1. Objectives and overview

- Objectives of incorporating ESG clauses in the investment agreement

  ESG clauses should be integrated into the relevant investment agreement to:

  - Ensure that the company's and the fund manager's interests and expectations on ESG matters are explicitly aligned.
  - Ensure sufficient influence and oversight.
  - Secure and formalise commitments from the company to meet applicable ESG requirements (including undertakings to implement any actions plans that are required).
  - Ensure a common understanding is reached between the fund manager and company management regarding how and when specific changes need to be achieved, the resources this will require, and who is responsible for implementing the changes. The action plan should be legally binding.
  - Protect the fund from reputational, financial and/or legal damage by providing legal remedies in the event of default risks or other problems arising.
  - Prevent inappropriate transactions (from an ESG perspective).
  - Enable exit if necessary (only in extreme cases).

  It should be noted that good legal rights are not a substitute for good relationships or for setting clear ESG expectations at the outset.

An overview of the activities included in the investment agreement stage is shown in the graphic below.

Click to view diagram

2. Activities

2.1. Negotiate ESG terms

By the time the investment agreement is being negotiated, a company should already have a good understanding of what the fund requires from an ESG perspective. Raising new material requirements at this stage is likely to erode goodwill with the company.

Before signing the investment agreement, the fund manager should ensure that the company understands and has planned for the necessary financial and human resource to comply with the terms of the legal agreement. Additionally, fund managers need to ensure that they will have sufficient post-investment influence on and oversight of the company. The inclusion of adequate ESG terms in the legal agreement is important in order to achieve this (further guidance on influence and oversight is provided in the Due diligence and Ownership and monitoring sections). CDC's 'ESG legal drafting guide for equity investments' is saved under 'CDC Templates' on the Reference materials page.

- Negotiating ESG terms with companies

  Negotiating ESG terms with a company provides an opportunity to:

  - Achieve a clear agreement and record of what the fund requires, and the company commits to achieving.
  - Put in place agreements and structures that will give the fund leverage/influence in the future should the company fail to implement what has been agreed.
  - Establish mechanisms for monitoring such as, information and inspection rights.
  - Verify DD findings via representations and warranties.
  - Prevent inappropriate transactions.
  - Address issues that arise.
  - Take action in cases of flagrant non-compliance, including remedies, compensation and, in extreme cases, exit.

2.2. Incorporate ESG clauses in the legal agreements

The fund manager's E&S management systems (ESMS) should ideally include standard templates and examples of E&S and BI clauses, designed to secure compliance with the fund's ESG policy and the requirements of the LPs. The clauses are likely to need to be tailored for each transaction, taking into account the fund manager's DD findings, the jurisdiction within which the fund is investing, the structure of the transaction, the action plan, the fund's plans for monitoring and the type of investment being made.

The ESG clauses would typically address the following:

- Confirmation of DD: Representations and warranties

  The company, or individual executive directors, should declare that a company is in compliance with the fund's ESG requirements, apart from any points identified in the action plan. This is an effective way for the fund to confirm the findings of its DD, since the company or its directors will have to reveal any significant non-compliance in order to ensure they have no legal liability to the fund. This can be particularly useful for confirming whether there have been any legal breaches, fines or official complaints.

  The above mentioned declaration is achieved through representations and warranties, which can be sought at the time of investment or repeated annually or on subsequent drawdowns.

  If the representation or warranty is untrue, it can give the fund the right to claim for damages and refuse to make further disbursements. A company itself or individual executive directors can provide the warranties. The latter approach may be more effective to ensure that the company is thorough in its disclosures. However, legal practice varies from country to country and depends on the nature of the transaction. The goal is to incentivise senior management – either through personal liability or indirectly through their shareholdings or other interests in the company – to fully disclose information on all key points.

  Examples of ESG representations and warranties are:

  (a) 'Each Group Company complies with all applicable ESG Laws and with the requirements set out in paragraph [x] of Party of Schedule [z] (Working conditions and labour rights)'.

(b) 'No ESG Claim has been commenced or (to the best of its knowledge and belief) is threatened against any Group Company'.

(c) 'No written notice or other allegation has been received by, or brought to the attention of, any Group Company to the effect that a Group Company has breached any ESG Laws'.

Note: Language such as that used above relies on a robust set of definitions relating to ESG matters; for example, 'ESG Laws', 'ESG Claims', etc.

Those providing the representations and warranties may ask that they are qualified so that they are only given 'so far as the company is aware'. From a minority investor's perspective, the principal objective of the warranties is to obtain disclosure, in which case language such as this may be unobjectionable. However, on acquisition, the objective may also be to transfer risk for any ESG breaches to the seller, in which case the language might be an unacceptable attempt to transfer the risk of unknown ESG matters to the fund. Fund managers should discuss what is appropriate with the fund's legal advisers.

- Compliance with ESG requirements

  The company must agree to comply with:

  - The fund's exclusion list.
  - Applicable ESG legislation.
  - Applicable ESG international standards (such as IFC Performance Standards and World Bank Group EHS Guidelines) per the fund's ESG policy.

The fund's ESG policy and exclusion list should comply with the ESG requirements of the fund's LPs.

It is prudent to include all of the fund's ESG requirements, not just those relevant at the time of investment, as the nature of company's activities can change during the life of the investment. For example, a business categorised as low E&S risk, such as a consultancy, might expand into land acquisition and construction or the company might acquire another business with different activities. An alternative approach might be to set the ESG covenants for the business as it currently is and rely on veto rights over changes in business activities and acquisitions. These vetoes are quite typical for a minority investor. As and when approval is sought from the fund, it could be a condition that suitable ESG covenants are provided for the new activities.

From a technical perspective, compliance is usually sought through four main legal routes:

- Covenants: To comply with ESG requirements (e.g. International Labour Organizations Conventions, IFC Performance Standards, no bribery).
- Conditions precedent: To remedy items revealed in diligence before cash goes in – a test of commitment.
- Conditions subsequent and/or ESG action plan: Used for specific, but less urgent, matters revealed in DD.
- Board/committee seats/veto rights: Using traditional private equity powers to prevent transactions with greater ESG risks.

An example of an ESG on-going covenant would be:

'[X].1 Compliance with ESG Requirements

(a) The Company must and must ensure that each other Group Company (whether acquired before or after the date of this Agreement) will:

1. *Comply with the ESG Requirements, subject to any period permitted to achieve compliance with a ESG Requirement set out in the ESG Action Plan; and*
2. *Take all reasonable steps in anticipation of known or expected future changes to the ESG Requirements'.*

'[X].2 ESG Action Plan

The Company must implement all actions set out in the ESG Action Plan within the timeframes set out in that plan.'

'ESG Requirements' should encompass not just legal compliance in the jurisdiction in which the company operates, but also applicable international standards (e.g. IFC Performance Standards) and other requirements of the fund. Anti-corruption law is a good example where local law may permit so called 'speed payments' to individuals at private enterprises (as opposed to public officials), but most funds would expect all forms of bribery (including such payments) to be prohibited.

- Monitoring

If monitoring is to be effective, the fund manager must work out what information they require and feed these requirements into the relevant legal agreement. The legal agreement should clearly set out:

- The ESG information the fund expects to receive regularly (e.g. annual monitoring reports and their content).
- Events of which the fund should be notified, such as serious incidents.
- Information and facilities the fund may wish to access.
- If the fund wishes to engage a consultant as part of the monitoring, this should also be outlined, including details of who will cover the costs.

The above is achieved via:

- Information rights: Provision of quarterly, semi-annual and/or annual ESG monitoring data and reports to the fund manager (including the format of such reports) and immediate notification to the fund manager in the event of serious incidents, including fatalities.
- Inspection rights: The fund manager's right of access to a company's premises and records for the purpose of ESG monitoring.

- ◦ Board/committee seats: The fund can use its influence to ask the company to cover progress on ESG matters (e.g. on ESG action plan implementation) at board meetings, or to establish an ESG sub-committee to the board where ESG matters can be discussed in greater depth. This provides the fund manager with greater influence over the implementation of ESG improvements and better oversight of progress made. It also encourages the company to take greater ownership of ESG at a strategic level.

When dealing with listed companies, they may have concerns about regulatory restrictions on sharing non-public information with one investor to the exclusion of others. A solution may be to require the public announcement of incidents and the publication of the ESG monitoring data to ensure that all shareholders receive the information at the same time.

- Addressing non-compliance

No legal agreement will guarantee legal compliance. Even in developed markets it can often be difficult to enforce agreements due to disputes over unexpected contingencies, the legal cost of enforcement and the complexities of litigating or arbitrating across borders. However, these difficulties can be mitigated with clear and specific obligations, particularly in the action plan(s), that provide specific remedies in case breaches occur.

As an investor in a business, possibly with an employee on the board of directors, the fund's priority will be to use both its legal rights and its softer influence and engagement to move the company back into compliance. Measured escalation is key. A range of responses is available to the fund in the event of non-compliance, including:

- ◦ Raising matters at board level and seeking to gather support from other investors.
- ◦ Appointing experts to investigate alleged breaches and recommend actions.
- ◦ Requiring a company to remedy breaches (and if it does not, a default is called).
- ◦ Step-up of rights (for example, additional board or committee representation,

veto rights etc) to ensure that remedial steps are taken.

  - Stopping investment in instances where the investment is being made in several tranches. Making the achievement of certain ESG milestones conditions precedent to subsequent rounds of funding can be extremely effective. However, this can be a double-edged sword if suspension of funding results in a business becoming insolvent.

  - Exiting in the instance of egregious and irremediable breaches. The legal agreements can provide the fund with the right to sell the instrument to a third party, put options/buy backs (though these require a credible counterparty) or drag-along rights. At a minimum, any existing restrictions on exit (e.g. rights of first offer or tag along on transfers by the fund) should fall away.

Often, a two-stage process can be taken where certain rights apply initially (e.g. appointment of advisers, step up of rights) and give a company time to remedy problems. If the breach is unremedied, or was serious, the fund's right to demand exit may apply.

When a fund takes a majority stake in a company it is still desirable to set out the ESG covenants and reporting obligations in detail, so that the fund's expectations are clearly understood by the company's management. For similar reasons it is important that detailed remedies are set out in the investment documents. As a controlling shareholder, the fund should be in a position to require remedial steps to be taken and possibly to change the board if necessary; however, a clear agreement is likely to reduce the scope for argument.

Where the fund is investing in a listed company, detailed remedies may be more difficult to achieve for other reasons. Often stock exchange regulations prevent a single shareholder directing a company's activities and board influence will be more critical. However, subject to any insider dealing requirements, it may be easier for the fund to exit the investment if the stock is liquid.

3. Outputs

In most cases, the outputs of this stage will consist of a shareholder's agreement or equivalent that includes appropriate ESG clauses and clearly outlines how ESG matters will be handled during the life of the investment in order to meet the fund's requirements and expectations.