment being implemented by U.S. private foundations.

7 Impact terms: Loan Financing from a Foundation with Impact-triggered Default (https://www.impactterms.org/download/loan-financing-from-a-foundation-with-impact-triggered-default/) has provided a term sheet that assumes this type of situation.

8 In order to ensure that the intended matters are implemented at the time of investment, these provisions may be drafted as obligations of the issuer that must be completed before the closing, or even as conditions of the investors closing the investment, or post-closing obligations, on the premise that investors and the issuer will implement these matters together after the closing.

(1) Including objectives and missions in the articles of incorporation and mission statement

First, the purpose and mission of the issuer, which are clearly defined in the investment agreement, could be set forth (or contractually mandated) in the articles of incorporation, which is a legal document required by the Companies Act, as well as in mission statements and other documents voluntarily established by the issuer. Japanese law obligates directors to comply with matters set forth in the articles of incorporation and in resolutions passed by the general shareholders' meeting of the company (Article 355 of the Companies Act). Therefore, if the articles of incorporation include provisions relating to a certain purpose and mission, as well as stakeholder considerations, and if these provisions are approved by a resolution of the shareholders' meeting, it will be possible (in the abstract) to impose a legal obligation on the issuer's directors to manage the business in accordance with the stated purpose and mission.[9,10]

In addition, since changing the purpose and mission of the issuer is a matter of extreme importance when it comes to the premise of impact investment, it is worth considering providing for implementation of a special procedure, separate from the requirements for passage of ordinary resolutions by the board of directors and general meeting of shareholders. For example, the company could add weight to the requirements for passage of board of directors' resolutions or shareholders' resolutions relating to amendments to the articles of incorporation under the Companies Act, or the company can require additional approval from an independent advisory committee within the company, or veto rights could be granted to certain shareholders (e.g., the impact investors) under investment agreements. This is a legal mechanism by which to guarantee the issuer's commitment to the stated purpose and mission, by ensuring that the purpose and mission cannot be modified by a simple capital majority vote.

(2) Restrictions on the use of funds, negative covenants, etc.

It is common for ordinary investment and loan agreements to contain negotiated limitations on the use of the invested funds, for example, limiting use of the funds to business development and related purposes. Similarly, from the perspective of preventing the funds invested by impact investors from being used for purposes other than realization of the envisioned impact, it is possible to restrict use of those funds to a certain purpose, such as specified projects and areas based on specific plans and objectives. In addition, as with general investment agreements, it is reasonable to establish matters that are subject to prior approval and to include negative covenants (obligations not to act in or on certain matters) governing certain important business matters.

It also is possible to use share types with veto rights under the Companies Act (Article 108, (1), 8 of the Companies Act) as a strong mechanism to prevent deviation from the mission. Specifically, it is permitted to issue shares with veto rights ("golden shares") to founders, foundations, and trusts, which are used in other countries. Since golden shares carry powerful rights, it is expected that their use will be limited. In addition, the scope of use of golden shares should be the minimum necessary to realize and maintain the company's objectives and missions, such as changes to the purpose clauses in the articles of incorporation. The scope

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9 Where a director fails to comply with the articles of incorporation, it theoretically is possible to pursue the personal liability of the relevant director, based on Article 355 of the Companies Act, or to demand an injunction against an act contrary to the company's mission, as set forth in the articles of incorporation, on the basis of Article 360 (2) of the Companies Act. However, in reality, it is necessary to engage in further, future discussions about situations in which a director's individual liability and an injunction against a director can be pursued.

10 As described below, there is a certain affinity between impact-startups and B Corp certification, and clarifying the issuer's purpose and mission in its articles of incorporation also may be useful in the assessment for obtaining B Corp certification.

of the veto power may include M&As, transfers of business or assets in a manner contrary to the company's purpose or mission, and the selection and dismissal of important officers.[11]

(3) Monitoring Through Governance Systems

It also is possible to monitor an issuer's actions and decisions through the company's governance system, without the need to establish the direct rights described in section (2) above. For example, a company could agree to establish a voluntary internal body with a certain degree of independence from management, such as an internal impact committee, to monitor compliance with the company's purpose and mission; these types of committees have been established at impact startup companies in recent years. The roles of these bodies vary but, in essence, they serve as voluntary advisors to the board of directors. In addition, they are expected to coordinate the interests of various stakeholders, identify the company's mission and objectives, formulate strategic goals and measures to achieve them, and monitor whether business operations are being conducted in line with the company's objectives and mission.[12]

In addition, even if this type of body is not established, investors may obtain the right to appoint and remove certain officers, as in a general investment project. Even where the appointment or removal of officers is not necessary, the investor could engage in moderate monitoring of normal business operations, for example, by sending observers to board of directors' meetings.

Furthermore, it is conceivable to incorporate a system of compensation for officers and employees that is linked (to a certain extent) to achievement of the company's purpose and Key Performance Indicators (KPI) of the desired impact, as incentives for achievement of the impact. However, since the officers and employees actually manage the business, it is possible that excessive emphasis on the achievement of KPI may have a negative impact on business operations and growth. Therefore, depending on the industry, and the status of the company, it may be difficult to discuss and negotiate KPI incentives.

(4) Mission-drift safeguards

In addition to the specific governance system described above, it is possible to agree to a change of corporate structure from an ordinary, for-profit corporation to a different entity type, such as a benefit corporation (if such a structure exists in the relevant country) or to agree to obtain B Corp certification as a safeguard to ensuring preservation of the issuer's mission and objectives. Benefit Corporations can ultimately return to being normal stock companies by following the procedures in the Companies Act, and they do not renew their B Corp certifications once every three years, they will return to uncertified status. However, this type of change in business policy may be detrimental to a company's business strategy, and can be expected to create certain psychological and practical hurdles. When investing in impact start-up companies, there are

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[11] When issuing shares with veto rights (also known as "golden shares"), from the viewpoint of ensuring the predictability of other investors, it is conceivable to set standards for the exercise of veto rights. For example, INPEX Corporation, the only listed company in Japan that has issued golden shares to date, established criteria for the exercise of veto rights in a Ministry of Economy, Trade and Industry Notification (the exercise of veto rights is determined mainly from the perspective of ensuring efficient, stable supplies of energy to Japan). However, in principle, the Japanese Stock Exchange generally does not allow listed companies to issue golden shares (See Rule 601.(1).17 of the Securities Listing Rules and Rule 601.(14).3 and 4 of the Securities Listing Enforcement Rules). It should be noted that in the case of a start-up that aims at listing, the golden shares need to be processed prior to the listing application.

[12] Outside Japan, for example, a mental health startup, "Togetherall," has established a Guardian Council to oversee the organization's alignment with its social mission as a mechanism to maintain impact after investors exit. In addition, when Unilever acquired Ben & Jerry's, it agreed to establish an independent board of directors to maintain the company's mission.

situations in which it is helpful to use B Corp certification as a mechanism to incorporate matters relating to impact into governance.[13] In Japan, since there is no corporate form similar to a Benefit Corporation, it is expected that B Corp certifications will be used, particularly by impact start-up companies.

Establishing strong negative legal effects (sanctions) is effective from the perspective of providing incentives for managers not to engage in business operations that lead to mission drift. For example, an investor may exit by selling their shares in the company (with a drag-along option for such exit), as a more powerful method, the investor may have the right to sell its shares to the company or existing shareholders (put option), or issue class shares pursuant to a right to request acquisition, in the event of mission drift. Also, it is possible to alter the exercise and/or conversion price of stock (including preferred stock), in the investor's favor if mission drift occurs.

However, it may be difficult to determine when mission drift has occurred (and thus, to set and apply the contract triggers). Accordingly, it is possible to reach an agreement that the existence of mission drift will be determined by an independent governing body or an outside third party (such as a mediator or arbitrator), the identity of which is agreed upon in advance. It also is possible to establish objective situations that constitute mission drift, and triggers therefor, and parties should do so whenever possible; for example a clause stating that when progress toward or metrics for achievement of a given impact KPI is extremely poor, it constitutes mission drift.

However, as mentioned above, there is a strong belief that when clauses with this type of strong effect are included in investment agreements, they should be prevented from affecting the operation and continuity of the issuer's business and subsequent fundraising efforts. The inclusion of strong provisions like this in investment agreements may cause ordinary investors (other than impact investors) to avoid investing in the relevant enterprise, either due to the existence of the provisions themselves or because it may be uncertain when (and if) the provisions will be triggered. Therefore, it is necessary to consider the nature and use of these provisions carefully.

4. Reporting and Information Disclosure

To ensure transparency with regard to the status of efforts to create a desired impact, many impact investments require the issuer to report to investors at regular intervals, in addition to providing the usual reports on financial status. In this context, the investment agreement may require regular reports on the status of certain, established impact KPIs, and that the impact reports must contain predetermined content satisfactory to investors. When defining impact KPIs, it is necessary to ensure that the indicators are appropriate and manageable, based on both the nature of the business and the size and complexity of the organization. Therefore, discussions between impact investors and issuers about the KPIs are expected to have the additional effect of promoting mutual understanding of the purpose and mission of the issuer, and how the business should be managed to achieve the desired impact.

The subject matter of required reports may depend not only on the impact contemplated by the issuer, but also the objectives of the investor's investment (and regulations applicable to the investor). In particular, if an issuer receives investments from multiple investors, each investor may require reports in a different form, or with different content; as a result, some say this will increase the burden on issuers required to make impact-based reports to investors. Certainly, some issuers will face a heavy burden when it comes to

13 Big Society Capital"What determines a successful exit for an impact startup?"(https://bigsocietycapital.com/latest/what-determines-a-successful-exit-for-an-impact-startup/) See also.

disclosing impact information to investors. Therefore, from the perspective of reducing the burden on issuers, it is important to establish the nature of the information to be provided to investors, for example, what information will be disclosed (e.g., sufficient to comply with Impact Reporting and Investment Standards methodologies and indicators, identify the indicators, etc.), how often reports must be made, and how the relevant data will be collected.

In addition to the information to be reported, issues may arise with regard to verification of reporting, for example, whether or not to require audits and outside evaluation or certification (for example, by third parties with expertise in impact reporting), and how to allocate the cost burden associated with each stage of the reporting process. In particular, in the context of receiving impact investments from foreign investors, it is likely that there will be requests for third-party evaluation and certification, and it will be essential to make arrangements in advance regarding the burden of cost and time required to obtain the requested certification and evaluation, to ensure these efforts do not interfere with the issuer's business.

5. Exit actions and strategies

When an impact startup is acquired via M&A and existing investors exit, it is important to ensure the issuer continues to pursue its original purpose and mission, and that the impact continues to be realized properly, on an ongoing basis. Therefore, investment agreements should make it possible to agree on M&A and exit strategies in advance.

In particular, since the expected time frame and tolerance for exits may be different for impact investors than for investments by ordinary VCs, and the impact of an exit by impact investors on an issuer may be different from that of an exit by an ordinary VCs, separate consideration of M&A and exits is required in the investment agreement from that in ordinary investment agreements.

For example, when an impact investor exits, a right of first refusal (the right of an existing related party to acquire shares before a third party is permitted to do so) may be granted to other shareholders, management, or the issuer, in order to prevent the participation of shareholders who lack an impact orientation. .
In addition, the investment agreement could state that the shares can be sold only to investors that are committed to working with the company to achieve its purpose and mission (with those decisions reviewed carefully by the independent governing body mentioned above). Also, with regard to the exercise conditions and effects of Drag Along and Tag Along, which are also set up with regular VC contracts, there is room for ingenuity specific to impact investing.

However, provision in the direction of restricting investor exits may discourage economically attractive acquirers, and may create a large hurdle for investors to overcome when attempting to exit from an investment, so careful consideration is required at the time of initial drafting.

IPOs are also an important exit method, especially for startup investments in Japan, but an IPO essentially terminates the agreements with existing shareholders, and the company's capital structure is changed significantly. Therefore, difficult issues arise with regard to how post-IPO impact companies can continue to create an impact appropriately in open capital markets. Attention should be paid to the results of a working group on impact IPOs organized by the GSG Domestic Advisory Committee, which was established on July 28, 2023; the results will be announced in the future.

6. Concluding remarks

In this newsletter, we have introduced terms relating to impact investment targeting startups, taking into account the ongoing discussions in foreign countries. This newsletter is organized mainly from the perspective of impact investors, but some of the suggested provisions should be incorporated proactively, from the standpoint of issuers seeking to receive investments. When raising funds for an impact startup, careful consideration is necessary because the type of investors and the conditions under which funds are raised may have a significant impact on the direction of the company's growth and development in the future.

Although we do not anticipate the terms and clauses introduced in this newsletter to enter standard Japanese contract practice immediately, we hope they will provide a useful reference and help to create a healthy ecosystem for impact investment in Japan.

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