BEST PRACTICE GUIDE FOR IMPACT INVESTING IN SMALL AND GROWING BUSINESSES (SGBS) IN MEXICO

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THOMSON REUTERS FOUNDATION
TrustLaw

Aspen Network of Development Entrepreneurs
KAYA ASESORÍA DE CAPITAL
Debevoise & Plimpton
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01. ABOUT

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ASPEN NETWORK OF DEVELOPMENT ENTREPRENEURS (ANDE)

The Aspen Network of Development Entrepreneurs (ANDE) is a global network of organizations that propel entrepreneurship in emerging markets. ANDE members provide critical financial, educational, and business support services to small and growing businesses (SGBs) based on the conviction that SGBs will create jobs, stimulate long-term economic growth, and produce environmental and social benefits. Ultimately, we believe that SGBs can help lift countries out of poverty. Launched with 34 members in 2009, ANDE now comprises more than 290 members who collectively operate in more than 150 countries. Members of ANDE include both for and nonprofit investment funds, capacity development providers, research and academic institutions, development finance institutions, foundations and corporations from around the world.

KAYA IMPACTO

Kaya Impacto is a team of finance and strategy experts helping socio-environmental change-makers to realize their vision and scale their impact. The key reason why social organizations fail is because they don't acquire and manage the financial resources they need: as a result, their positive impact on the world doesn't materialize. Kaya Impacto exists to change this. By providing strategy, financial consulting (capital raising, outsourced CFO, investment strategy) and educational services to its clients. Since 2015, Kaya has empowered more than 30 agents of change, including impact funds, investors, accelerators, universities and socio-environmental enterprises. Kaya has facilitated over 11.5 million USD in investment for early stage impact entrepreneurs and supported over 10+ global impact causes. Kaya Impacto is B-certified organization and has been designated as 'Best Company for the World' both in 2018 and 2019.

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DISCLAIMER

Thomson Reuters Foundation, the Aspen Network of Development Entrepreneurs (ANDE), Kaya Impacto, Von Wobeser y Sierra, S.C., White & Case LLP, and Debevoise & Plimpton LLP have created this Guide purely to inform and to assist its readers in learning more about investing in Small and Growing Businesses (SGBs) in Mexico. However, Thomson Reuters Foundation, the Aspen Network of Development Entrepreneurs (ANDE), Kaya Impacto, Von Wobeser y Sierra, S.C., White & Case LLP, and Debevoise & Plimpton LLP, neither verify the accuracy of, nor assume liability for, the information within the Guide. The contents of this Guide are for information purposes and to provide an overview only. This Guide is current as at December 1, 2019 only. Although we hope and believe the Guide will be helpful as background material, we cannot warrant that it is accurate or complete, particularly as circumstances change after publication.

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FOREWORD

Thomson Reuters Foundation supports inclusive economies to emerge around the world, including by helping to create a positive environment in which social enterprises and purpose-driven companies can thrive.

Through TrustLaw, Thomson Reuters Foundation's global pro bono service, we provide innovative organizations using market forces to address environmental and social problems with free legal advice and resources to navigate regulatory frameworks and access the funds they need to succeed.

In Mexico there is a growing interest in impact investing, as social entrepreneurs look to expand and seek alternate means of funding. One of the challenges that social entrepreneurs and organizations that support them face is understanding the complex legal structures that are often part of the investment process.

In collaboration with the Aspen Network of Development Entrepreneurs (ANDE), Kaya Impacto, Von Wobeser y Sierra, S.C., White & Case LLP, and Debevoise & Plimpton LLP, TrustLaw has published this "Best Practice Guide for Impact Investing in Small and Growing Businesses (SGBs) in Mexico". This guide aims to inform and educate social entrepreneurs, investors, capacity developers, and other support organizations on impact investing in Mexico, including those who are new to the process of as to Small and Growing Businesses (SGBs). It analyzes the relevant laws and structures by which social enterprises operate in Mexico and studies twenty-seven term sheets from eight Mexican local investors.

We hope this guide is a valuable tool to support impact investing in Mexico that ultimately empowers social enterprises to act with confidence and achieve the positive outcomes they seek. We thank our partners on the outstanding effort and extensive resources they provided in its preparation.

Glen Tarman, Director of TrustLaw

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01. INTRODUCTION

We are excited to share with you this Best Practice Guide for Impact Investing in Small and Growing Businesses (SGBs) in Mexico, a collaboration between the Thomson Reuters Foundation – TrustLaw, the Aspen Network of Development Entrepreneurs (ANDE), Kaya Impacto, Von Wobeser y Sierra, S.C., White & Case LLP, and Debevoise & Plimpton LLP.

One of the challenges faced by entrepreneurs and other support organizations is understanding the complex legal structures that often form part of the investment process. Some of the questions that frequently arise include: what does a term sheet mean? How should they be negotiated? What are the local laws and how do they work?

Equally, investors—particularly global investors—need to understand the local laws and criteria for investing in Mexico.

In order to enhance understanding of these terms, we analyzed twenty-eight term sheets from eight local investors and created this introductory guide, aimed at entrepreneurs and investors who are new to the process of negotiating term sheets. It is not meant to provide legal advice; instead, it is designed to provide examples of certain common provisions that are not always easy to grasp.

Although the information is focused on Mexico, we are confident it can be useful in other Latin American countries.

To prepare this document, legal experts and social finance experts discussed common challenges faced by entrepreneurs and reviewed examples of existing impact investment term sheets. They subsequently focused on entrepreneurs' need to grasp complex concepts as simply and practically as possible. Finally, they drafted the structure of this guide, following the various aspects entrepreneurs must decide on when starting, running and scaling a social business.

In this guide, experts begin by summarizing the options for setting up a business in Mexico, while balancing information completeness and simplicity. Here, they focus on the main characteristics of these options and their governance clauses. They also highlight the differences between legal structures. Then, they address third party investments to raise capital, where they analyze the types of investors and investments, and suggest considering aspects such as business model, goals, scalability, etc. Further along, they address the concept of "impact investment", followed by an explanation on capital instruments and key economic terms and a final chapter on other "common terms" which includes, for example, a section on governance and control.

We hope SGBs, local and international investors, and capacity developers who provide support to entrepreneurs in their due diligence and fundraising stages will use this guide, strengthen their capacities and be in a better position to negotiate term sheets.

02. SETTING UP A BUSINESS – CORPORATE, PARTNERSHIP AND OTHER ORGANIZATIONAL FORMS

The choice of a business' legal structure is among the most important steps or challenges an entrepreneur will face at the beginning of setting up a business.

There are several options to establish a business undertaking in Mexico. The best option will depend on the business plan for each company. The more information founders have about their business, the easier it will be to make the appropriate choice. If the business plan requires the organization of a separate business entity from the ground up, then the founders should consider the simplest possible structure. This principle applies in general to all legal and operational aspects of organizing a business: keep it simple. Unless the business has determined - after thorough consideration of the possible alternatives - that it is highly likely that a certain course of action will be taken, it should not commit itself in advance to adopt a certain structure or require certain specific actions. Doing so may eventually hinder, rather than support, its growth and development.

If the business progresses adequately, founders will have plenty of time to adjust to new needs. Depending on the stake of the founders, they may wish to ensure that the chosen type of organization provides them with adequate protection of their interests. In any case, the decision on the type of entity should be taken as late as possible, once there is as much information as possible on the stakes of the different partners, growth and development forecast, and the likelihood and timing of additional investments by equity partners. In the long run, this will save the founders both efforts and money, particularly when the time comes to re-examine the business plan and future of the business.

Below, we provide a brief overview of the most common types of legal entities in Mexico, which are likely to be appropriate for most types of business, providing different degrees of flexibility: the Sociedad de Responsabilidad Limitada (SRL), a form akin to a limited liability company, and the Sociedad Anónima (SA), a form of stock corporation. We also include information about two additional variants of the Mexican stock corporation: (i) a legal entity known as Sociedad Anónima Promotora de Inversión (SAPI), which was created to provide additional flexibility for businesses with a greater need to raise financial investments and (ii) a legal entity known as Sociedad Anónima Simplificada (SAS), which was created in order to simplify the process of incorporating a legal entity and allows its incorporation with a single member.


REUTERS/Daniel Aguilar

2.1 SOCIEDAD DE RESPONSABILIDAD LIMITADA

The SRL is one of the simplest types of capital company established between partners and is intended for smaller businesses, since the maximum number of partners is limited by statute. Capital or contributions are represented by "participations" or "social quotas" and are not evidenced by certificated securities.

▸ **The main characteristics of this type of entity are:**

- **Limitation of liability of the partners vis-à-vis third parties.**
- **Statutory maximum of 50 partners.**
- **Capital is divided into "social quotas", which can have different values and categories.**
- **There are certain restrictions on transferring the social quota among partners.**

When compared to a SA, governance and the decision-making process of the SRL are simpler as it has fewer formal requirements to take action. Social quotas can have different values and be of different categories. Therefore, SRLs may not raise equity capital through a public offering on a stock exchange.

This type of organization may be more appropriate for small- to medium-sized businesses, or those with a particular growth plan that will not require a high number of partners, since it is limited to a maximum of 50, or cases where the investors are not foreseeing an exit through a public offering.

GOVERNANCE

The management of an SRL is structured in a similar way as that of a stock corporation (e.g. an SA). The difference lays mainly in the terminology used and the SRL's reduced flexibility to restrict the rights and obligations of the partners. The highest decision-making body of an SRL is called Partners' Meeting. The management of the company is entrusted to one or more managers (gerentes), and practice has created a collegiate body of managers akin to an SA's board of directors. If no manager is appointed, management is entrusted to all partners. A limited liability company does not require a separate oversight body. However, independent supervision and control mechanisms can still be agreed upon in the company's by laws, which may help provide transparency and good practices, making investment more attractive for third parties.

2.2 SOCIEDAD ANÓNIMA

The SA is the most common type of business organization in Mexico because of its versatility and management ease, as it can be made almost as complex or as simple as desired.

▸ **The main characteristics of this type of organization are:**

- **Limitation of shareholder liability, as shareholders are not held liable for the corporation's obligations and are only obligated to make the contributions to the corporation required upon the subscription of their shares.**
- **Equity stock represented by shares, which may grant different rights to different series.**
- **Free transferability of shares.**
- **Stock capital can be increased through a public offering of newly issued shares, which allows bringing in new investors through sales on a stock exchange.**
- **Organic structure is not dependent on the identity of specified people.**

One of the main differentiating characteristics of this type of organization is the ability to issue different series of shares that grant different rights to their holders, that is, not every shareholder must have the same rights. Likewise, although it may be somewhat restricted by contract, the negotiability of shares is another important characteristic, which can facilitate raising capital and exit strategies.

Bear in mind that an SA must always have at least two shareholders, and there is no maximum number. Each shareholder must subscribe at least one share.

The advantages of an SA are: (i) limitation of shareholders' liability, and (ii) the ease to attract investors due to a looser control system than SAPIs, where, for example, certain governance and control requirements are more demanding than for an SA.

GOVERNANCE

The shareholders' meeting is the highest decision-making body in an SA, and all acts and operations may be agreed upon and/or ratified by it.

REUTERS/STRINGER Mexico

The company management can be entrusted to a sole director or to a board of directors. The oversight committee is an additional body which is entrusted with reviewing and reporting on the corporation's operations for the benefit of its shareholders. Any individual, including shareholders, can be part of management (whether compensated or not). The shareholders are also entitled to supervise the management's work (to a certain extent) and, as a group, are the competent body to approve the most relevant decisions affecting the company's capital and general performance.

2.3 SOCIEDAD ANÓNIMA PROMOTORA DE INVERSIÓN

SAPIs are legal entities incorporated with the purpose of accessing the stock markets as small and medium-sized companies. Unlike the SAs and SRLs, SAPIs are also subject to specific regulation under the Securities Market Act (LMV, from its name in Spanish, Ley de Mercado de Valores).

The main characteristics of this type of organization are:

- **Allows placing restrictions, of any nature, on the transfer of shares of the same series or class.**
- **Allows setting special grounds for exclusion of members, or to exercise rights of separation, put or redemption, as well as the price or the basis for its determination.**

Allows shares that:

- **Do not confer voting rights or only confer voting rights regarding certain issues;**
- **Grant non-economic governance rights other than voting rights, or exclusively voting rights;**
- **Limit or broaden the rights to distribution of profits or other special economic rights; and**
- **Provide veto rights or otherwise require the favorable vote of one or more shareholders in relation to the resolutions of the general shareholders' meeting.**
- **Allows the implementation of deadlock breaking mechanisms.**
- **Allows expanding, limiting or denying preemptive subscription rights.**
- **Allows limiting liability of directors and officers, arising from actions they take or decisions they make in such a capacity.**

The main advantages of a SAPI are mostly linked to the economic rights that can be granted to shareholders. Usually, the decision to incorporate a SAPI would mean that the business organization is more structured or consolidated and the future needs

or development plan to be followed are better known. Therefore, a more robust set of rules and standards are to be implemented from incorporation. These characteristics provide more certainty to shareholders and potential investors. Shareholders' rights can be more specific or flexible and, statutorily, are more protective of minorities. On the other hand, this type of organization brings with it a higher burden on management, requiring more work from the compliance point of view, and therefore a higher cost. Nevertheless, despite the higher burden that a SAPI might imply, it is worth pointing out that many early stage companies decide to incorporate as a SAPI because of the flexibility and minority protections it provides.

GOVERNANCE

Decision-making and management of a SAPI is mostly based on the structure of the SA, with certain modifications. The management of a SAPI must be entrusted to a board of directors, it does not allow a sole director. Therefore, it provides for a more complex structure and management is subject to greater checks and balances.

In addition, a SAPI may opt to undertake the higher governance standards required of public stock corporations. When opting in, directors and the chief executive officer (director general) of the corporation will be subject to regulations related to the organization, functions and responsibilities provided for by the LMV; otherwise, they will be subject to the organization, functions and responsibilities established for the SA. Fulfilling board and management duties under the SA regime is less burdensome (financially and otherwise), but it provides less accountability and transparency.

MAIN DIFFERENCES BETWEEN THE SA AND SAPI

The main differences between SAs and SAPIs include:

- **Minority Rights** - The SA rules provide for some minority rights, such as the appointment of a member of the Board of Directors (with 25% of votes required), requesting that a shareholders' meeting be called (33%), judicial opposition to resolutions reached in shareholders' meetings (25%). However, the SAPI rules lower the thresholds required for the minority shareholders to exercise such rights: appointment of a member of the Board of Directors requires 10% of votes, request the call for a shareholders' meeting (10%), judicial opposition to resolutions reached in shareholders' meetings (20%).
- **Right of First Refusal** - Shareholders are entitled to acquire newly issued shares if the corporation increases its capital. In the case of an SA, the number of shares that a shareholder is entitled to acquire pursuant to such right of first refusal will be proportional to the number of shares they hold. In the case of a SAPI, the right of first refusal can be limited or broadened by the shareholders at will.
- **Acquisition of Own Shares** - While the SA cannot acquire its own shares, the SAPI can do so, prior approval of the company's board of directors.
- **Limitation on Liability of Officers and Directors** - The SAPI allows limiting the liability that members of the board of directors or other officers of the entity may incur as a consequence of: (i) actions executed in the exercise of their appointments; (ii) decisions that are made; or (iii) decisions that are not being made when a relevant meeting is not held in order to adopt a decision. Such liabilities can be limited by the shareholders of the company (in the bylaws or in a general shareholders' meeting) providing the acts or omissions that gave rise to the liabilities are not unlawful, malicious or carried out in bad faith. The SA does not allow such limitation.
- **Separation Rights** - While the SA grants a separation right (i.e., the right to demand the redemption of shares by the corporation) to its shareholders in a limited number of events (e.g. when a shareholder votes against the modification of the corporate purpose), the SAPI provides the possibility of bylaws including any event as a trigger for a shareholder's separation right.
- **Management** - In an SA, the management of the corporation can be assigned to a sole director or a board of directors. The management of a SAPI must be performed by a board of directors.
- **Corporate Governance** - The SAPI's corporate governance structure is significantly stricter than that of an SA, and includes allowing the appointment of an audit committee to supervise the corporation, as well as independent members of the board of directors. This means that the SAPI can adopt the corporate governance structure of a public entity (e.g. the Sociedad Anónima Bursátil), or the corporate governance structure of an SA.

REUTERS/Soe Zeya Tun

2.4 SOCIEDAD POR ACCIONES SIMPLIFICADA

A new form of organization was recently added to the types of entities foreseen under Mexican law, the Sociedad por Acciones Simplificada (SAS). Their governance and operation may be even simpler than for an SRL, while allowing for some of the shareholder protections that are only available for holders of shares in stock corporations. This is the only organization that allows a sole member.

The main characteristics of this type of entity are:

- **Limitation of shareholders' liability.**
- **Allows incorporation with a sole shareholder.**
- **All shareholders, including a sole shareholder, must be individuals.**
- **Its incorporation must be carried out electronically through a digital platform operated by the Ministry of Economy and does not require the intervention of a public notary.**
- **Shareholders are not allowed to control or participate in the management of other entities.**
- **Its annual income may not be higher than 5 million pesos, and if it is, the shareholders must convert the SAS into an SA, otherwise they risk becoming jointly and severally liable for the obligations of the corporation.**
- **All shares have the same value and grant equal rights among shareholders.**

Although the SAS option is not often used, it provides individuals the opportunity to incorporate an entity in a few simple steps, without requiring the services of a public notary, and at a very low cost.

GOVERNANCE

SAS management must be entrusted to a sole director, who must be one of the shareholders. Such a director is entitled to enter into, or execute, any act or agreement within the corporation's purpose, or acts or agreements related to the corporation's performance.
The highest decision-making body of the SAS is the shareholders' meeting, composed of all the shareholders.

03. THIRD-PARTY INVESTMENT

Once a business has identified the opportunity to access new or larger markets (for example, because it has reached the point where it has an established business model, operational track record and steady revenue) and is ready to grow beyond the financial capacity afforded by its revenues, its own assets or the financial means of its founders, it will be time to consider seeking third party investments, to support its growth.

There are various types of investors and alternatives to raise capital. The type of investor and most adequate investment for each business will vary based on different circumstances, business model, goals and scalability, as well as the stage and needs such as growth capital or others, and purpose of the company. Based on its investment thesis, an investor may be classified as an angel investor, institutional investor, family office, etc. Each type of investment has its own characteristics. The entrepreneur's most important item to consider when approaching investors should be their investment thesis and motivation. Additionally, each business will have to consider which is the most appropriate type of investment instrument to finance its operations, based on its specific circumstances, which may differ across industries and companies.

The business will have to decide whether to leverage its operations by borrowing money, adding new equity from third parties or seeking some sort of hybrid structure, which will include characteristics of both debt and equity instruments.

Straight debt investments usually enable founders to retain the upside of the operations, and greater control over the day-to-day management of the business' operations. However, because they require interest payments, they put a strain on its cash flow. Furthermore, most debt investors require either some form of collateral or that the business own enough assets or maintain enough liquidity to mitigate the risk of payment defaults. Therefore, straight debt is not readily available to early-stage entrepreneurs and is not usually considered as a source of capital to finance growth, but rather recommended to finance assets, wwhether fixed assets or working capital.
On the other hand, equity investments entail a closer relationship between the business and its investors and an increased risk for the invested capital and expected equity returns. Therefore, raising equity typically involves a lengthy and time-consuming review (due diligence) and negotiation process. This higher recovery and return risk generates a demand for higher expected returns and oversight than for other types of investors. Therefore, founders will give up not just part of the business' upside, but probably a larger degree of control over the business and policy-making decisions. As it happens in majority interest acquisition transactions, investors are likely to require a greater degree of control over the business when investing in early stage businesses (i.e., without fully tested business models or products). However, in the case of minority investments in better established companies, with a longer proven track record for management, limitations on control rights of founders or other existing equity holders may not be essential to the investor.

When deciding on which type of source of funding to tap into, the business must determine what would be the real value brought by these choices, and whether the value received, and the consequences thereof, are commensurate with the flexibility and value given up by the founders, and consistent with the business plan and vision. A business that is truly committed to delivering social impact should consider whether its new investors share that commitment and will support and help attain that social impact, or whether they will be focused solely on financial results, which may cause the business to shift the focus away from its original vision. In this guide, we provide a brief analysis and examples of some of the terms that both founders and businesses on the one hand, and potential investors, on the other, commonly consider once a decision to invest or receive investment has been made. Most of these terms are applicable to both social impact and other undertakings. Our analysis is partly based on a study of twenty-eight term sheets for investment by different types of investors in Mexican social enterprises in their initial organic growth stage and using non-founder capital.

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3.1 IMPACT INVESTMENT

Impact investment refers to investments made with the aim to generate a measurable, beneficial social or environmental impact, alongside a financial return. Impact investment has gained momentum as it provides an opportunity to take advantage of businesses to address social problems, while being profitable. The "Impact Investing Landscape in Latin America", published by ANDE and the Association for Private Capital Investment in Latin America (LAVCA), identified twenty-seven Latin American investors with an estimated US$1.4 billion assets under management that made impact investments in the region during 2016 and 2017 (the prior version of this report estimated that up to 2015 impact investors HQ in the region had US $1.2 billion in assets under management, which demonstrates an acceleration of impact investment has occurred)1.

The impact investment market is young compared to other investment markets, and impact investors have not yet developed many standard practices. In practical terms, this means that impact investors often start from venture capital practices with the aim to gain economic returns and add environmental measurements or social impact requirements from public and international development organizations. This enables them to fulfill their parallel goal: to obtain social and/or environmental returns.

Impact investing requires a set of unique skills in order to achieve both social and economic returns. To a great extent, impact investors are still figuring out how to make it work. Successful investors are creative in how they structure terms to incentivize the desired performance and enable unusual exit strategies. Some examples include identifying ways to reward companies for achieving social returns or setting up alternative exit options for social entrepreneurs who wish to maintain long-term control of their company. This guide focuses on the terms and approach followed at the investment level. However, innovations to promote and ensure the pursuit of impact investment goals also happen at the fund organization and operation level. Here, investment managers may agree to fee structures based on the impact metrics of the overall portfolio, or to special due diligence and sourcing practices, for example.

In addition to the terms commonly seen on any start-up investment, social impact investment requires the incorporation of covenants and oversight mechanisms to ensure that the business stays committed to achieving said impact in the medium- to long-term, and objectively measures the fulfillment of its commitment. However, our study seems to indicate that this topic is rarely, or only very vaguely, covered at the term sheet stage. When covered, the terms of these covenants require reporting or other measurement systems to be put in place, but none of the reviewed sample term sheets included any provisions foreseeing accountability for failure to satisfy minimum social impact performance standards.

Nevertheless, three investors among the nine that were part of the study included covenants related to social impact investment at the term sheet stage, and of these three, only two did so consistently. However, the extent of the obligation was either to obtain an impact certification of the business at the inception of the investment, or to perform periodic reporting or otherwise implement and impact management system, without actually requiring they reach minimum impact thresholds that could be enforced by the investor.

Example: the company shall develop, together with the investor, an impact management program in accordance with the methodology and standards of Impact Reporting & Investment Standards (IRIS), including at least a minimum number of field exams.

[1] ANDE, LAVCA, The Impact Investing Landscape in Latin America. Trends 2016 & 2017, October 2018. See http://bit.ly/ImpactInvestingLatam

We are faced then with three main questions that are key in making any impact investments: What is impact? How to maintain the impact mission? How to measure impact? We are faced then with three main questions that are key in making any impact investments: What is impact? How to maintain the impact mission? How to measure impact?

I. DEFINING IMPACT

There are as many definitions of impact as there are impact investors and social businesses. What constitutes impact for one investor does not necessarily do so for another. Investors usually develop their own set of investment criteria which are used as a guide to define which companies to invest in. While it is generally agreed that term sheets are not the place to define or measure impact, it is striking that it figures so sparingly in the term sheets of impact investors. Indeed, at an explicit level, they are limited to commitments to communicate impact measurements. Nevertheless, impact is presumably taken into consideration across the investment thesis of impact investors, from their selection criteria to their return targets and governance demands. Investment criteria are key to defining focus sectors, financial returns expectations and risk exposure. However, the market does appear to be getting closer to, at least, a common set of rules to define impact.

II. PROTECTING THE IMPACT

Generally, the investment documentation does not include agreements to protect the impact goal nor to prevent mission drift. Investors trust that their investment criteria and due diligence processes will allow them to select companies aligned with their own values. Furthermore, some businesses choose to be certified as "B Corporations", adopting high standards of verified social and environmental performance, public transparency and legal accountability, in order to be more attractive to impact investors. This certification is issued by B Lab, a non-for-profit organization focused on driving the development of impact investment standards. During the due diligence process, some of the key aspects investors consider when assessing impact are:

- Entrepreneurial motivation. What is driving the founders' mission? Is it solving a social problem, or obtaining financial returns?
- Business impact. Includes theory of change, the impact metrics used and their quality, depth and potential for scaling the impact, as well as questions like, what would happen if the impact element were removed from the business model, expectation that impact will deliver "system change", etc.
- Potential exits. What are the potential exits for the business? What type of companies could be interested in this particular business? Are those companies aligned with the business values?

One of the most common mechanisms used by investors to protect the impact mission are governance rights (covered in section 5.2). By requiring a say in the management of the business (whether through a seat in the board, special shareholder rights or otherwise) an investor can ensure that a business maintains its original mission (e.g., deciding on mergers and acquisitions, pivoting into new markets and products, etc.).

Put options triggered in case of mission drift can also serve as deterrents to avoid drifting away from the impact sought by an investment. Pursuant to such puts, the investor would be entitled to sell its shares to the company or a controlling shareholder following events that jeopardize the accomplishment of the expected impact. Although possible on paper, in practice this mechanism is very complicated and it may be difficult for an investor to enforce it, due to the likely limited economic resources of the party obligated to purchase the shares.

III. MEASURING IMPACT

Despite existing efforts to identify or agree on common metrics, the sector is a long way from reaching a consensus on the meaning of "impact", let alone how to measure it. Impact investors generally include in the terms of their investments requirements for measuring impact, whether independently or in reference to standard benchmarks or measuring organizations. Common benchmarks include Impact Reporting & Investment Standards (IRIS) and B Impact Assessment (BIA). Companies that use the BIA can be recognized for their performance by electing to become a certified B Corporation or rated by the Global Impact Investing Rating System (GIIRS).

In addition to general benchmarks, investors can include in the terms of their investment specific impact indicators that align with the company's business model, creating incentives to achieve specific impact that would be natural for that type of enterprise.

Example: the interest rate paid could be reduced by X% if the company reaches Y number of users in Z years.

REUTERS/John Kolesidis

04. CAPITAL INSTRUMENTSAND KEY ECONOMIC TERMS

A key decision for investors and businesses will be to select the most appropriate capital instrument, as it will influence economic returns of an impact investment. This decision will depend on the sector, business model, risk and return profile, desired impact, and the project being financed with the proceeds of the investment. Out of the study sample cases, we identified three "common shares" transactions, ten "preferred shares" transactions, eleven "convertible debt" transactions , three "revenue shares" (royalties) transactions and one "pure unsecured debt" transaction.

4.1 EQUITY

An equity investment is money invested in a company through the purchase of shares. The main benefit from equity investments is the chance to increase the value of the principal amount invested. This comes in the form of capital gains and dividends.

Once it has been decided that an investment in a business will take the form of equity, the parties must decide what rights the new investors will obtain. Will the new investors be entitled to the same rights as founders or prior investors? Are the founders or new investors entitled to a preferential treatment, economic or otherwise? Are the investors ready to fully commit to an equity investment, or is their equity holding status subject to fulfilling certain conditions?

Depending on the answers to these and other questions, the investment may be structured in different ways. Below we provide a brief description of some of the main terms of equity investment identified in our study.

I. COMMON SHARES

A common share is one which represents a proportional part of the capital stock in a company. These are shares with full voting and economic rights (except for matters that may exclusively affect a preferred or special shareholder class). These shares have proportional rights to any dividend paid and rights to the residual value of the business after all creditors and preferred shareholders have been paid. This means that common shareholders are the last ones to get paid with the remainder of the business' estate. In cases of business insolvency or liquidation, common shareholders generally lose most, if not all, of their investment.

In the absence of a special class of shares reserved for founders, investors receiving this type of share will hold the same governance and economic rights and residual value as founders. This type of investment is more likely to happen in mature enterprises, with

[2] https://iris.thegiin.org/b-impact-assessment-metrics

[3] One of which also included a preferred share component.

reduced ramp-up or development risk. However, there are investors in the impact investment sector who believe in sharing the same risks as the entrepreneurs and will opt for common shares.

II. PREFERRED SHARES

Preferred shares are those that have additional, or preferred, rights over those granted to common shares. They grant a claim on assets and earnings with priority ranking over common stock. In order to achieve this, preferred shares are often structured as shares of a different class. From the moment a share class has rights that are not enjoyed by all share classes, it can be described as preferred.

Certain preferred shares could have full, limited or no voting rights. In some cases, a preferred shareholder who has full voting rights could agree, as a contractual rather than corporate matter, to mirror-vote its preferred shares with the common shares held by other shareholders, or otherwise limit or restrict its voting rights.

In addition to the downside protection afforded by priority rights in the event of liquidation, preferred stock may also provide for the right or obligation to convert preferred stock into common stock. There are two typical reasons to convert to common stock: upon selection of the holder in a liquidation or sale of the company, if the liquidation preference is "nonparticipating" (as explained below), and at the company's decision to restructure its capitalization in connection with a public offering of shares.

III. VALUATION

When using equity, one of the main points of discussion is the percentage of company shares that will be given to the new investor. This discussion is typically framed around an evaluation of the company's worth, called, in this context, the company's valuation.

A company's valuation can be defined as pre-money or post-money. Post-money valuation refers to a company's value after outside financing or equity injections are added to its balance sheet. The post-money valuation is equal to the pre-money valuation plus the amount of any new equity received from new investors, while the equity share awarded to the new investors is equal to the amount received divided by the post-money valuation. Valuing an early-stage impact business can be extremely challenging, partly because of the difficulty of defining impact. There are different methods to valuate an entity, based on a variety of factors. One such measure could be comparable businesses: an assessment of the revenue and market value of established, more mature companies that have a similar focus and operational approach can serve to gauge the potential for either pre-money or post-money valuations. The valuation may be a figure proposed by a potential investor or by the company. This number could then be used as a basis for the amount of funding to be provided and how much ownership is expected in return.

Although equity investments are a very common form of investment, in subsequent rounds of equity financing, dilution (i.e., the reduction in value or voting power of an existing investor due to an investment made by a later investor) becomes an issue. It is essential that shareholders bear in mind their equity share and the implied dilution before accepting any investment in equity. Additional equity raises may involve liquidating preferences from preferred shares. Other types of financing, such as warrants, convertible notes and stock options, may be considered in dilution calculations, where applicable.

IV. STOCK OPTION POOL

When starting a company, entrepreneurs may struggle to find working capital and talented employees who can add value to the company. There is another form of equity that may help overcoming this issue: a stock option pool. It consists of shares of stock reserved for a company's employees. The option pool allows the startup company to attract talented employees. If the employees help the company do well enough and reach certain planned goals, they will be compensated with stock. The shares distributed from the option pool may be determined by the employees' roles as well as the time of their hiring. The option pool grants, like other types of stock options, often require a passage of time before the options are vested. This means the employee may not be able to acquire the shares for several years. The common belief is that the employees will contribute more to the overall health and growth of the company by delaying their ability to reap monetary value from their portion of the option pool, in order to see the greatest possible gains when their options vest.

REUTERS/Alex Lee

Stock options pools are often formed around an equity capital raise and are negotiated in the context of a growth strategy involving the acquisition of additional financial and human resources. Establishing a stock option pool will have a cost for equity holders in the form of dilution of their equity stake. This cost can be borne exclusively by existing equity holders, by all shareholders (including the new investors) or split between them. If the equity issued for the stock option pool is included in the pre-money valuation (i.e., in the number of shares used to calculate the subscription price per unit), the cost is borne exclusively by the existing shareholders. If the shares issued for the stock option pool are excluded from the calculation of the subscription price per share, it means they are only part of the post-money valuation, and the dilution related to their creation therefore impacts all shareholders, including the new equity investors.

V. ANTI-DILUTION MECHANISMS

These terms are consistently found across equity or convertible debt transactions. The mechanisms aim to ensure that the investors' value or control power will not be reduced in case of a down round (i.e., a subsequent equity investment where the subscription price per unit is inferior to a previous round). Dilution may be caused directly with respect to the equity of the company, or indirectly with regards to the company's operating subsidiaries. In addition, an investor could suffer further economic dilution if the company were to offer new equity to third parties at a value below that paid by the investor. There are two common types of anti-dilution clauses, known as "full ratchet" and "weighted average". Both are triggered in case of a down round and will lead to awarding additional units to the investor exercising his anti-dilution rights. With a full ratchet provision, the conversion price of the existing shares is adjusted downwards to the price at which new shares were issued in later rounds, meaning that the total number of units the existing investor will own is equal to the number he/she would have received had he/she immediately paid the lower price per share from the new round.

The weighted average provision uses a formula that adjusts the rate at which preferred stock converts into common stock based on: (i) the amount of money previously raised by the company and the price per share at which it was raised, and; (ii) the amount of money being raised by the company in the subsequent dilutive financing and the price per share at which this new money is being raised. In such a case, the investor receives some new shares to reduce the monetary impact of a down round, but this compensation is only partial, as opposed to absolute as foreseen in the "full ratchet". It has become customary to provide weighted average anti-dilution protection, while full ratchet is widely considered to be unfair to the entrepreneur. Indeed, our study did not identify a single term sheet with a full-ratchet provision.

Example: The Investors will receive the customary anti-dilution provisions, to equitably adjust for any merger, division, consolidation, stock split or similar event. (Note: because the provision is said to be "customary", it is presumably referring to weighted average anti-dilution).

VI. PREEMPTIVE RIGHTS

Preemptive rights are rights granted to equity holders to acquire newly issued equity in accordance with their proportional share of the company's total capital, before the new equity is offered to other parties. In a sense, this is a form of anti-dilution provision, intended for the equity holders to maintain their percentage share, although it will require additional capital contributions. Nearly all convertible debt and revenue share transactions in our study included the investor's right to participate in future funding transactions, which may be considered a form of preemptive right. Pursuant to Mexican law, all shareholders and members of a company enjoy preemptive rights. However, for SAPIs, such rights can be limited in the company's bylaws or by an agreement among equity holders.

Example: The Investors shall have the preemptive right to subscribe and to pay their corresponding shares regarding any increase in capital, proportional to the total number of shares that they hold at the time of issuance.

VII. LIQUIDATION PREFERENCE

Liquidation preference, typically used in venture capital deals, is a pre-agreed order of payout in the case of liquidation. However, the ability to enforce this type of provision must be analyzed in each jurisdiction. Although 'springing liens' (i.e., a lien on collateral granted in a transaction that allows payment of other debts ahead of the secured debt, so long as no liquidation event has occurred) may be permitted and can be enforced, if the investment is made as an unsecured loan or as a share transaction, local law may not respect the supervening creation or attachment of a lien or preference if other parties obtained liens over the company's assets prior to this supervening creation or attachment.

Example: Upon triggering of a default event or any liquidation, dissolution or winding up of the company, the Investor shall be entitled to receive, prior and in preference to the payment or distribution of any amounts to: (i) the holders of any other company debt or (ii) the holders of the company stock, an amount equal to X times the original investment sum.

Nowadays, it has become common practice for the multiple applied to the original investment to be "times one", because any higher figure could be considered abusive. Indeed, the liquidation preference is intended as a downside protection for investors, so any mechanism that would lead them to get more than their proportional share of the distribution in the event of liquidation could be unfair and contrary to the goal of aligning incentives.

Liquidation preference may also be "participating" or "nonparticipating". A nonparticipating liquidation preference only gives the preferred stock a liquidation preference over common stock equal to the price the investor paid per share (or some multiple thereof, which is typically "times one"). The effect of a nonparticipating liquidation preference is to require the preferred stockholders to convert their preferred stock into common stock, to participate in any gain on their investment. If a situation arises whereby preferred stockholders would receive more per share as holders of common stock than holders of preferred stock, preferred stockholders can convert their shares into common stock, giving up their liquidation preference in exchange for the ability to share pro-rata in the total liquidation proceeds.

A participating liquidation preference entitles the holder to a preferential payment upon liquidation, typically an amount equal to their initial investment plus accrued and unpaid dividends. Furthermore, investors receive their percentage share of the remaining liquidation proceeds on what is referred to as an "as-converted to common stock basis". Sometimes, participating liquidation preference may be considered abusive, for the same reason as a multiple higher than "times one", because it grants the investor the opportunity to receive more than their proportional share of distribution in the event of liquidation.

VIII. EXIT RIGHTS

An important aspect of an investor's protection is exit rights. Exit clauses are often incorporated into the bylaws of the company or an equity holders' agreement, to ensure that equity holders will be able to dispose of their shares and exit the company in a manner that is fair to all of them.

REUTERS/Caren Firouz


REUTERS/Jim Urquhart

• Right of First Refusal

The right of first refusal is a shareholder's contractual right to acquire the shares another shareholder proposes to sell, once an offer has been made. Before any transaction to a third party can be completed, the selling shareholder must offer the same terms to the holder of the right of first refusal. Only if and when the holder of the right of first refusal turns down the transaction, the selling shareholder is free to complete the sale to other parties. This type of right is likely to reduce the value of a shareholder's stake, because the number of potential buyers that would be willing to risk another party coming in at the last minute and stealing the transaction from under their nose will be limited.

Example: The Investors and employees holding more than 1% of company shares shall have the right of first refusal to purchase any new securities issued by the company, or any existing shares sold by any company shareholder.

• Right of First Offer

This is a contractual obligation to negotiate with right holders first, before offering assets to a third party.

Example: Each Investor will have the right of first offer to any company capital stock shares proposed for transfer by other shareholders. The time allowed for any stockholder to exercise the right of first offer contemplated herein shall be within thirty calendar days following the notice given by the sellers.

• Tag-Along Rights

Tag-along rights, also known as co-sale rights, are used to protect minority shareholders. It grants them the right to join a sale transaction, selling their minority stakes in the company. The value per share of a controlling stake typically carries a premium over non-controlling ones. minority holder may find itself receiving less value in an individual sale of its stake than in the sale of the whole company. Furthermore, a minority stakeholder that invested under the assumption that the company would be controlled by, or benefit from, the skills of specific people, may not be willing to continue its investment if those individuals will no longer have an interest in the company.

Example: The Investors shall have the customary tag-along rights when any of the parties sell part, or all, of their shares. All selling parties shall have the right to sell shares in proportion to their ownership stake in the company at the time of sale.

• Drag-Along Rights

Drag-along rights are normally, but not exclusively, granted to majority shareholders (or to shareholders that collectively own a majority of the shares). They enable the beneficiary to force, or drag-along, all remaining shareholders to participate in the sale of the company in the same terms as the holder of the drag-along rights. These rights are typically requested by investors that have a defined investment horizon and may need to sell their stake within such a horizon. The ability to force the sale of, at least, a controlling interest in the company, may facilitate an investor's exit by the end of their investment horizon. Typically, the larger the stake that can be offered to a third-party purchaser, the higher the value that can be obtained. Conflicting interests will exist between parties that may need to sell as soon as possible at the best value available, and others that can, and may prefer, to wait until a better value can be obtained (or simply do not desire to sell for any reason, financial or otherwise). For instance, this right may be a key tool for limited investment horizon investors to ensure that another investor that has made an investment on the basis of an expected rate of return, without having the same investment horizon, will not hold back from a potential sale until a certain hurdle rate of return has been achieved, particularly if the other investor expects the value of the company to continue growing.

Example: The Investors shall have the customary drag-along rights with each other, along with any and all other company shareholders.

The Investors will only be subject to a drag-along when the proposed transaction would yield an annualized return for each investor of at least X%, calculated from the time of their initial investment in the company.

4.2 CONVERTIBLE DEBT

In certain cases, an investor may be interested in acquiring an equity stake that will ensure its long-term participation in the upside of the business, but the business and the investor may decide instead to structure the transaction as convertible debt. Typically, convertible debt instruments are short-term (6-18 months), with a relatively small interest charged, which is capitalized instead of being paid in cash. Convertible debt does not receive collateral and is usually junior to all other debts, meaning that their return risk resembles that of an equity investment. In practice, because the interest rate is relatively low, the debt must be converted into equity for the investor to meet its target return. As for any other instrument providing for capitalization of interest (instead of cash payment), close attention must be paid to the tax treatment of accrued interest, which may significantly reduce the effective return.

The following are some reasons investors use convertible debt:

- Convertible debt terms allow investors to avoid the upfront negotiation of a company valuation, to a certain extent (although the parameters around conversion, such as the "conversion cap", are sometimes considered a proxy for a company valuation).
- Convertible debt transactions are quicker and cheaper to implement, because they do not require modifications of the bylaws and, therefore, the required consensus of a majority of shareholders.
- Convertible debt allows different terms to be provided to different investors. While it is recommended to keep the same general structure for all investors, terms swuch as the interest rate or the valuation cap can be modified, for instance, to reward an early investor with better terms.
- Disbursement of the investment by a specific investor is not conditioned on closing the entire round of investment.
- Convertible debt is less costly for the investor in case of bankruptcy of the business prior to conversion.
- Convertible debt does not require the same degree of commitment by the investor to the company's oversight and management, until it grows enough to justify the exercise of conversion rights.
- In case of early liquidation, the investor is guaranteed a higher probability to recover its investment than if it were an equity investor.

The investor may be willing to take the option to turn the investment into an equity interest, in which case the founders will want to ensure that the investor pays a fair price for this option. The price will normally be set based on the value of the company at the time the debt was provided, subject to potential adjustments. One common adjustment requires a repricing of the option if a better price was offered to a later investor (most favored nation, or MFN, clauses).

Conversion of the debt may be mandatory for both investor and company when certain events occur, or only for one of them at the election of the other, which may be decided at will, or linked to the occurrence of certain events, or a combination thereof. The following are some examples of conversion triggers found in our study:

I. Automatic Conversion in a Qualified Equity Financing

If the company were to issue equity securities in a transaction or series of related transactions resulting in aggregate gross proceeds to the company of at least $ X, including conversion of the "convertible promissory note" and any other indebtedness (a Qualified Equity Financing), then the "convertible promissory note", and any accrued but unpaid interest thereon, will automatically convert into equity securities issued pursuant to the Qualified Equity Financing.

II. Conversion price examples:

At a conversion price equal to the lesser of: (i) X % of the per share price paid by the purchasers of such equity securities in the Qualified Equity Financing; or (ii) the price obtained by dividing $ X by the company's fully-diluted capitalization immediately prior to the initial closing of the Qualified Equity Financing (assuming full conversion or exercise of all convertible and exercisable securities outstanding at the time, other than the "convertible promissory note" by the relevant "conversion price".

[4] Found in four out of eleven convertible debt transactions.

REUTERS/Vasily Fedosenko

II. TERM OR PERIODIC CONVERSION

Following an X-month lock-out period, the Investor will have the right to convert any outstanding balance of the invested amount into an equity interest in the company, without payment of any additional consideration. The purchase price for this equity interest will be the unpaid balance of the investment amount, which the Investor shall pay by endorsing its convertible loan.

Valuation example: The company's pre-money valuation at the time of conversion will equal the larger of: (i) the product of multiplying X times the company's Net Revenues, minus any outstanding debt plus any cash-on-hand; or (ii) the product of multiplying X times the company's Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), minus any outstanding debt plus any cash-on-hand. For the purpose of calculating the company's outstanding debt at the time of conversion, the Convertible Loan will be regarded as zero.

III. VOLUNTARY CONVERSION

- **Exercise of the Loan Option by the Investor**

The Investor has the right to convert up to $ X of its outstanding $ X convertible loan into Series X shares. Any amount converted by the Investor (the "Converted Amount") would be structured concurrently with the issuance of the Founder's Shares and the proposed transaction at a price equal to [x]% of the final price paid for the Series X shares (the "Conversion Option").

- **Maturity Conversion**

If a Qualified Equity Financing has not occurred on or before the Maturity Date, then the Investor may choose one the following: (i) request that the company repay all outstanding principal and accrued unpaid interest under the convertible note, in full, with funds immediately available at Maturity Date; or (ii) request that all outstanding principal and accrued unpaid interest under the convertible note be converted into Conversion Shares, using the relevant Conversion Price (a "Maturity Conversion"). The number of shares issuable upon a Maturity Conversion shall be determined by dividing the principal amount and accrued unpaid interest under the convertible note by the relevant Conversion Price. Any decision to make a Maturity Conversion will be made in writing and delivered to the company at least X days prior to the Maturity Date.

- **Change in Control**

If the company were to be acquired prior to the Qualified Equity Financing, at the Investor's option, either: (i) the Investor will receive an aggregate amount equal to X times the aggregate amount of outstanding principal and accrued but unpaid interest; or (ii) the Investor's convertible note will be converted into Common Stock shares at a conversion price determined by a $ X fully-diluted valuation.

4.3 REVENUE SHARE (ROYALTIES)

In certain cases, investors may believe in a business' growth proposition and revenue opportunity, but the entrepreneur and investor could decide that an equity investment is not appropriate. They may also agree that a simple debt investment is not suitable either. Building on a recent trend, they may decide to explore hybrid structures, which can be designed using debt or equity structures but with characteristics that are somewhere in between classical debt and equity investments. The most common hybrid investment structure is a revenue share. Revenue share transactions stipulate that the investor will receive a percentage of all revenues, or revenues from a company's specific products, typically without taking any equity interest in the company. These transactions may be structured in different ways, depending on the desired return profile risk, increasing or decreasing the volatility of the expected payouts, most notably by having, or not, a scheduled payment structure. For instance, a revenue share transaction can be designed as a simple loan with a clear interest and principal payment schedule, plus some royalty payments to increase the expected return (which will be treated as additional interest for tax and accounting purposes). It can also be structured with no scheduled interest or principal payment whatsoever, and only include royalty payments, which will be applied towards principal and interest payments (in which case, this type of transactions is probably more akin to an equity transaction than a lending one). Revenue share transactions often come with no guarantees or collateral, although in some cases, the company may offer recourse to its receivables.

The following are some reasons to use a revenue share structure:

- Typically, a revenue share transaction provides for a higher expected return than debt, but lower than equity.
- Revenue sharing aligns, to a certain extent, payments realized to the capacity to pay.
- Linking the return to the company's revenue generation capacity provides an incentive for the investor to support the business and help it boost its revenues.
- The tax treatment of royalty payment may be more attractive for the parties than the tax treatment of dividends.

Furthermore, an investor may prefer a revenue sharing transaction over other instruments because it is self-liquidating, which means that providing it with a complete financial return (an "exit") does not require finding another investor to buy its economic interest. In other words, the terms of the investment can provide a high financial return and ensure that the investor will be out of the company after a certain point. Hence, investors know from the outset how much money they will make from the inception of their investment, which provides certainty and removes some pressure from negotiation exit alternatives.

Because the goals of a revenue share transaction often include aligning payments to the capacity to make them, they can include a grace period, reducing the short-term pressure on the company's cash flow.

Example: the company shall make the Royalty Payments commencing from whichever should occur first: (i) the end of the first quarter in which the company generates a Gross Revenue of $ X from [country] operations; or (ii) X months following the investment date.

Following the same logic, the percentage of revenue to be shared is often designed to increase over time, since it is expected that the company's margins will increase after a few years, and that its capacity to repay the investor will also increase as a percentage of its revenues.

Finally, revenue share transactions may also include convertibility features, allowing the investor to turn its royalty interest, which may be documented as convertible loan, into an equity interest. A common reason to elect conversion of a revenue share transaction into pure equity is failure by the company to satisfy the minimum performance requirements that would result in royalty payments.

Example of a convertibility clause: If the company's EBITDA for any calendar year were less than X % of the EBITDA projected for the same year in the [business plan/budget] approved by the board of directors, the Investor may convert any outstanding balance of the Convertible Loan into Preferred Shares.

The purchase price for this conversion shall be X times the unpaid balance of the Convertible Loan, minus any repayments made upon such conversion.

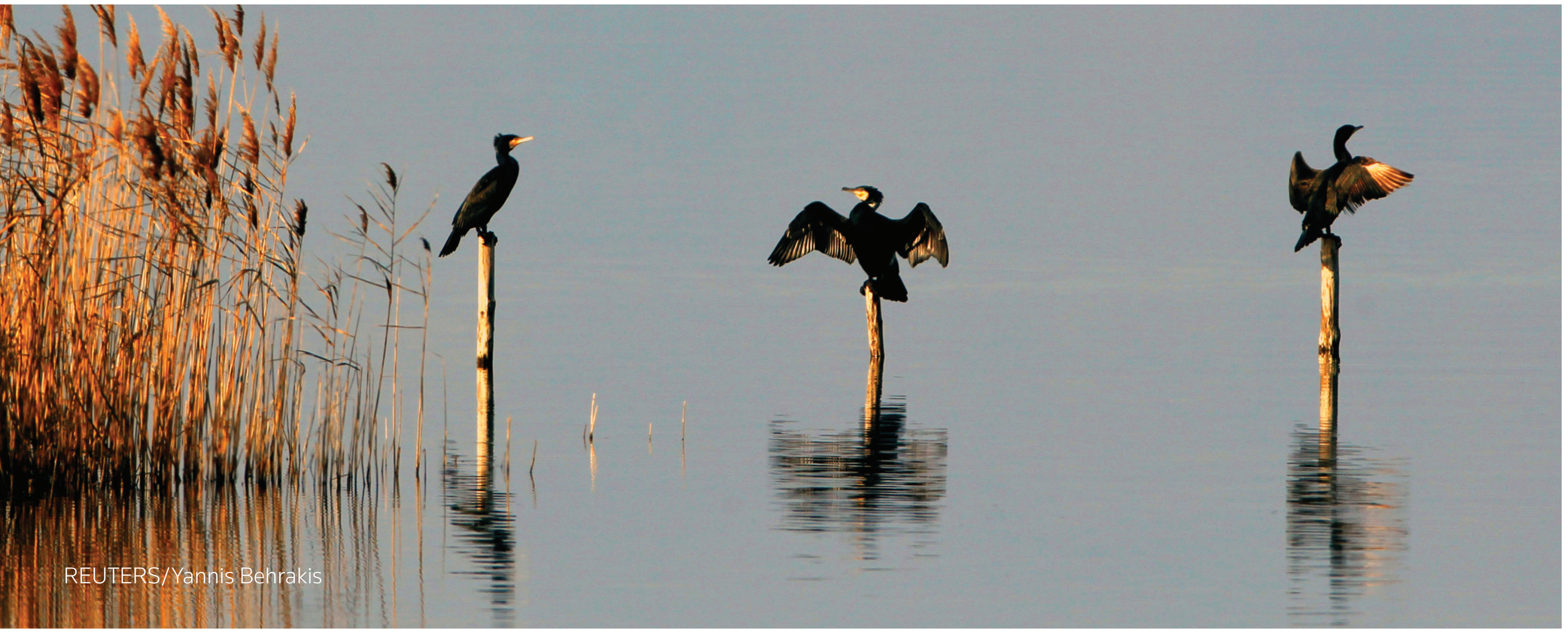
However, revenue share transactions can also seek to include convertibility features, intended to capture further upside in cases of more positive scenarios such as in a Qualified Equity Financing, or in any other convertibility features of more conventional convertible debts.

[5] Found in eight out of eleven convertible debt transactions.

[6] Found in one out of eleven convertible debt transactions.

[7] Found in four out of eleven convertible debt transactions.

[8] Found in three out of eleven convertible debt transactions. Definitions of change in control vary significantly among equity transactions, depending on the composition of the equity holding group. However, any definition of change in control will likely include acquisition by a person other than the founders or the relevant investor, of the ability to determine the business' management or policy decisions, whether by shareholding, by contract or otherwise.



05. OTHER COMMON TERMS

5.1 DISBURSEMENTS

Once an investment structure has been determined, one of the main negotiation points will be how and when the investor will disburse the funds. The capital contribution mechanisms boil down to funding at closing or periodic funding subject to achieving a set of milestones, or at pre-agreed funding dates. Founders may want to have as much cash as possible ahead of any future needs, or to have flexibility to use the cash to satisfy the business' requirements, while investors will most likely want to reduce their exposure until cash is actually needed and the business has an increased likelihood of viability. Moreover, delayed disbursements avoid having large amounts of cash sitting in the company's bank account while the investor could place it more effectively. The decision to use one formulation or another should be made on a case-by-case basis, considering the specific needs and development stage of the business, **and a survey of transactions should not be indicative of what is "market".** Depending on the type of instrument used, the company may reserve the right not to call for the disbursement of the investment, if such a disbursement would result in unnecessary increased costs or otherwise not be in its best interest.

Example of periodic disbursement conditions upon achievement of a milestone: Disbursement of the investment amount will require the achievement of the following milestones, measured over the prior twelve-month period and compared to the financial projections provided by the management team: (i) completion of the construction and launch of the company's manufacturing plan operations; (ii) projected total units sold at regular board-approved prices; (iii) projected EBITDA margins; (iv) projected total accounts receivable ratio, measured as a percentage of sales; and (v) projected inventory ratio, measured as a percentage of cost of goods sold.

5.2 GOVERNANCE AND CONTROL

Debt transactions do not typically provide for participation of the investor in corporate decisions as part of the company's governance structure. However, because they could directly impact the company's ability to honor its debt obligations, it is common that a lender requires the company, or its shareholders, not to take or omit certain actions, without first obtaining said lender's consent. Lenders often also request the right to have observers attend shareholder or board meetings, without voting rights. Although it is not usual, our study turned up one example in which a convertible debt lender is entitled to appoint members of the board of directors, even prior to conversion. Normally, lenders would want to stay away from the company's decision-making process, because the more involved they are, the greater the likelihood they could be deemed to have incurred liability to the company or its stakeholders for unduly exercising control over it, usurping the prerogatives and business judgment of shareholders and management.

I. MINORITY PROTECTION

Minority investors take a substantial risk when they take an equity position in a closely held company. They have limited control over its management and do not have a liquid market to sell their equity should anything go wrong. Therefore, before investing, a minority investor will typically ask for substantial protections to go along with their investment. Revenue share investors find themselves in a similar position,
where their return expectations require the company to make good decisions but having limited control over them and will, therefore, often request similar protections. The most common protections requested by minority equity and revenue share investors are the following:

Appointment of Board of Directors and Officers

- In accordance with investors' pro-rata interest, and potentially granting the right to nominate certain officers to the holders of specific series of shares.
- Independent directors, who satisfy criteria that ensures they are not beholden to any particular group of shareholders, and whose vote is required for the company to take material actions. Alternatively, appointing independent directors ensures that neither founders nor professional investors (acting individually or as a group) control a majority of the board, in which case, appointing one or more of them is a compromise that can be reached during the negotiation of the investment terms.
- Springing right to appoint management:

Example: if the company does not achieve at least X % of total revenues as presented in the board-approved annual budget during X consecutive calendar years, the Investor shall have the right to name the company's CEO, CFO, COO, and any other key senior managers

VETO RIGHTS

Veto rights do not entitle investors to make decisions on behalf of the company, but rather, allow them to block decisions they disagree with. Some of the issues covered by veto rights may be crucial for the adequate governance of the company. A veto right may be of particular importance to protect minority investors against decisions that may affect the value of their equity interest, such as: excessive dilution, excessive incurrence of indebtedness, creating means by which founders can leak cash out of the company without good faith business reasons, etc. Veto rights may be implemented at the equity holder level or at the management level, where an investor is entitled to appoint part of the management body.

The challenge to implement veto rights is usually not the right itself, but rather, who holds it, since veto rights grant the holder significant power. When this right is given to a single investor, it can sometimes be abused. Providing veto rights to several investors can generate delays in decision-making because legitimate differences of opinion and conflicts are highly likely to arise throughout the process of starting a company. However, conflicts can be resolved through open discussions and compromises, to reach decisions and overcome obstacles. One way to mitigate the risk of veto deadlocks is by giving veto rights to a group of investors rather than just one. Individual investors will not be able to place a veto, but as a group they can halt unreasonable decisions within the company, thereby ensuring that their collective interest is properly taken into consideration.

Example: In addition to any other vote or approval required under the company's bylaws, the company will not, without the written consent of the holders of a majority of the [types of shares] (voting together as a single class on an as-converted basis), either directly or by amendment, merger, consolidation, or otherwise:

- liquidate, dissolve or wind up the affairs of the company, or effect any merger or consolidation or any other Deemed Liquidation Event;
- create or authorize the creation of, or issue any new class or series of stock, or any other security convertible into or exercisable for any equity security (by reclassification, amendment or alteration of any existing security, or otherwise), having rights, preferences or privileges senior to, or on parity with, the [types of shares];
- amend, alter or repeal any provision of the bylaws;
- increase or decrease the authorized number of shares of Common Stock or Preferred Stock (or any series thereof);
- redeem or repurchase any Common Stock or Preferred Stock;
- increase or decrease the size of the Board of Directors;

• purchase or redeem or pay any dividend concerning any capital stock other than stock repurchased at cost from the company's service providers upon termination, and other than the exercise by the company of contractual rights of first refusal over such stock;

• become obligated under any loan or guarantee of indebtedness (other than indebtedness to financial institutions) in excess of $ X in the aggregate;

• create or hold capital stock in any subsidiary that is not a wholly owned subsidiary, or dispose of any subsidiary stock, or all or substantially all of any subsidiary assets;

• cease to engage in a business that is substantially similar to the business engaged in, or contemplated to be engaged in, as of the Closing;

• engage in, or consummate, any sale, lease, assignment, transfer, exchange or other conveyance (including by exclusive license or otherwise) of all or substantially all the company's assets in a single transaction or series of related transactions.

II. INFORMATION RIGHTS, RIGHTS OF INSPECTION AND REPORTING OBLIGATIONS

All investors require a minimum of periodic information in order to monitor their investment and ensure that its terms are being met. Mexican law specifies the minimum of information and oversight rights that must be provided to any equity holder. However, investors may be particularly interested either in more frequent (e.g., reports on material event as they occur, rather than waiting for quarterly or annual reports) or specific reports that may not be envisaged in the applicable law. This is especially the case of impact reporting requirements.

Examples: (a) annual, audited, financial statements within [150] days following the end of each fiscal year; (b) unaudited monthly financial statements within [twenty] days of the end of each month; (c) operational budget with estimated profits, expenses and monthly cash flow of the company; (d) all material communications (written or otherwise) with the company by its auditors or any governmental agency; and, (e) any other information the Investor reasonably requests.

III. FOUNDER OR KEY PERSON LOCK-UP PERIOD

This refers to a period during which the founder (or a key person in case it is not the founder) is not allowed to transfer, sell, leave the project, or take certain other actions with their shares or assets. In the business' early development and growth stages, founders and key persons are essential to its success and are usually required to accept conditions and limits on their present and future options over the company or competing businesses. Investors rely heavily both on the company benefiting from the know-how and skills of said founder or key person, and on them not using such know-how and skills to compete with the company. Therefore, lock-up period provisions are typically attached to strong non-compete provisions. This type of clause is usually accompanied by an economic penalty in case it is breached.

Example: During the first X years following the Closing Date, the Founder will not transfer, or create any lien or encumbrance over, or dispose of any equity shares or other securities in the company, or any interest in such securities, except with a majority approval from a Shareholders' Meeting, including approval by the Investors.
The Founder has been named a key person for the company and shall thus commit to a formal engagement with the company for a period of X years following the Closing Date.

5.3 OTHER COMMON COVENANTS

I. EXCLUSIVITY AND NO SHOP COVENANTS

This is a period during which the company's founders (and the company) agree not to solicit other potential investment offers. It usually includes a broad language covering everyone connected with the company, including founders, directors, officers and employees. This is most often found in syndicated loan transactions and is commonly known as a clear market clause. This term is also found in non-syndicated transactions, where, for example, equity investors may request exclusivity to negotiate the funding of a round of investment with preference over other potential participants, particularly if some level of control is to be attained by the investor. A common reason to request such a clause can be that, after signing the term sheet, the investor will engage in intense due diligence and incur significant costs to do so. Before incurring these costs, the investor will want to ensure that the risks the transaction will fall through for reasons beyond its control are limited to a minimum.

Example: From the date the term sheet is entered into, the company and its offices, agents, directors and affiliates will terminate discussions with other parties and will not engage in any further discussions with other parties relating to financing arrangements that compete with that contemplated in the term sheet for a period of X calendar days.

II. NON-COMPETE

Non-compete obligations are common restriction imposed by investors on the company's founders. We observed this type of restriction in practically all the transactions included in our study. Restrictions will vary from business to business in terms of the period during which they remain effective and the geographic area they cover. In order to enforce a Non-compete clause or agreement, it must be limited to a specific person, time and territory, and the restrictions must be reasonable and proportionate to the benefit being received by the person who agrees to limit their ability to perform the relevant activity.

Example: the company and each founder will enter a reasonable non-compete agreement that is acceptable to the Investors.

III. TRANSACTION COSTS AND EXPENSES

Most of the transactions included a provision regarding the allocation of fees and expenses pertaining to: (i) legal counsel; (ii) auditors; and (iii) tax advisors, incurred in connection to the investor's due diligence process and the subscription, purchase or making of the investment. In equity transactions, each party usually bears its own costs and expenses. In debt transactions, on the other hand, the borrower tends to pay its own expenses and reimburse the lender's expenses. In all transactions in between, which party bears the cost will depend on what nature more closely resembles the transaction, and the negotiation stance of the parties. For instance, an impact fund might pay for part of the legal expenses of the entrepreneur, even in equity transactions, while more aggressive investors may require the entrepreneur to pay some of their expenses in all cases. It is important to negotiate the allocation of fees and expenses upfront, in order to avoid subsequent disputes.

IV. REPRESENTATIONS AND WARRANTIES

Representations and warranties clauses figured in almost every agreement term sheet included in our study. They describe statements of fact that an investor, founder, buyer or seller makes regarding
the subject of a transaction or related matter. On entering into an agreement, parties rely on each other to provide a true account of all information and supporting documents to close the transaction. The accuracy of such statements are conditions to the obligation to make an investment, or a breach of a contractual term that may give rise to collecting damages or other remedies. The entrepreneur and the company basically provide assurances that the business is worth the investment that the investor plans to make. These assurances may be qualified by materiality or through disclosures made to the investor during the due diligence process.

Some of the information covered by representations and warranties (which are typically part of the due diligence performed by any investor) includes financial statements, lists of current contracts, customer listings, proof of asset ownership, etc.

Some issues that are typically confirmed through representations and warranties include:

• Legality of the Business: the legal formation of the business, permit to operate, and the right to enter into a binding contract with the buyer.

• Tax Audit Queries: whether the business has been under scrutiny by tax authorities for breach of tax obligations.

• Accuracy of the Financial Instruments: all financial statements of the business have been prepared in accordance with applicable rules, and fairly present the conditions of the company, as well as the underlying information being up-to-date and accurate to the point of verifiability.

• State of the Inventory: accuracy of information concerning inventory.

• Employee State of Affairs: whether the company follows all labor and social security obligations, as well as disclosure of the nature and extent of existing labor relationships (e.g., existence of a union and terms of the collective bargaining agreements).

• Environmental Liability: absence of violations of environmental laws or any environmental liabilities, which could entail substantial economic and reputational costs.

• State of the Documents: terms and status of main contracts with suppliers, service providers, customers and other third partie.

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