

Policy Practicum: Impact Investing In the Absence of Credible Legal Institutions

Impact Investing in Developing Countries: Legal Institutions and Work-Arounds

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Stanford Law School Policy Lab Practicum,
Impact Investing in Developing Countries: Legal Institutions and Work-Arounds
Autumn Quarter of 2015

Impact investors are investors who place capital in enterprises that they expect to generate social or environmental goods, services, or ancillary benefits, with expected financial returns ranging from the highly concessionary to risk-adjusted market rates or better.

Impact investors include foundations making program-related investments (PRIs), family offices, high net worth individuals, and investment funds. The investee enterprises range from startups to small and medium enterprises in developed and developing countries. The enterprises provide goods and services in industries as diverse as urban development, health, sanitation, environmental goods, education, and care for the elderly.

Impact investors are a subgroup of private equity or venture capital investors with these three distinguishing characteristics. First, as mentioned above, impact investors seek social outcomes as well as financial returns, which entails that they must try to ensure that an organization delivers on its social mission. Second, most impact investments are relatively small, which means that the costs of due diligence may be disproportionately high compared to the size of the investment. Third, while investors who seek only financial returns can reduce the volatility of their portfolio by diversifying their investments within and across countries, diversification does not bring the same advantages to the social goals of impact investments. Money is fungible, so that a loss in the investment of one company can be compensated for by good returns from another. In contrast, the failure of an impact investment intended to reduce malaria is not compensated for by the success of one intended to provide solar lighting.

When disputes between investors and their investees, or between the enterprises and their major business partners, come to a point where their rights can only be protected through litigation or arbitration, everybody usually loses. But the very existence of legal regimes that recognize the parties' rights with threats of enforcement can play an important background role in inducing the parties to live up to their agreed-upon obligations.

Investors and enterprises in highly developed countries count on the existence of mature legal regimes, even as they use other measures—such as doing due diligence on the reputations of prospective counterparties, maintaining strong relationships with them, and monitoring their performance—to ensure adherence to contractual obligations. But an increasing number of impact investors are investing in enterprises in countries that lack stable property rights, independent judiciaries, and other elements of the “rule of law” that are taken for granted in more developed countries. How can investors protect their rights when these legal institutions are absent? This is the question that this paper addresses.

The paper is aimed at impact investors who wish to invest in developing countries. It is based on interviews with experienced impact investors and private equity investors in those countries, from organizations including:

- Acumen Fund
- Aspen Network of Development Entrepreneurs (ANDE)
- Blackrock
- FSG's Inclusive Markets Group in India
- Helios Investment Partners
- LGT Venture Philanthropy Foundation
- Mulago Foundation
- Omidyar Network
- OPIC
- Schulze Global Investments
- SEAF
- Technoserve

The paper is a product of a Stanford Law School Policy Lab Practicum, *Impact Investing in Developing Countries: Legal Institutions and Work-Arounds*, taught in the Autumn Quarter of 2015. Paul Brest, former dean and emeritus professor (active) at Stanford Law School was the Practicum instructor, and the students were:

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Kunal Sangani played a particularly valuable role in assisting Paul Brest in editing this essay.

Although the seminar participants surveyed some of the relevant foundational literature, including Robert Ellickson's study of self-regulation by farmers and ranchers in Shasta County¹ and Lisa Bernstein's study of the diamond industry,² we decided that our comparative advantage would be in learning from the experiences of impact investors and the broader community of private equity investors of which they comprise a subset.

We are grateful to the experts from the organizations mentioned above, who gave generously of their time, and to lawyers from Omidyar Network and faculty at Stanford Law

¹ Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (1991).

² Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, *Journal of Legal Studies*, Vol. 21, No. 1 (Jan., 1992), pp. 115-157

School who provided critical feedback on earlier versions of this article. They are responsible for the insights reflected in this paper. We alone are responsible for any errors.

Stanford Law School
April 2016

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Impact investing often takes place in developing or frontier markets, and, as a result, impact investors will likely encounter problems unique to investing in countries where legal institutions are weak, ineffective, or entirely absent. The absence of credible legal institutions—and hence the lack of credible penalties for misbehavior—gives counterparties a wider berth to act in ways that are disadvantageous for the impact investor. Beyond the possibility of adverse behavior by investees or co-investors, impact investments are vulnerable to a second set of broader risks that result from the higher levels of political and market uncertainty often present in developing/frontier markets.

In the first two sections of this paper, we disaggregate these types of risk and offer techniques for mitigation: Section I provides an overview of country-level risks, including those from dealing with government regimes and those flowing from broader characteristics of developing markets, and Section II addresses the exacerbated risks of dealing with counterparties in the absence of realistic contract enforcement. Two aspects of the impact investing process, deal-structuring and dispute resolution, deserve special attention, and we spend Sections III and IV providing best practices as described by our interviewees on each.

SECTION I: Government and other Overarching Risks of Doing Business in Less Developed Countries

Impact investors concerned with improving the lives of the world’s poorest communities invest in less developed countries. Unstable political regimes in these countries can expose investors to distinctive governmental risks, including abrupt and sometimes violent changes in government, frequent changes of government officials, perilous socio-economic conditions, religious and ethnic conflicts, and corruption. We begin by considering risks of this sort.

1.1. Political Risks

The national security of a developing country is less predictable than that of developed countries. War, famine or other causes of social upheaval in a country can create instability that interferes with a business’s capacity to operate, thus making investments risky. Political instability poses a problem for an investor seeking to establish long-term and stable ties with local governments: for example, a change of regime may leave the business aligned with the wrong political party. In the category of political risks, we consider these sorts of country-specific risks that threaten a business model's viability or an enterprise's day-to-day operations.

Experienced private equity investors (including impact investors) have checklists to assess the risks of investing in a particular country—a basis for balancing the risks against the potential financial value of an investment. They may also retain a firm, such as The PRS Group, with expertise in country risk assessment.

Investors may also seek political risk insurance to compensate for losses caused by political upheaval. Such insurance is available to American investors through Overseas Private

Investment Corporation (OPIC), an independent U.S. government agency that provides investors with insurance, funding, and guarantees for projects in developing countries and emerging markets. OPIC's political risk insurance is available to American investors, lenders, contractors, exporters, and NGOs for investments in 150 developing countries.³ For example, one of OPIC's political insurance products is Political Violence coverage, which compensates investors for equity assets (including property) and income losses caused by (i) declared or undeclared war; (ii) hostile actions by national or international forces; (iii) revolution, insurrection, and civil strife; and (iv) terrorism and sabotage.

1.2. Regulatory Challenges and Risks

1.2.1. What is Regulatory Risk?

By “regulatory risk” we mean (1) the risks flowing from vague and conflicting laws, whose interpretations may depend on the whims of courts and officials subject to political or economic pressures or corruption, and (2) the risks of unexpected changes in the law that will adversely affect the investee business or the investor, including changes in taxation laws, reversal of previously granted incentives or subsidies, and revocation of licenses or permits. The revocation of licenses is a particular risk in regulated markets, such as utilities and telecommunications, and in investments related to land use and ownership. These regulatory risks can increase the cost of doing business, reduce the value of an investment, provide an unfair advantage to competitors, or even prevent the business from continuing operations altogether.

In addition, some regimes, though purporting to encourage foreign investment, have lengthy and burdensome regulatory procedures for permitting flows of funds into and out of the country. These can result in uncertainties and delays in investment funds getting to investees and interest payments and profits being returned to investors.

1.2.2. How Can Impact Investors Minimize Regulatory Risks?

As an initial regulatory risk mitigation strategy, investors' due diligence should include identifying laws and regulations that might apply to the specific business venture at various stages. However, acquiring reliable information about appropriate laws may be difficult in countries with a limited number of qualified lawyers and where legislative documents are not easily obtained or are so vague as to make it impossible to determine the rule. Even approaching government agencies may not be a solution when different agencies provide inconsistent answers about the country's licensing and regulatory procedures.

Some particular regulatory burdens placed on capital flows can be mitigated through special investment vehicles and side agreements. For example, to overcome regulatory challenges related to foreign ownership of domestic companies, an investor may consider owning shares in a holding company in the target country, which in its turn owns the desired investee. In countries where local regulations limit the size of loans, side agreements can set up a

³ <https://www.opic.gov/what-we-offer/political-risk-insurance>

mechanism for the business to pay for the investor's technical assistance, thus (for better or worse) evading regulatory caps.

American impact investors may also consider OPIC's special regulatory risk insurance.⁴ To date, this relatively new insurance product is offered only for investments in the renewable resources field and protects against these regulatory actions by the host government: (i) changes to feed-in tariffs, (ii) changes to the taxation laws and other regulations that interfere with the renewable energy project's operations; (iii) revocation of the necessary licenses and permits; (iv) wrongful interference with carbon credit generation or sales; and (v) repudiation of a concession, technical assistance, or forestry-related service agreements by a foreign government.

1.2.3. The Pros and Cons of Government Relationships as Risk Mitigation

Some investors try to either steer clear of markets that are highly regulated or dependent on licenses and permits (e.g. utilities or projects involving land use or ownership), or choose to invest in smaller companies that can stay under the government radar. Alternatively, some investors search for market segments that a government has identified as important to growth and has invited foreign investors to help develop. In any event, maintaining a good relationship with the government is an important aspect of regulatory risk mitigation.

Some investors, while striving to maintain good government relationships, keep government stakeholders at arm's length. They avoid investing alongside government bodies and persons and minimize investment in areas that depend on government payment and licensing. They may also try to invest in small companies to avoid intrusion, including nationalization, by host country governments. Once a business becomes profitable, however, it opens the door for government intervention and manipulation, providing concomitant trouble for the investor at that point.

At the other end of the spectrum, investors may seek government support and government contracts for their investees. This strategy is particularly important in highly regulated or publicly owned industries, or in sectors deemed vital for national welfare, such as education and healthcare. One interviewee explained that a government contract has been the key for its success in an education business. Investors who wish to gain government cooperation or expect that their investments will be monitored meet with government officials to understand their priorities and develop relationships, conveying the message that they care about the country's development and wish to be of help.

Internationally-known investing firms may even use their brand to impress government regimes and stimulate cooperation. This can also be a win for governments in developing and frontier markets, too, as cooperation with internationally recognized business organizations can contribute to their government's reputation in domestic and international markets. In any event, it is essential to have a local person who can maintain government relationships day-to-day—

⁴ <https://www.opic.gov/what-we-offer/political-risk-insurance/types-of-coverage/regulatory-risk>

usually the CEO or a local well-informed entity that can act on behalf of the investor and the business in the face of external conflict.

It should be noted that managing government relationships can be potentially dangerous in developing countries with high levels of corruption. Instead of spurring economic development, careless investment can feed corruption. Moreover, dealing with corrupt officials may harm the investor's reputation—and, in the case of American investors, can leave the investor vulnerable to significant civil and criminal penalties under the Foreign Corrupt Practices Act (FCPA). The FCPA prohibits bribery of foreign government officials and, in certain cases, private commercial bribery. Before investing in countries where bribery or other forms of corruption are common practice, impact investors should understand the corruption present in the political and economic fields in these countries, as well as activities prohibited under the FCPA, and carefully consider whether investing in these countries is worth the risk.

1.3. Currency Risk

Impact investors usually choose to both provide and receive capital in their own country's currency—dollars, euros, and the like. But since their investees do business in their local currencies, investments are susceptible to fluctuations in the value of those currencies. The impact investing industry has only just begun to identify potential methods for de-risking currency fluctuations. A solution proposed by one of our interviewees was to partner with foundations who may be willing to take on currency risk by providing a cushion of capital through their program related investments (PRIs).

The International Institute for Sustainable Development offers several solutions for mitigating currency risk, though the authors note that these strategies are typically costly to one of the parties involved (the investee, the investors, or the government). Among these long-run strategies is local currency financing.⁵

1.4. Social Risks

In addition to changes in governments and government officials, the attitudes of local communities, civil society leaders, and politicians can be a powerful risk variable for investors. If ties to the local community in which the business is based are not well-managed, social entrepreneurship can be stunted by civil society blowback. A notable example is the public backlash against microfinance in the Indian state of Andhra Pradesh in October 2010. Reports citing links between microfinance institution practices and suicides in the Indian state stirred public opinion against the microfinance institution SKS, and resulted in a steep drop in the firm's share price. A report published by the World Bank's Consultative Group to Assist the Poor

⁵ <https://www.iisd.org/sites/default/files/publications/currency-risk-project-finance-discussion-paper.pdf>

(CGAP) notes that the crisis “exposed issues of reputation management for an industry whose very existence is based on doing good by serving poor people.”⁶

Ventures with foreign leadership or staff may be especially vulnerable to these social risks. Mitigating these risks requires thoughtful reputation management, as the CGAP report mentions. It is important to build local networks, strengthen relationships with local community representatives, and foster dialogue, so that the social venture’s mission is well understood by the communities it intends to benefit.

1.5. Environmental Risk

Linked to the security risk outlined above, environmental risk in a foreign business venture may serve as another unpredictable factor in assuring the longevity of a business. Changing climate conditions may significantly affect the viability of investments, especially in countries where an unpredictable disaster-prone climate can wreak havoc on existing public infrastructure. Groups like Omidyar, with investments in agriculture-based businesses in countries like India, factor unpredictable weather or climatic patterns into their projections of returns. Encouraging private investors to become signatories to international agreements and other instruments that hold policymakers accountable to an international body can also mitigate environmental risks in the medium- to long-term, as these actions specifically call for “multilateral development banks and other development finance institutions to apply risk-reducing finance tools that can enable market development and help scale up private investment in developing countries.”⁷

1.6. Risks of knockoffs and other intellectual property infringement

One of our interviewees described an investment in a startup that sold solar lanterns in a rural region of India. A major setback was the discovery that small Chinese businesses were producing and selling cheap knockoffs of the startup’s lanterns. These imitations had two effects: reducing the size of the company’s market and, because of the knockoffs’ poor quality, undermining customers’ trust in the product.

In developed countries, intellectual property law provides innovators with a degree of protection that is absent in many developing countries. When investing in businesses that produce easily replicable products, impact investors should ensure that investees strategize around this possibility.

⁶ <https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Andhra-Pradesh-2010-Global-Implications-of-the-Crisis-in-Indian-Microfinance-Nov-2010.pdf>

⁷ <http://www.unpri.org/press/global-investor-statement-on-climate-change-reducing-risks-seizing-opportunities-and-closing-the-climate-investment-gap-2/>

SECTION II: Counterparty Risks

By “counterparty risks” we mean risks emanating from the adverse behavior of investees or co-investors. Counterparty risks arise in any investment, but they are heightened in developing countries where legal enforcement of contractual obligations is weak or nonexistent. In addition to the general risk that an investor may be unable to recover capital and returns, an investee or co-investor may engage in activities—including fraud, embezzlement of funds, double bookkeeping, failure to fulfill contractual obligations, poor management, and drift from the social impact mission—that endanger the social as well as financial objectives of the investment. This final point deserves attention, because concerns of mission drift are unique to mission-driven investors who desire both social and financial returns.

2.1 Due Diligence—The Counterparty’s Reputation and Track Record

The counterparty’s reputation is a crucial indicator of the likely success of an investment even when investing in countries with strong legal regimes. It is especially important in the absence of a robust rule of law. Markets in many developing countries lack the same kind of credentialing mechanisms available in highly developed countries. A party’s reputation, therefore, is a critical factor in determining the fitness of potential investees and co-investors. This knowledge can also serve as a proxy for the investee’s competence and credibility during the course of an investment when other relevant performance metrics are hard to discern.

In conventional markets, an established, centralized and readily accessible system of background checks can yield clues to an investee’s character, providing financial, business, and personal information about the entrepreneurs. Timely access to reliable and vetted information is relatively inexpensive and straightforward. In developing/frontier markets, on the other hand, performing even a basic background check often requires a much higher level of investor involvement. Poor access to reliable local information means that investors need to establish a trustworthy local network of references who are able and willing to provide unbiased information about the potential investee’s character. An investor may need to rely on co-investors for information, raising the stakes involved in choosing resourceful and trustworthy co-investors as well. These problems add complexity to the due diligence process and add significant time and expense.

Our interviewees have suggested several ways to gauge the reputation of potential investees during the due diligence process in the face of these challenges. First, rather than relying on a single source, it is advisable to cross check assessments from different parties. When soliciting input from businesses with deep ties to the investee, the investor should consider the possibility that the information is biased. Second, since the impact investor seeks to understand a party’s reputation along various dimensions, including financial performance and social impact commitment, it is important to understand how reputational assessments of the potential investee may differ in the weight they assign to these various dimensions. Some interviewees were skeptical about conducting due diligence by searching databases altogether, preferring to gather information on investees by extensively mobilizing the investor’s local networks.

Some of our interviewees suggested partnering with knowledgeable and trustworthy co-investors as a risk mitigation strategy, especially when an investor's unilateral efforts do not provide adequate information and co-investors could help fill in the gap. The value of a partnership depends, of course, on the co-investor's sophistication and independence, and the extent to which the latter shares the investor's interests in social and financial outcomes.

Some interviewees recommended investing alongside multinational or listed companies, or development finance institutions like the IFC. Doing so has several advantages. These public entities have access to a wide range of reliable information resources. Equally important are the significant consequences of defaulting on an organization such as the IFC, which are likely to deter any misbehavior on the part of the investee. Aligned, established co-investors can be formidable partners in ensuring adherence to an investment contract.

As a complementary strategy, investors can retain a consulting firm to learn about specific entities' track records and reputations.

2.2. Cultivating The Investor-Investee Relationship

Once an investor decides on an investee and other co-investors, it is important to develop sound relationships with them.

The foundation of a strong relationship is alignment with the venture's mission, motivation, goals, and operations. Investing at a very early stage can be helpful in this respect. The Mulago Foundation, whose seed investments usually stem from a two-year fellowship program where entrepreneurs receive training and advice in developing social ventures, provides an interesting example. The fellowship program allows Mulago to build a strong relationship with the investee, as well as familiarity with the venture, before the Foundation makes an early stage investment. An impact investor considering any early stage investment will benefit from having played a role in guiding and developing the investee organization and its management team in its mission, strategies, and business plan.

A clear contractual agreement is an essential anchor of the investor-investee relationship. Even if this agreement will not be ultimately enforceable in that country's legal system, it incorporates mutual expectations and reinforces that the investment is a serious undertaking. One of our interviewees relayed his experience investing in small enterprises in North Korea. Despite the fact that no business contract would realistically be enforced in the country, the very creation of a detailed contract signaled to the enterprise owners the degree of the investor's commitment and the seriousness of the terms of business. In such cases, clear contractual agreements can reinforce trust between investor and investee.

Although the impact investor's ultimate concern is to develop and cement a business relationship in which the counterparty maximizes both social impact and financial returns, one cannot overestimate the role of personal relationships in achieving these outcomes. An investor's strong personal bond with the investee and, especially in the case of a family-owned business, with his or her family, reinforces incentives to perform and discourages slacking and cheating.

The point is so obvious as not to need elaboration, but it was emphasized by many of the investors we interviewed.

2.2.1. The Importance of a Local Presence

Beyond strengthening the investor's relationship with the investee, an investor's local presence can provide a realistic understanding of the local culture and business environment. The process of gaining locally-sourced information about the investee can also help an investor develop a network of relationships with local businesses that create leverage against the investee's contract default.

Some of the investors we spoke to felt that, while it was valuable for the entrepreneur to have significant ties to the Global North, a local team was essential to understand the region's culture, community, governmental activity, and business environment. Others believed it valuable to invest in organizations led by local entrepreneurs.

In any event, it is important to retain a reputable local lawyer. A local lawyer will understand and navigate the local business environment and be able to draft documents in the local language—a practice that is often crucial to maintaining the investee's confidence and trust.

2.2.2. Adding Future Value

One important way to maintain a strong investor-investee relationship is for the investor to add value beyond providing capital. For example, the Mulago Foundation model makes the investor an integral participant in the venture, rather than simply an external party seeking to profit from it. In an ideal relationship, the investee will turn to the investor for advice and assistance when trouble arises, rather than seeking to hide financial or other troubles. A former investor with SEAF emphasized that providing advice or other managerial support to the investee on a continuing basis, thereby creating trust as well as adding value beyond financial resources.

Investors can also give an investee access to their business networks, thus providing the venture as well as entrepreneur new opportunities for growth.

2.3. Reputation as a deterrence mechanism and enforcement channel

While a strong relationship between the investor and investee holds the two parties accountable to each other, investees' reputations also holds them accountable to a broader community. Ideally, opportunistic behaviors by investees will tarnish their reputations in communities that matter for future social and business success, thus helping deter misbehavior.

Just as reputation is an important proxy for investors in ascertaining investment risks, it is also a valuable way for investees to attract future investments. The incentive to maintain a good reputation is arguably magnified in emerging markets given the weighty role it plays in the due diligence process. Several interviewees recommended ways to leverage a party's reputation or concerns about its reputation to deter non-compliance.

Locally, it might be beneficial to invest in companies that have a lot to lose if they engage in questionable behavior. It might be better to invest in a company with a consistently strong track record or in an entity that is relying on the current investment to rebound and reestablish itself. In the case of the former, the company might already be the model investee in the community and losing that status is more psychologically painful than not being able to achieve it in the first place. As for the latter, the current investment might represent its last opportunity for success. Hence the cost of potential reputational damage is considerably higher, and the incentive to adhere to the agreement is increased. An investor who understands that an investee would face ostracism as a result of non-compliance with an agreement has a potent deterrent against opportunism.

The reach of an investee's reputation, and hence the scope of potential damage, can also affect the strength of this deterrence mechanism. Whereas an investee with a local presence may risk engaging in some opportunistic behavior only to try its luck with other investors later on, an investee with a more global profile may have more at stake.

It is for this reason that some of our interviewees argued for the benefits of investing in Western or Western-trained local entrepreneurs who are plugged into global business networks. If they engage in any foul play and prove to be less than trustworthy, they risk damaging their credibility and losing future business opportunities on a much larger scale. The last thing any globally ambitious entrepreneur would want is to be blacklisted from the global business network. Thus, third party reputation may also serve as an effective channel for enforcing party compliance with contractual obligations in the absence of rule of law.

2.4. Mission Drift

While impact investors struggle with the same principal-agent problems endemic to other kinds of investing, they have the additional responsibility to ensure that their investees achieve social returns in addition to financial returns. Several of our interviewees mentioned the problem of "mission drift." Mission drift occurs, for example, when a business is launched to serve a base-of-pyramid population, but gradually shifts away from that mission, generally to serve a wealthier population, for financial gain. Mission drift can also happen when investor and investee share a social mission but disagree on the best way to identify target populations or achieve the parties' goals. Unlike financial returns, social returns can be difficult to measure.

Corporate governance can help ensure alignment of goals and incentives between investor and investee, and the impact investor may choose to take an active role in the investee's governance to prevent mission drift. This may take several forms. Like other investors, impact investors may negotiate information rights, which allow them to examine the investee's books, get regular reports on operations, be apprised of problems, and retain an external accountant to audit the investee's books. (Access to information is important for monitoring both financial and social outcomes. In countries where double bookkeeping is rampant, several of our interviewees mentioned the importance of getting access to the investee's books that reflect the objective state of the business and progress toward meeting social impact goals.)

Impact investors may also negotiate control rights that dictate how much input investors have in organizational decision-making. Investors may insist on having a seat at the investees' Boards of Directors. This may help bind the organization to its stated mission and may also give the impact investor more control over the pool of future investors.⁸ Several of our interviewees noted that maintaining a position on the Board of Directors was one of the most important ways in which they were able to monitor and advance the investee organization's social impact.

Note that while we include negotiating for information and control rights primarily as techniques for protecting against mission drift, these may be equally effective tools for monitoring financial outcomes over the course of the investment as well.

SECTION III: Deal Structuring

Contracts serve as the primary mechanism for the often highly structured deals that take place in developing and frontier markets. As mentioned above, regardless of the likelihood of enforcement, simply forming a contract signals both the investor's and investee's commitment to the deal. Further, a formal agreement is valuable as a guide to equitable resolution even in settlements outside the formal judicial system.

A formal contract can also heighten reputational risk for the party that may otherwise choose to renege on the agreement. In a situation where one party defaults, a contract is a clear evidence of a formally established business relationship with attendant rights and obligations. A failure to uphold such an agreement can discredit and undermine the position of the defaulting party in business networks. The potentially significant consequences of renegeing therefore serve as a self-enforcing risk mitigation strategy for the investors. It is worth repeating, however, that once litigation becomes necessary, the business deal is typically doomed, and the parties have little choice but to abandon or renegotiate the agreement. As a result, business partners generally strive to avoid court dealings and over-reliance on contracts.

Because of the inherent complexity of developing and frontier markets, deals in these environments tend to be highly structured. Investee companies vary widely and as a result have unique financing needs. The deal idiosyncrasies often call for approaches other than conventional debt or equity investments. For example, some investors we spoke with expressed a preference for self-liquidating securities, such as loans or convertible loans, as well as securities positioned higher in the capital structure, i.e. securities receiving liquidation preference and/or priority access to investment cash flows.

Another method sometimes deployed by frontier market impact investors is the creation of shell investment vehicles. Typically, such investment vehicles are established in a jurisdiction the investors perceive as friendly. The vehicles are then used to invest in a target market. This

⁸ One of the interviewed investors mentioned the problem of providing early-stage funding to a mission-driven enterprise and then having a profit-driven investor provide later funding and shift the mission away from social impact and toward profits.

mitigation strategy eliminates some of the uncertainties as the investee is subject to and protected by the laws of a jurisdiction with a mature legal system. (However, a shell investment vehicle does not guarantee that the local law enforcement will defer to or enforce the laws of the vehicle's country of origin.)

In this section, we will first introduce important concepts for debt investments, then sketch considerations relevant to equity investments. We will then compare the two approaches, and offer a few creative finance strategies.

3.1. Debt Investments

As is the case of all investments, due diligence is an essential risk mitigation tool. Assessment of creditor's character, capacity to repay, available collateral and the available collection processes are conventional steps of debt due diligence process that aim to lower the investment risk. It is worth repeating the importance of understanding the business environment, the relevant industry, and the particular business in a local context.

While loan collateral is a popular tool for risk mitigation in conventional markets, the assets typically used as collateral may not be available in developing countries. Business owners often do not own assets such as land directly; in many cases business owners rent from landlords or possess permits to use land owned by local governments. Moreover, even when some collateral is available, impact investors may not be able to execute their rights and seize the collateral because of risks to their own reputations. For example, seizing land from local small-size farmers may be ethically challenging for mission-driven investors.

Debt collection is also more difficult for investors in emerging markets. The burden of debt collection rests often more with the investors themselves rather than with banks or other centralized loan servicers, and, generally, the investors are forced to be more involved in the collection process than is typical in conventional markets. To mitigate the risk of widespread investee moral hazard, it is important for investors to take immediate action at the first case of payment default. The lender/investor must maintain a reputation of a diligent debt collector in the community to prevent future defaults.

3.2. Equity Investments

3.2.1. Ownership Structure

Ownership options for equity investors include taking a minority stake, a majority stake, or participating in a club deal. Selection of an ownership structure defines the amount of risk an investor wishes to take as well as the amount of control the investor gains. Each ownership option thus offers a unique set of advantages and disadvantages relevant to investment risk mitigation in developing and frontier markets.

Taking a minority stake in an investee company often fits the entrepreneur's goals: A minority stake does not extensively infringe on the entrepreneur's ownership and thereby reduce motivation to lead the company in the most profitable manner. The local business owner's

identity may be closely tied to ownership of the business in question. Therefore, a minority stake prevents moral hazard arising in a situation where an entrepreneur is left with a minor stake in a company that he or she previously owned. Yet holding a minority position can leave the investor without control.

A potential solution to this dilemma is to take a large minority position. Considered by some investors as an investment “sweet spot,” such a position can allow the investor to negotiate robust risk mitigating mechanisms (i.e., hire/fire rights, control provisions, etc.), while also preserving the entrepreneur’s sense of responsibility for successfully running the business. A minority stake may also be more acceptable in local communities.

Of course, taking a majority interest in an investee company accomplishes the objective of gaining control of the investment outcomes. This may be valuable to investors with local teams able to monitor and implement desired changes in the company if the above-mentioned concerns—moral hazard and acceptability to local communities—can be mitigated.

An alternative to having full control is to leverage trusted investment partners and enter into a club deal. In such an arrangement, while no party has a controlling right in the company, the “club” can exercise control when acting in consensus. Beyond risk-sharing, this approach allows sharing of the due diligence process and monitoring responsibilities. The key challenge in a club deal is finding partners that are trustworthy and hold similar investment values and vision for the investee company.

3.2.2. Follow-on Investment Considerations and Exit Strategy

Investors must consider the future capital needs of their investee companies. Especially in a situation where investors are leveraging a local investment partner, it is important to assess the co-investor's inclination and ability to deploy additional capital in the future.

Since liquidity in developing markets tends to be low or non-existent, investors should also have a clear exit strategy in place when deploying equity investments. Some of our interviewees mentioned difficulties with exit execution, for instance, in cases where capital was deployed into a family enterprise. When the time of exit approached, the family no longer shared the investor’s vision for selling the company, as the family’s lives were closely tied to the company. Similar situations can lead to a deadlock and destruction of enterprise value.

3.3. Debt vs. Equity Comparison

Due diligence prior to and monitoring over the course of an equity investment is often more challenging than on a debt investment. Interest payments made regularly over the course of a debt investment provide a built-in way of monitoring the investment's continued success. Equity investments, however, require more active monitoring and governance over the course of the deal. As a result, investors are forced to rely on a local team providing investment research, due diligence work, and ongoing monitoring and governance, increasing the expenses required for an equity investment.

Debt investments can offer more flexibility than equity investments with respect to investment size as well as size of the investee company. This is an important advantage for impact investors, particularly when investing in emerging microenterprises, as investors may be able to deploy debt capital in smaller installments. Debt also allows investors to provide capital faster and potentially closer to the bottom of the pyramid. Finally, debt may be more acceptable to business owners as it doesn't require relinquishment of company ownership.

Debt lacks the incentive alignment inherent in equity investments, however. While having less at stake may serve as a risk mitigation technique for investors, some investees view equity investment as investor commitment to the business. Debt investments may also incentivize more risk taking by the investee, since 100% of the upside belongs to the owner.

3.4. Quasi-Equity and Other Creative Finance

Quasi-equity is commonly used by impact investors. Quasi-equity is a form of debt with some characteristics of equity, such that returns are tied to the underlying organization's performance. A common form of quasi-equity is a revenue-sharing agreement, under which the investor gets a certain percentage of quarterly revenues. The investor is thus able to share in the investee's profits as an equity owner would, but does not have the voting and control rights that shareholders usually have. Quasi-equity is helpful for fledgling organizations for whom regular loans may be too risky, or in places where equity investments are illegal. One investor interviewed used quasi-equity to create something like ownership when investing in a business in North Korea.

Quasi-equity can be structured to incentivize entrepreneurs. One investor we interviewed described an arrangement that his firm used when dealing with investees who might try to hide revenues. The investor would get the higher of 2% of actual revenue or 2% of projected revenue. By holding the entrepreneur to his estimates, the investor was able to discourage revenue-hiding. This structure, though, shifts more risk to the entrepreneur.

SECTION IV: Planning for Disputes

Granted that the value of an investment is likely to plummet if disputes cannot be resolved through negotiation, the existence of a robust legal system or reliable dispute resolution mechanism acts both as a deterrence to illegal behavior and provides some possibility of redress when it occurs.

Impact investors should foresee and plan for possible disputes, whether arising from political turmoil, regulatory changes, counterparty fraud, breach of contract, or a failed business venture. Careful contract drafting with a favorable dispute resolution provision can provide a remediation mechanism down the road and serve as a deterrent to the counterparty's, co-investor's, or host government's engaging unfavorably with the investor. This final section will focus on common methods that our interviewees used to prepare for potential disputes. Depending on whether a dispute involves a governmental agency, a counterparty, or other private players, there are important nuances in terms of available dispute resolution mechanisms.

4.1. Disputes with Private Parties: Commercial Arbitration

As a general rule, a good dispute resolution provision should specify the applicable substantive law and procedures; location of the adjudicating court or tribunal; and, if the provision calls for arbitration, how the arbitrators will be selected. Among our interviewees, international arbitration in a neutral third country was by far the most preferred mechanism for dispute resolution. Leading international arbitration institutions include the International Chamber of Commerce (ICC) Court of Arbitration, the London Court of International Arbitration (LCIA), the International Center for Dispute Resolution of the American Arbitration Association (ICDR), the Singapore International Arbitration Center (SIAC), and the Hong Kong International Arbitration Centre (HKIAC).

Impact investors and other parties engaged in transnational business and foreign investment prefer international arbitration for a number of reasons. First, international arbitration provides an impartial and neutral forum unaffected by the interests of the host country's domestic courts. A common mechanism for selecting the arbitrators is for each party to appoint one arbitrator, with the two arbitrators then selecting the third; but the parties may choose any other method they deem fit. At least one of our impact investors gave an example of the difficulties that arise from not carefully thinking through the process of arbitrator selection in a three-party contract.⁹

Second, by agreeing to arbitrate, parties centralize all disputes in one forum, instead of potentially litigating parts of it in different courts. Moreover, parties in arbitration have flexibility to agree on any procedural rules they want the arbitrators to use, thus simplifying the process. The arbitration rules of most of the leading arbitration institutions (for e.g. ICC, LCIA, ICDR, HKIAC and SIAC) allow seeking emergency and interim relief from the tribunals themselves without the need to go back to local courts of the host country. Of course, this does not guarantee that local courts will enforce such interim relief.

Finally, with the proliferation of countries that ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, international arbitral awards enjoy enforceability in 156 state parties around the world.¹⁰ Unfortunately, most nations that have not adopted the New York Convention lie in Africa or other parts of the developing world, where impact investing predominates.

Among signatories, the New York Convention provides much wider enforceability for an arbitral award than a foreign country court judgment is likely to have. Enforcing a foreign court judgment is usually a very lengthy and difficult process with low chances of success, especially when the judgment arises in a developing country with weak due process guarantees.

⁹ In one example, each one of three parties—the foreign investor, the local company and a government-owned entity—had a right to appoint its arbitrator. Later on, though, the government-owned entity acquired majority shares in the local company, thus creating a situation in which two out of three arbitrators were appointed by parties with fully aligned interests and hostile to the interests of the foreign investor.

¹⁰ https://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXII-1&chapter=22&lang=en

4.2. Disputes with Sovereign Parties: Investor-State Arbitration

When structuring investments in developing countries, it is important to understand the multilateral and bilateral investment mechanisms that exist in the host country. Is there a Bilateral Investment Treaty (BIT) between the investor's country and the host country? Are there bilateral and multilateral free trade agreements? Is the host country a party to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States establishing the International Centre for Settlement of Investment Disputes (ICSID) to facilitate arbitration and conciliation between states receiving investments and private investors operating in those countries (investor-state disputes)? Or is the host country a party to the Energy Charter Treaty that provides for state-state and investor-state dispute resolution mechanisms in the energy field?

Answering these questions may aid in identifying the precise scope of investment protections afforded in a developing country and potential venues for dispute resolution, if the investment fails due to sovereign actions. A Bilateral Investment Treaty (BIT), for example, provide that a foreign investor should be treated no less favorably than the host state's own nationals ("fair and equitable treatment"), or no less favorably than the host state treats investors from other states ("the most-favored nation treatment"); or guarantees that the host state will not directly or indirectly expropriate the investment without adequate compensation.¹¹ Moreover, BITs and membership in the ICSID or the Energy Charter Treaty establish important mechanisms and venues for investor-state dispute resolution. For example, if both the investor's home country and the host country are members of the ICSID Convention and the terms of their respective countries' BIT call for the ICSID arbitration, the investor may be able to bring an investor-state arbitration claim with the ICSID tribunal located in Washington, D.C. In addition, in investor-state disputes, parties may choose to pursue their claims in other international arbitration tribunals listed in Section 4.1 above that are open to both private and public disputants.

CONCLUSION

Investors in businesses in developing countries face risks stemming from problems with the host government, co-investors in the venture, and other factors determining the local business environment. We have discussed various strategies for mitigating these risks, but they can be quite costly, and none of them ensure the safe return on the investments.

Deployment of these strategies is highly contextual and depends on a number of factors including investment size, the target country's economic and regulatory climate, investment vehicle/structure and the investor-investee relationship. For instance, although it is prudent to include a provision calling for international arbitration, arbitration itself—especially investor-state arbitration—is very expensive in practice. For some smaller-size impact investment funds,

¹¹ <https://ustr.gov/trade-agreements/bilateral-investment-treaties>

submitting disputes to ICSID with its substantial filing fees and related attorney's fees may not be practicable. However, most of our interviewees believed that the formal nature of the contract matters more than its actual enforcement. As previously mentioned, comprehensive contractual provisions that clearly set the applicable dispute resolution mechanisms may serve as an effective deterrent.

As is the case with any investment, the first and most important step involves due diligence and the willingness to walk away from an investment that is attractive in terms of the mixture of social impact and financial return if the risks seem excessive. For an investor who decides to move forward, the strategies we have offered—establishing strong and trusting relationships with the investee and other stakeholders, structuring a deal with adequate provisions to deal with potential dispute, taking time to consider risks endemic to the business environment, and negotiating rights or other means by which the investment can be effectively monitored—promise to aid the impact investor in achieving the financial and social outcomes the investment is set out to accomplish.