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Management Decision

# ESG and impact litigation: identifying and governing the causes through strategic accountability patterns

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## Abstract

**Purpose** – As financial firms incorporate impact strategies more extensively into their operations, they are asked to sustain their impact claims and thus face increased risks of regulatory scrutiny and lawsuits from private and public parties. The lack of reliable frameworks to measure impact gives rise to phenomena like impact washing, leading to litigations. This article aims to explore the main factors contributing to the impact litigation risk and the mechanisms employed by practitioners in the impact investing field to navigate and address this challenge.

**Design/methodology/approach** – We conducted semi-structured interviews involving three impact investors and three impact lawyers with specific knowledge of ESG and impact controversies, adopting the Gioia Methodology for the analysis. We triangulated such information with the analysis of secondary data.

**Findings** – The "great noise" around the impact investing world and the rise of impact washing, the lack of shared standards for measuring impacts and the misalignment of interests among actors involved in the initiatives constitute a potential "litigation bomb". Such a scenario is detrimental to an investment strategy, which has the potential to tackle societal issues.

**Originality/value** – This study represents an initial effort to connect the academic debate on impact litigation with the expert's active "on-field" standpoints. The identified and validated drivers of impact litigations provide valuable insight to enhance the governance and accountability of impact investing. Implementing Impact Measurement and Management (IMM) tools, participatory governance models, clear impact-focused contracts and a proactive approach could serve as prospective solutions to mitigate the risk of disputes.

**Keywords** Impact investing, Impact litigation, Impact washing, Impact governance, Accountability

**Paper type** Research paper

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## 1. Introduction

Worldwide, wicked issues and grand challenges are at the forefront of investment decisions and business initiatives (Bebbington *et al.*, 2007; Campbell *et al.*, 2019; Ferraro *et al.*, 2015; Guthrie and Dumay, 2021; Kosmala and McKernan, 2011; Unerman and Bennett, 2004; Voegtlin *et al.*, 2022). The need to reshape the way(s) of doing business and address new and old stakeholders' expectations are the grounds for conceiving new tools for a better business world.

In this context, ESG criteria are increasingly used to make informed decisions that consider not only financial returns but also the broader impact that investment initiatives may have on people and the planet. ESG stands for Environmental, Social and Governance; introduced in 2004 (United Nations Global Compact, 2004), it represents a framework now widely incorporated into investment strategies for sustainability evaluations, ranging from risk management to a proactive willingness to address social and environmental issues. Financial strategies that include ESG factors are widely referred to as sustainable finance.

Among these, impact investing covers an increasingly salient role (Hehenberger *et al.*, 2019) as a new way of making investments with the potential to benefit society. Impact investing can be viewed as applying ESG principles to achieve specific positive outcomes. According to the Global Impact Investing Network (GIIN), "*Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending on investors' strategic goals*" (Global Impact Investing Network, 2021). Thus, two out of the three ESG factors (the "E" and the "S") are central to the success of impact investing initiatives. However, as noted in the literature, the third one – the "G" – is equally essential for the proper implementation of impact investing initiatives (Agnese *et al.*, 2023; Godfrey *et al.*, 2009; Monks and Minow, 2011; Yoon *et al.*, 2006).

Phenomena like impact washing have been increasingly witnessed in recent years (Findlay and Moran, 2019). They are particularly problematic as they create room for ESG controversies, defined as "news stories such as suspicious social behaviour and product-harm scandals that place a firm under the media spotlight and, by extension, grab investors' attention" (Aouadi and Marsat, 2018).

This study builds on this debate, addressing the following research questions: *What factors contribute to the impact litigation risk? How do practitioners in the impact investing field address this risk?*

More narrowly, the focus is on the risk of potential and/or actual impact litigation(s), their determinants and the possible consequent rise of "ESG liabilities". Existing literature has extensively investigated the risk of "shareholder litigation" as an external governance mechanism that can deter opportunistic managerial actions (Treepongkaruna *et al.*, 2022).

Particularly, the potential threat of shareholder lawsuits may dissuade managers from taking advantage of shareholders, thus minimizing agency conflicts (Chatjuthamard *et al.*, 2021). Inadequacies in governing and accounting for impact investment initiatives are also the leading causes of impact litigation (Busco, 2023; Busco *et al.*, 2020; Maas and Liket, 2011; Cohen and Serafeim, 2020). However, internal governance mechanisms and accountability of impact investments are two underexplored sides that deserve further investigation by scholars.

To bring a cutting-edge contribution, we conveniently selected a group of individuals with specific knowledge on the topic of ESG and impact controversies to participate in our study. Then, the analysis of interviews has been conducted with an inductive approach, adopting the Gioia Methodology (Asante-Appiah and Lambert, 2022; Gioia and Chittipeddi, 1991; Gioia *et al.*, 2013) to fill the gap of knowledge around the topic of litigation in the impact investing arena. Experts provided insights on the areas within impact investing that require

enhancement, as well as effective strategies to prevent or adeptly handle impact litigations. We found that potential litigation bombs stem from the "great noise" around the impact investing sphere, the lack of shared guiding principles and standards for measuring impacts and the misalignment of interests among actors involved in the initiatives. We discuss these issues, prospecting valuable solutions derived by combining the experts' viewpoints and the relevant Coase's Transaction Theorem (Coase, 1960; Williamson, 1979) and agency (Agrawal and Hockerts, 2019; Fama and Jensen, 1983) theories. Indeed, from the practical standpoint, "contractualization", tailored legal frameworks, internal auditing procedures and processes, governance tools and a proactive approach, represent the most urgent elements in which the impact investing stakeholder should invest in.

Given these premises, the article is organized as follows. Section 2 depicts the impact of the investing landscape and the emerging litigation issues; Section 3 introduces the methodological approach adopted; Section 4 points out the findings of the study as they came from the experts' interviews; Section 5 and its subparagraphs firstly discusses the results getting back to the literature that fed the research purposes, then dives into the implications for practice and policy; Section 6 points out the study limitation and avenues for further research and Section 7 provides concluding remarks.

## 2. Literature background

In recent times, societal expectations have marked shifts, with increasing demands for businesses to integrate profit with social impact (Kolk and van Tulder, 2010). The 2008 financial crisis notably tarnished the perception of financial actors. This negative image, accentuated by media scrutiny, drove these business entities to emphasize environmental and social concerns (Sciarelli *et al.*, 2021). Departing from conventional investment and financing strategies, novel capital provision models emerged, placing unprecedented importance on social and environmental elements which had long been sidestepped by the financial world (Sciarelli *et al.*, 2021). The momentum behind these models also found fuel in the inefficiencies of charitable ventures and the inadequate deployment of public funds in addressing critical social demands (Calderini *et al.*, 2018).

Thus, the investment domain has emerged as a pivotal player in the transformative journey toward sustainable investment and development (Bril *et al.*, 2020). Hence, the onus on financial bodies to uphold their image on socio-environmental fronts has surged (Asante-Appiah and Lambert, 2022). Here, "sustainable finance" encapsulates financial endeavors that embed ESG considerations into their investment decisions (Reynolds *et al.*, 2020).

Within sustainable finance models, contemporary literature and industry practices identify two primary methodologies for screening entities based on ESG criteria: the negative screening technique, which essentially weeds out entities, industries or nations from potential investments based on their non-adherence to specific norms or global treaties (e.g. Fundamental Conventions of the International Labor Organization – ILO) (Kotsantonis *et al.*, 2016); and the positive screening method, tailored to target investments in sectors and corporations that either meet specific sustainability benchmarks or exhibit a dedication to ESG principles (Schlütter *et al.*, 2023). Both methodologies converge on one core goal: embedding ESG considerations into investment decisions, primarily to mitigate risks and assure financial growth (Sandberg *et al.*, 2009). In a related yet uniquely nuanced domain, impact investments deliberately channel funds to tackle pressing social and environmental challenges while achieving financial gains (Clarkin and Cangioni, 2016; Hehenberger *et al.*, 2019; Quinn and Munir, 2017; Global Impact Investing Network, 2013).

Impact investing is based on the foundational belief in a causal relationship between financial input and environmental or social results (Busch *et al.*, 2021; Schlütter *et al.*, 2023). This differs from financial strategies leveraging ESG criteria to amplify returns (Sandberg

*et al.*, 2009). Unlike ESG-centric methodologies, which assess contributions after investments are made, impact investing zones in on direct implications, positioning itself as a more potent catalyst for societal evolution (Carroux *et al.*, 2022).

Three salient features typify impact investing (Alijani and Karyotis, 2019; Bugg-Levine and Emerson, 2011; Hebb, 2013; O'donohoe *et al.*, 2010; So and Staskevicius, 2015). First, its *intentionality* captures investors' conscious commitment to channel funds to foster social or environmental change (Alijani and Karyotis, 2019; Bugg-Levine and Emerson, 2011). Second, its *measurability* dictates that the resultant social impact be quantified, either qualitatively or quantitatively (Agrawal and Hockerts, 2019; Carè and Wendt, 2018; Chen and Harrison, 2020; Hebb, 2013; O'donohoe *et al.*, 2010), as this is crucial to ensure transparency and accountability in terms of impact creation. Third, its *additionality* evaluates the added value of an investment in achieving a predefined socio-environmental objective beyond the outcomes achievable without investor intervention (Brest and Born, 2013; Hockerts *et al.*, 2022).

However, despite the mounting focus on impact investing within financial circles (Borrello *et al.*, 2023; Schlütter *et al.*, 2023), our grasp of its complexities remains fragmented. A further complication is the lingering confusion between impact investing and its sustainable finance counterparts in terms of definitions, terminology and strategy field (Höchstädter and Scheck, 2015; Sandberg *et al.*, 2009). For instance, the terms "ESG" (or SRI), "investing" and "impact investing" are often used as synonyms (Höchstädter and Scheck, 2015; Schlütter *et al.*, 2023). The situation is worsened because academic researchers have not yet delved into the operational elements and strategies that clarify how impact investing firms operate (Agrawal and Hockerts, 2019). This ambiguity guides our literature exploration into the controversies on environmental, social and governance issues, focusing on the impact investing context and the accountability and legal tools or schemes that might address these issues.

### *2.1 Controversies on sustainability issues and related aftermaths*

The overall equilibrium among stakeholders is often the result of bilateral and/or multilateral agency relationships that, in the issue under investigation – impact litigation – rarely see some stakeholders more powerful than others. A consequence is the so-called agency problem type II, where conflicts arise between the same categories of stakeholders with different contractual or bargaining power, or into the agency problem type III, where shareholders (in this context, the impact investors) may put in action biased cognitive behavior detrimental for the remaining stakeholder population (Core *et al.*, 2006; Cremers and Nair, 2005; Fama and Jensen, 1983). Within the broader sustainability discourse, controversies often stem from events that arouse stakeholder scrutiny, such as unethical conduct allegations or issues with product integrity (Aouadi and Marsat, 2018; Cai *et al.*, 2012).

Strategic litigation phenomena have escalated in a new political environment, where citizens' opinions have increasingly gained centrality in national and supranational decisions regarding sustainability topics (Buckel *et al.*, 2024). Notably, strategic litigations brought forward by activists, NGOs and political actors have the potential to attract public attention to marginalized issues for social change even before achieving victory in court (*ibid*). In the context of emancipatory theories, disputes over sustainability claims can give power to marginalized issues, and less powerful stakeholders by including them in political participation (Banerjee, 2014, 2022; Fuchs, 2013).

In the context of impact investing, disputes over impact claims brought forward by stakeholders can escalate into legal battles, i.e. impact litigation, leading to hefty financial consequences and reputational erosion for the businesses involved (Aouadi and Marsat, 2018). The threat of impact litigation can be considered as an external governance

mechanism that may prevent unfair and illegal organizational behaviors, such as claiming false impact results.

The recent decade has witnessed an upward trajectory of financial firms opting for public disclosure of their sustainability results (Ioannou and Serafeim, 2019). However, amid this surge, some organizations camouflage their activities under the guise of sustainability, leading to ambiguity between genuine contributions and mere public relations tactics. There is a rising concern over "impact washing" [1] in the specific case of impact investing. It derives from the broader greenwashing concept, described as "the intersection of two firm behaviors: poor environmental performance and positive communication about environmental performance" (Delmas and Burbano, 2011).

The most prominent catalysts for this deceptive trend are the ambiguity surrounding impact investing criteria (Findlay and Moran, 2019) and the vague differences with other types of sustainable financing strategies (Höchstädter and Scheck, 2015).

Besides, although there is a vast array of impact measurement tools available, the absence of standardization means assessments often veer toward subjective narratives (Avard *et al.*, 2022; Nicholls, 2018), making impact measurement generally less rigorous than financial analysis (Bengo *et al.*, 2016). The absence of standardized practices and universally accepted guidelines in reporting sustainability matters represents an additional exacerbation (Juddoo *et al.*, 2023).

The need to ensure that stated social and environmental objectives are not only declared but actually pursued is essential to maintaining the credibility of impact investing. In this sense, investor transparency and accountability to stakeholders are crucial. Both internal governance practices and market-wide efforts can fuel these. In the internal processes of financial organizations, it is crucial to set up an impact creation strategy, e.g. through the theory of change tool (Jackson, 2013) – and to develop an impact measurement and monitoring mechanism in collaboration with relevant stakeholders (i.e. investees and beneficiaries).

Thus, the creation of an impact measurement and monitoring mechanism is strategically crucial to build legitimacy and foster accountability on both the investor and investee side (Borrello *et al.*, 2023), as being accountable for impact claims is considered a "moral obligation" for all stakeholders involved (Bengo *et al.*, 2016). In brief, impact measurement and management and consequent reporting are not to be seen as a purely communicative act: they are a central practice in the internal governance of impact organizations and should not be considered (only) as a marketing lever (Bugg-Levine and Emerson, 2011; Viviani and Maurel, 2019).

In light of current insights, there is a pressing need to establish a robust governance structure for Impact Measurement and Management (IMM), given that the success of an impact investment is deeply tied to its tangible societal and environmental outcomes. IMM must be governed in every step of the investment process: this includes setting mechanisms to evaluate companies and define impact objectives during the screening and due diligence phase, monitoring impact performance during the investment and verifying the achievement of impact objectives at the end of the investment. A comprehensive evaluation of impact and transparent reporting, combined with careful impact management throughout the investment process, not only exemplifies a genuine commitment to societal improvement, as highlighted by Findlay and Moran (2019), but also prevents issues like impact washing and related legal disputes.

Investors aiming for real transformation should actively acknowledge the societal changes they initiate, as Bengo *et al.* (2016) suggested. They must prioritize IMM processes at the heart of their operations (Borrello *et al.*, 2023), underscoring their dedication to real impact. This end requires clear impact goals, evaluations of relevance and consistent measurement methods throughout the investment process. These efforts should be backed by policies that guarantee accountability and alignment with predefined impact objectives

(Schönherr and Martinuzzi, 2019). Furthermore, those receiving investments (i.e. investees and/or end beneficiaries) should have a significant role in this assessment process (Borrello *et al.*, 2023). However, setting up such procedures is often challenging (Trippe and Bengabsia, 2022). Under this standpoint, the idea of "internalizing" to a greater extent the current and future costs linked to the impact investing initiatives – among which, the litigation risks – recall to the scholars' attention the principal dictates of the Transaction-Cost Theory in its early and subsequent developments (Coase, 1960; Williamson, 1979, 2008; Schmitz, 2016).

In essence, trust among varied stakeholders can only be built through a solid IMM governance structure, which truly mirrors an organization's commitment to declared impact goals.

## 3. Research methodology

We chose to employ a qualitative research methodology, which is appropriate when exploring a new area of study or aiming to formulate theories about significant issues (Jamshed, 2014). Indeed, there is little to no literature about impact controversies and potential litigation in the context of impact investing, and this study represents a pioneering effort to initiate research in this area.

The primary data source was semi-structured interviews, complemented by a selection of secondary data. We adopted a purposive sampling approach (Robinson, 2014) to build the sample of interviewees, with the aim of increasing the depth of the topics covered rather than the size of the sample selected (Campbell *et al.*, 2020; Palinkas *et al.*, 2015). Purposive sampling is commonly employed as a qualitative method to select "information-rich cases" (Patton, 2002; Palinkas *et al.*, 2015). Indeed, it is based on the selection of potential study participants who have a high level of expertise or experience associated with a specific topic of interest (Creswell and Clark, 2011; Palinkas *et al.*, 2015) and is therefore appropriate when trying to include respondents that are the most likely to provide relevant and pertinent information (Campbell *et al.*, 2020; Kelly, 2010).

### *3.1 Data collection*

We selected a group of individuals with specific knowledge on the topic of ESG and impact controversies to participate in our study. When choosing potential interview participants, we focused on picking individuals with specific knowledge of the European landscape. This decision stems from the fact that European institutions are particularly advanced in addressing impact claims and related controversies. We interviewed six individuals: three impact investors (hereafter I1, I2 and I3) and three impact lawyers (L1, L2 and L3).

Both categories of stakeholders occupy pivotal roles within the sustainable finance ecosystem and bring unique perspectives on such a newly emerging phenomenon. Our interviews terminated when we reached satisfactory data saturation (Glaser and Strauss, 1999). Our approach to data saturation involved code meaning and code frequency approaches (Hennink and Kaiser, 2022), as utilized in other fields such as medicine and science (Young and Casey, 2018; Constantinou *et al.*, 2017; Namey *et al.*, 2016; Morse *et al.*, 2014; Guest *et al.*, 2017; Ando *et al.*, 2014; Nascimento *et al.*, 2018; Hennink *et al.*, 2017, 2019). Specifically, through the code frequency method, we identified the appropriate number of interviews when the frequency of new codes began to diminish upon adding new interviews, a phenomenon also explainable by the novelty of the topic investigated. This approach was corroborated by the code meaning strategy, which entails the achievement of data saturation when all authors comprehensively understood all codes.

We opted for semi-structured interviews as our data collection method. Indeed, the semi-structured format is the most employed interviewing method in qualitative research (Dicicco-Bloom and Crabtree, 2006), as it is recognized "to be both versatile and flexible".

We built two different interview protocols: one for impact investors and one for impact lawyers. The discussions revolved around various topics. Firstly, we delved into the current landscape, exploring their experiences in impact investing and pinpointing controversies to identify primary weaknesses and the subsequent causes of litigation. Secondly, we took a forward-looking approach, outlining the potential evolution and governance mechanisms to enhance the management of ESG investments and mitigate future impact controversies.

We ensured that all questions were not leading and clearly formulated (Åstedt-Kurki and Heikkinen, 1994; Turner, 2010) to allow interviewees to openly express their personal experiences and opinions, favoring the development of new themes and concepts. We internally tested the interview protocol (Chenail, 2011; Barriball and While, 1994), which led to the removal or rewording of some questions. Overall, we developed a list of eight questions for both investors and lawyers. The complete protocols can be found in appendix annexes I and II.

We undertook the data collection process from July 2023 to September 2023. The interviews were conducted remotely via video calls for an average length of about 45 min each. After obtaining consent from the respondents, we audio-recorded all the interviews and subsequently generated *verbatim* transcripts (Jamshed, 2014).

We additionally conducted desk research to gather data on how the ESG and impact investing market is tackling the challenges related to controversies on sustainability issues.

The analysis of the secondary data was essential to validate and enrich the results of the interviews, which form the foundation of a theorization on the topic of impact-related controversies.

The desk research was organized as follows: we searched for documents (i.e. industry reports, white papers, market analysis, articles in press, newsletters, case studies and conference proceedings) discussing the topics covered in our semi-structured protocols. The search was conducted on both the Google search engine and databases specific to legal topics (e.g. Bloomberg Law, Nexis Uni, Lexology), and it resulted in the collection of 44 documents. We screened the documents on the basis of relevance to the research themes, the robustness of the source and the publication date. We then proceeded to qualitatively examine the remaining documents on NVivo, and we performed a thematic analysis with the development of a coding scheme to categorize the information. The Annex (I) offered as Supplementary material to this article provides the coded themes and a relevant set of information for each of them.

### *3.2 Data analysis*

The analysis of interviews has been conducted with an inductive approach, adopting the Gioia Methodology (Asante-Appiah and Lambert, 2022; Gioia and Chittipeddi, 1991; Gioia *et al.*, 2013) to fill the gap of knowledge around the topic of litigation in the impact investing arena. Such a methodology consists of developing theories grounded in the informants' experience and their understanding of that experience (Gioia *et al.*, 2013). Therefore, it allows the needful flexibility for exploring emerging patterns in unexplored areas consistently with a rigorous approach (Gioia *et al.*, 2013).

The critical part of the Gioia Methodology concerns the development of data structure. Under Gioia *et al.* (2013), it involves three standard processes: (1) a first-order stage, informant-centered; (2) a second-order stage, theory-centered; (3) aggregate analysis, the findings which explain or describe a phenomenon. The data structure represents the process by which raw concepts emerging from the interviews have been transformed into significant themes and dimensions of analysis. NVivo software facilitated the analytical process, especially in the exploration phase (Peters and Wester, 2007).

In the first-order analysis stage, or exploration phase, the interviews have been analyzed, entailing the concepts and terms adopted by the participants with an open coding approach.

Phrasal descriptors have been adopted to summarize the most critical issues. Memos were used to keep track of the relationship between the codes in NVivo and ease the subsequent theoretical abstraction process (Peters and Wester, 2007).

The second-order analysis adopted a more critical approach. It was more focused on the perspective of the researchers, with the aim of matching the concepts underlined by the participants with the relevant themes from the literature and coming up with additional themes neglected in the current debate so far. In this phase, an axial coding method was employed (Corbin and Strauss, 2014). Due to the different nature of the two groups of participants involved, the analysis also aimed to understand if and to what extent some differences between the two groups emerged through the use of matrix queries in NVivo.

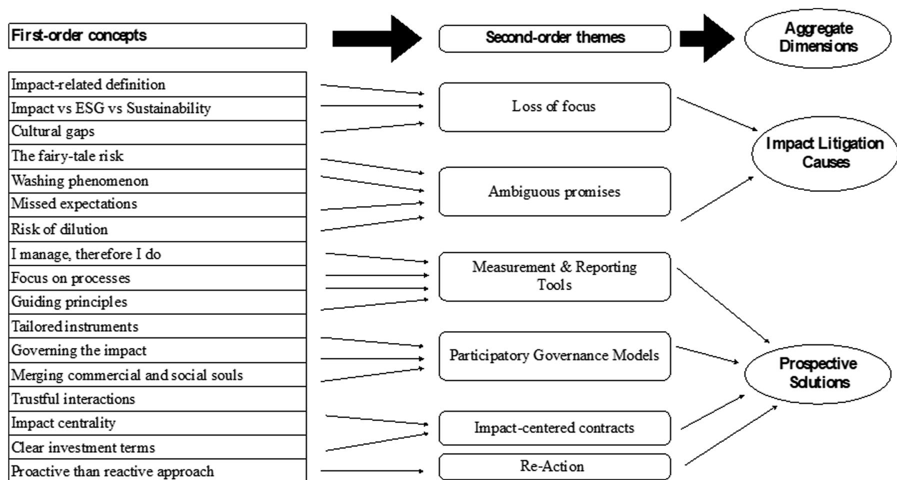
After selecting the most relevant codes, the last stage – aggregate dimension – involved gathering the themes in order to make sense of the data, contributing to advancing the knowledge on the topic.

## 4. Results

Interviews with lawyers and investors have highlighted the critical aspects of impact investing that could lead to litigation. However, they have also outlined prospective solutions for preventing or managing them. Figure 1 presents the data structure process in tabular form, embracing the emerging informant-centric terms, the research-centric themes and aggregate dimensions as the researchers interpret. These components will be elucidated in the following paragraphs.

### *4.1 Impact litigation causes*

The primary cause of impact litigation, as revealed in the interviews, is a loss of focus on the debate on impact. Indeed, some participants were focused on the topic of impact litigation, pointing out the wide range that embraces either litigation against the government for its policies or private initiatives against multinational companies because of their environmental and social misconduct.




**Source(s):** Authors' elaboration

**Figure 1.**
Data structure process

> There is a question around what exactly constitutes impact litigation. It has a relatively broad range. Within that category, I would probably put things that include litigation against governance, for example, challenging their policies. And whether those are compliant with the government's legal obligations. But I think other people would also put in that category the kind of private tortious law claims that seek to gain damages from multinational companies for the alleged role in or failure to provide a remedy for issues including environmental damage and personal injury. (L1)

Others were more focused on the broader topic of impact investing, emphasizing the existing confusion surrounding the concept. Impact investing is often perceived as a developing field with numerous grey areas and slower progress than expected. According to L2 and I1, this confusion may stem from the improper assimilation of impact into the broader realms of sustainability and ESG.

Participant L2, who established a structured initiative on impact litigation, believes that the worlds of impact and ESG should be kept separate. As a consequence, the tentative convergence toward a shared definition of impact may represent a matter of ideological litigation (I1).

> The big issue is to understand what social impact is and to have the same definition of the concept. Looking at the results, we saw that we don't have the same definition of social impact. However, we cannot activate a litigation about a definition. (I1)

A consequence is a cultural gap that leads to a lack of awareness of the implemented initiatives. A participant from the investor side (I1) emphasizes the need for a cultural change, which should start from the board of directors with a more focused discussion on the impact-related issues.

The vague promises that often characterize impact approaches contribute to this gap. Many participants noted an overemphasis on intentions rather than tangible actions. In that regard, one participant stated that there is an abundance of presentational approaches to impact investing, driven either by the desire to monetize impact (L3) or the tendency to emphasize ameliorative events (L2). The most common consequence of this "great noise" (L3) is the phenomenon of impact washing, which is widespread.

The metrics alone are insufficient to drive the necessary change. From the legal perspective, an embryonic change in forms of association of expert lawyers in the field has emerged.

> It seems to be something that is a developing subject in all respects. And so, you know, it's not mainstream and, so the idea that it becomes something that becomes litigated, it seems like that is quite developed anyway. (L3)

From the investors' perspective, disappointment regarding the delivery of impact represents the primary driver of litigation due to unmet expectations. Dilution of founders also poses a significant risk, and investor I2 suggests that this can be prevented by supporting founders in staying aligned with the impact. The proposal of an investor (I2) is the introduction of redeemable equity as a solution to mitigate the risk of dilution and related impact litigation. It allows entrepreneurs to repurchase their equity up to a certain level, ensuring an acceptable rate of return for the investor by ensuring current and future stakeholder representativeness.

### *4.2 Prospective solutions*

A recurring theme for prospective solutions is promoting the knowledge of the measurement and reporting tools that facilitate better impact management. As one of the investors (I1) argued, the management of impact measurement is central. Lawyers have made efforts to support clients in gaining a deeper understanding of measurement systems, guiding them in rigorous and transparent compliance.

This way, on the one hand, the companies also gain a better understanding of regulation. On the other hand, it allows for better risk management that mitigates the possible responsibility for managers.

> We have helped to create knowledge and management of information flows and therefore the emergence of potential risks in favour of transparency of this information towards risk management, that is, to create a flow of immediate availability of information related to risk. (L2)

Measurement-based management necessitates the establishment of transparent chains of data collection. Secondly, it requires the definition of the value chain, which represents the basis for identifying the most suitable indicators. Companies also have to assess the desired outcomes. In accordance with one of the investors (I3), these efforts not only increase awareness of positive impacts but also enhance control over negative impacts.

However, an investor pointed out the need to focus on processes that are more preliminary than the assessment phase. Indeed, the more the monitoring process is inherent to the business itself, the more impact litigations are reduced.

The relevance of context arrangements requires the development of customized instruments in addition to the already developed ones. As the most known instruments are tailored to large companies, this aspect is particularly crucial for small companies starting to embrace an impact culture.

The second critical theme affects governance. Effective impact management can be achieved by implementing participatory governance models. The most urgent step is to intervene on the governance of target investees, creating a “double governance” mechanism. Following one of the participants (I1), to foster a corporate cultural on the impact, an effective prospective solution is to introduce specific expertise of ESG or sustainability committees within the board. Instead, one of the lawyers (L2) proposed a consolidation of governance by encouraging the migration to a benefit company model consistent with ESG requirements. The balance between the commercial and social purpose is, indeed, another critical issue, as the commercial one is often still prevalent and sometimes contrasting with the impact. Notwithstanding, such participative governance models have to be built on trustful relationships among the parties, balancing the “trade secret” with the call for high transparency and collaboration.

> It is much more desirable to focus on the positive aspects of these types of relationships. If you are thinking about relationships in the best way; you’re thinking about working relationships, you’re thinking about the social aspects being integrated into those working relationships. And you’re not really thinking of them as separate from the commercial aspects. The focus should all be on the collaborative pursuit of the social aspects and not on how you’re going to make sure that the other party does what it is going to do. There’s a mutuality about it. (L3)

Another prospective solution involves the development of impact-centered contracts that clarify: (1) the impact areas that the parties are going to work on will be, (2) the impact objectives and (3) a mission drift clause embedded in a statute at the beginning of the investment. Besides settling the impact positioning of the fund, the provision of clauses that guarantee the impact delivery may reduce the risk of unmet expectations. The basis is the reciprocity and collaboration among parties to establish a win-win, impact-centered relationship with clear goals and defined consequences for unexpected events. One of the investors (I1) emphasized that contracts must say in black and white that the contract object is not merely a financial operation with some impact but is, in fact, an impact operation.

Overall, a proactive approach is recommended to avoid impact litigation, especially from a legal perspective. It involves anticipating regulation and developing best practices that encourage a focus on impact as an integral part of the strategy.

Table 1 presents the data structure, including the three orders of analysis under the Gioia Methodology and samples of the interview excerpts. A more detailed version is offered in an Annex (II) as Supplementary material to the article.

## 5. Discussion

The journey has revealed the current complexity that characterizes impact investing initiatives and related governance and accountability mechanisms. As often happens when new paradigms arise, controversies result from controversial or unclear definitions and purposes. ESG, sustainability, sustainable finance and impact investing are frequently used as interchangeable or similar terms (Agrawal and Hockerts, 2019; Höchstädter and Scheck, 2015; Sandberg *et al.*, 2009; Schlütter *et al.*, 2023). The interviewees confirmed that vague definitions often lead to vague promises jeopardized by the construction of tangible actions and commonly shared impact intentions. The experts pointed out how, in many initiatives, the impact is only declared or overemphasized while reaching higher economic benefits.

The experts argue that the raise of the ESG framework as a tool to tackle societal grand challenges (Calderini *et al.*, 2018 Kolk and van Tulder, 2010; Sciarelli *et al.*, 2021) has created great societal expectations (Agnese *et al.*, 2023; Godfrey *et al.*, 2009; Monks and Minow, 2011; United Nations Global Compact, 2004; Yoon *et al.*, 2006). With the contemporarily surge of sustainable finance paradigm(s), these expectations went much beyond, especially when the possibility to get environmental/social positive impacts depends on the potential or actual effective usage of financial inputs (Reynolds *et al.*, 2020). The three elements that distinguish impact investing initiatives from other kind of initiatives (intentionality, measurability and additionality) represent the baseline for potential issues among stakeholder that, in turn, could lead to disputes, litigations and reciprocal allegations (Alijani and Karyotis, 2019; Brest and Born, 2013; Bugg-Levine and Emerson, 2011; Carè and Wendt, 2018; Chen and Harrison, 2020; O'donohoe *et al.*, 2010). The newness of impact investing initiatives make them fragmented both in terms of schematization and contemporary presence of the three mentioned elements, notwithstanding the salient importance they are gaining into financial circles (Borrello *et al.*, 2023; Schlütter *et al.*, 2023), as confirmed by the interviewees. What organizations involved in impact investing activities can do is to legitimize themselves through appropriate (strategic) accountability tools. Indeed, the reputational side of impact investing is crucial for both the success and credibility of them (Aouadi and Marsat, 2018). In this sense, experts underline the felt need of an alignment between the disclosure and the performance of impact investing initiatives. As witnessed by the experts interviewed, there are many initiatives labeled as impact ones that since their beginning or in a short period of time lose completely their impact-driven purpose, jeopardizing the public trust and creating room for reputational issues (Yoon *et al.*, 2006).

However, after systematizing the impact investing criticalities and the related litigation landscape by finding confirmation into the literature, the study provides new theoretical lenses for reading the impact litigation landscape and practical solutions to address the leading causes of litigations.

### *5.1 Implications and contribution to the literature*

The literature on sustainability in general and impact investing in particular has mainly focused on the content of the initiatives and, therefore, on the environmental and social dimensions (Bril *et al.*, 2020; Hebb, 2013; Hockerts *et al.*, 2022; Kotsantonis *et al.*, 2016; Reynolds *et al.*, 2020; Schlütter *et al.*, 2023). The findings of this study instead shed light on the criticalities within the governance dimension, which embraces the strategy, organizational arrangements and behaviors and open many accountability-related issues.

**Table 1.**
Data structure

| Interviews' excerpts | First order concepts | Second order themes | Aggregate dimension |
|---|---|---|---|
| There's a question around what exactly constitutes impact litigation. Within that category, I'd probably put things that include the litigation against governance, for example, challenging their policies. And whether those are compliant with the government's legal obligations. But I think other people would also put in that category the kind of private tortious law claims that seek to gain damages from multinational companies for the alleged role in or failure to provide a remedy for issues including environmental damage and personal injury. (L1)<br>I don't think impact really is defined. (L3) | Impact-related definition | Loss of focus | Impact Litigation Causes |
| I always keep ESG and Impact separate because they are two different things. (L2)<br>They often trivially confuse ESG and Impact, sustainability and impact. (I1) | Impact vs ESG vs Sustainability | | |
| So now it is obvious that there is a lot of confusion because there has not been time for a cultural change to settle down. (I1)<br>But still, it's important, I think, to sensitize everyone on these topics. (I3) | Cultural gaps | | |
| There's a huge area of self-declaring and presentational approaches to impact investing, where I would question how much of that presentation really results in serious substantive impact as opposed to something that's got a theory attached to it. And part of that is to do with the monetization of impact. (L3)<br>Intentionality is not a statement. (I1)<br>One of the risks is the habitual propensity to tell the market about events that are ameliorative to what you are, which at best as a jurist is the so-called dolo bonus, i.e. the pill to sell the product and sometimes instead is done with guilt if not malice. (L2) | The fairy-tale risk | Ambiguous promises | |
| A transparency of processes in the start-up phase of fund setup helps to counter any challenges related to the phenomenon of greenwashing. (L2)<br>I'd certainly say that impact washing is everywhere. (L3) | Washing phenomenon | | |
| However, I imagine that any legal problems, in terms of precisely impact risk, non-delivery of impact and then confrontation on a whole set of terms that were part of the contractual package where we measure and define mutual obligations, then you can have a controversy. (I1)<br>This is because it was about a controversy precisely on these different expectations of the delivery of the impact. (I2) | Missed expectations | | |
| There is the problem of start-ups, precisely dilution, and so a fear of dilution of founders. (I2)<br>The redeemable equity is something that I think would be very suitable in the Impact investing industry because it would protect from that impact risk from that excessive and even immediate or too fast dilution of the founders and therefore also lead to reduce with the risk of litigation, at least we investors with the founders. (I2) | Risk of dilution | | |

(*continued*)

| Interviews' excerpts | First order concepts | Second order themes | Aggregate dimension |
|---|---|---|---|
| Another issue that we are working a lot on is that of creating transparent chains of data collection. (L2)<br>Subsequent to entry into the company we give ourselves six months with the target [company] to close the value chain and define the indicators and to a further addendum will be signed which at this point will become part of the overall Investment Agreement in which the indicators are defined. Why do we do this work subsequently? Because the evaluation of what are the indicators, the dimensions of outcomes, require further reflection by the enterprise. It requires some training, it requires some accompaniment and it is not something that is done in our opinion in a month because it risks that the target [company] is not aware of what it is doing more. (I1) | I manage, therefore I do | Measurement and Reporting Tools | Prospective Solutions |
| By collaborating with other SGRs we realized that the processes are different and in my opinion it's important that the definition of processes comes before even the measurement, that it becomes a key element that is invasive for the target and for the SGR. (I1)<br>So from a political side, there should be more clarity on definitions and how to achieve measurement, so clarity on the processes from the scouting. (I1) | Focus on processes | | |
| I think it's about kind of having this package which is kind of set out in the LISIs [Legal Innovation for Sustainable Investments] guiding principles. (L1) | Guiding principles | | |
| The problem is that all the resources that are on ESG are much more adapted to big corporates. (I3)<br>We try as much as possible to avoid external elements always because the more the monitoring process is inherent with the business itself the more you reduce litigation events within investment agreements. (I1) | Tailored instruments | | |
| "Double governance" at the level of the financial entity and governance in the target. We always ask to have an involvement in the governance of the company. (I1)<br>Well, look, the interventions start from the most mundane ways of creating within the board, specific expertise of ESG or sustainability committees. (L2) | Governing the impact | Participatory Governance Models | |
| I think there's a big area there for the development of documentation, governance, and governance approaches that really match up that commercial operation to the impact and the social part of it. (L3) | Merging commercial and social souls | | |
| We really spend time talking to other funds especially because today everybody is doing the same business. (I1)<br>There's this tricky balance to try and achieve between opening yourself up enough in order to get the real feedback and the input from external stakeholders into strategy and plans for implementation. (L1) | Trustful interactions | | |

(*continued*)

Table 1.

Table 1.

| Interviews' excerpts | First order concepts | Second order themes | Aggregate dimension |
|---|---|---|---|
| The political authorities should challenge the provider for not delivering on the important impact aspects of the contract. (L3) | Impact centrality | Impact-centered contracts | |
| We clarify what the impact areas that we're going to work on will be, what the impact objectives are and then obviously a mission drift clause that we include in a statute at the beginning of the investment, as it is difficult to change it later | | | |
| We try to define the mission and then link it to the mission drift from business plans as well as statements that become part of the investment agreement. (I1) | | | |
| From a from a legal perspective, what you're always trying to do is put in place the right kind of contractual provisions and contractual levers to make sure that you've got this kind of framework in place, under which you can make sure that you have this framework that's you know, rigid enough so everyone knows kind of what the end goals are and that it's not going to change and but also flexible enough to make sure that when unexpected things do come up, and they can be put in place and obviously part of that may well be to put in place provisions that say, you know, certain monitoring techniques, for example, need to be employed. (L1) | Clear investment terms | | |
| With the companies in the portfolio, we often put clauses linked to impact, saying, for instance, if you were to abandon the impact or if the impact wasn't strong enough anymore, we wouldn't be allowed to exit. (I3) | | | |
| The critical element is just to anticipate the further evolution that will necessarily come of the regulatory framework and its application because slowly the techniques, the knowledge, the awareness of the regulators of those who will have to investigate for fraud and so on will grow. (L2) | Proactive than reactive approach | Action | |
| I think that more and more lawyers are interested in the impact space. And I think there's also a kind of generational thing in terms of junior lawyers in particular, feeling more empowered to speak up about things that they feel passionate about. (L1) | | | |

**Source(s):** Authors' elaboration

Inadequate governance is indeed detrimental to an organization's multifaceted performance. Governance pitfalls like opaque operations, stakeholder misalignment or ethical lapses can compromise decision-making and stakeholder trust (Godfrey *et al.*, 2009; Monks and Minow, 2011; Yoon *et al.*, 2006). Organizations with lax governance are more prone to sustainability-related disputes, often due to inadequate risk foresight and mitigation measures (Agnese *et al.*, 2023).

In impact investing, currently, the impact is weakly integrated into the strategy of firms, generating "great noise" and poor results. As happens for whatever initiative, an undermining aspect concerns the alignment of interest. In impact investing, it is sometimes due to founders' dilution over time. A situation like this would create a new kind of agency problem type II (Fama and Jensen, 1983) observed between the same category of stakeholder, or type III where shareholders through biased cognitive behavior can damage the residual stakeholder population (Core *et al.*, 2006; Cremers and Nair, 2005) between the impact investors and other stakeholders, which needed further exploration, theoretical explanations and practical solutions for stakeholder representativeness (Chakhovich and Virtanen, 2023).

While efficiency represents the primary criterion for monitoring the agency problem (Jensen and Meckling, 1976), a shift toward impact is required in the context of impact investing. The combined reading of the loss of focus in current initiatives and the need for impact-centered contracts underline the urgency of a new compass – traditionally represented by the profit – to explore the relationship between the principal(s) and agent(s). Therefore, the traditional agency framework (Eisenhardt, 1989), which focuses on monitoring costs, and the behavioral agency theory (Pepper and Gore, 2015), which focuses on agent performance, can be applied only after a clear statement in the contracts of diffused and interwoven ensemble of interests.

A stronger contractualization also paves the way for a new age of the Coasian view of the firm and its related cost transaction theorem (Coase, 1937, 1960). The costs incurred at the beginning for contractualization might create future savings, reducing the risk of litigation and, therefore, preventing additional costs for litigation. Internalizing potential future issues (including litigation trigger points) can benefit the impact investing initiatives since its inception. From a theoretical standpoint, scholars can delve into the issue by questioning the possibility of outsourcing part of the impact investing governance (Williamson, 1979, 2008).

To conclude, prospective solutions that came out from the interviews are consistent in their foundations with these well-known theories. At the same time, they call for new developments updated to current times and tailored to impact investing.

### *5.2 Implications for practice and policy*

The complained inadequacies of impact investing governance seem due to the absence of proper governance organisms (as ad-hoc ESG committee/board) or to the overall for-profit corporate legal scheme that does not fit with the purpose and the *reason to be* of impact investing initiatives (Agnese *et al.*, 2023; Chintrakarn *et al.*, 2016; Jain and Jamali, 2016). Thus, the first practical solution is adopting the benefit-corporation scheme that would adhere more to the purpose, neutralizing disputes and clarifying stakeholder expectations (Godfrey *et al.*, 2009). Practically, the benefit corporation is a legal scheme that clearly states in the company statute the intention of the firm to reach social impacts and returns alongside the financial ones. Besides, participatory governance models represent a good instrument of internal assurance over the control and the achievement of pre-established impact targets. Enhancing governance can help firms better channel their sustainability endeavors to face current criticalities (Ioannou and Serafeim, 2019). Robust ESG governance can shield against controversies, as it bridges the interests of shareholders and management while potentially

boosting firm valuation (Chintrakarn *et al.*, 2016; Jain and Jamali, 2016). Indeed, the introduction of specific expertise in ESG or sustainability into the governance hierarchy can lead to a more coherent governance policy.

In the words of one of the interviewees, an additional pivotal practical solution relies on a structured "*measurement-based management*". The referred lack of standardization of measurement processes and tools (Bengo *et al.*, 2016) might represent the first issue, leading to controversies (Avard *et al.*, 2022; Harji and Jackson, 2012; Nicholls, 2018). In this respect, the impact investing value chain covers a key role. Once the critical nodes in the chain have been identified, there is a need to communicate them to the investors. This way, a monitoring board of impact (value) can be built up alongside valuable Key Impact Indicators (KII). Differently, "how impact can be – or is actually – measured" remains largely unanswered.

The need for evolved accountability patterns must be completed on time. As highlighted by experts, both internal and external accountability tools of impact investing initiatives can benefit the different categories of stakeholders involved. From an internal standpoint, whatever tools to monitor the process (scorecards, *tableau de bord*, structured internal auditing procedures) would help prevent disputes (Schönherr and Martinuzzi, 2019). As for external accountability, the reporting practices should be shared and commonly intended, useful and informative and aligned with established standards or guiding principles (Ioannou and Serafeim, 2019; Luo and Tang, 2023; Murphy and McGrath, 2013; De Silva *et al.*, 2022).

Thus, strategic and accountability aspects of impact investing initiatives can be incorporated, as underscored by the experts, in developing best practices, protocols and any tool able to anticipate ongoing and confused regulation across jurisdictions. In this way, logic, desired impacts and proper metrics are developed from the design phase to the implementation of the initiatives, and different standpoints can converge, avoiding or reducing the risk of future controversies.

From the lawyers' perspective, two are the observable trends and desired solutions. Firstly, the tendency to aggregate professionals in associations to dominate the complexity brought by this kind of litigation and lawsuits. This way, the legal advisory function can be properly addressed, merging different expertise. Secondly, the rise of impact investing "contractualization", a legal tool used to partly or wholly prevent possible disputes. As one of the interviewees proposes, the development of impact-centered contracts might represent one of the most effective solutions. Indeed, a binding agreement among actual and potential impact investors that rules the initiatives and establishes appropriate rewards and sanctions schemes might prevent many potential drivers/causes that often lead to litigations.

## 6. Study limitations and avenues for future research

Given its nature, this study presents several limitations. Firstly, all the experts involved are based in Europe, limiting the generalizability of their insights on a global scale. Secondly, the Gioia Methodology employed for analysis (Gioia *et al.*, 2013, like any qualitative method, is inherently subjective. Furthermore, the main findings and related theoretical and practical implications result from a double-tied subjectivism in reading and interpreting the phenomenon. Indeed, the interviewees read the phenomenon through their experience, while the authors analyzed the results, looking for a comparison with the most relevant academic literature on the topic. Lastly, given the rapid evolution of the impact investing landscape, there is a need for continuous research to assess emerging issues and the effectiveness of addressing those identified in this study by adopting the solutions proposed within.

As for future research avenues, while there is abundant research into the catalysts of responsible behavior (Bril *et al.*, 2020; Hebb, 2013; Reynolds *et al.*, 2020), more studies are needed that focus on the drivers of controversies in ESG and impact, their subsequent investor responses and proactive strategies to prevent controversies. Impact investing

initiatives have great potential and can be beneficial for society in achieving sustainable development (Sciarelli *et al.*, 2021). The other side of the coin is represented by plenty of drawbacks, which emerged from the analysis carried out and fairly represent the full spectrum of situations that may lead to disputes. As reported, scholars active (Hockerts *et al.*, 2022; Kotsantonis *et al.*, 2016; Schlütter *et al.*, 2023) in the field already pointed out several weaknesses. The interviewees confirmed all of them and added others alongside valuable prospective solutions. This is the desired root for further research, especially those aimed at formulating new tools and instruments (or adapting the existing ones) like the ones depicted from experts on-field interviewed.

Contributions from the wide range of scholars active in the field of multiple social sciences (law, management, accounting and organizations, to mention just some) are welcome to explore further visible and hidden shortcomings of impact investing and desired solutions. This way, findings and conclusions achieved by this work can be extended, integrated or partly (wholly) disproved.

## 7. Concluding remarks

This study delved into the impact litigation causes, analyzing the main drivers and determinants through the valuable viewpoints of on-field experts. Subsequently, by building the litigation landscape, the article analyses theoretical implications and prospective practical solutions through the usage of the Gioia Methodology.

From the theoretical perspective, four are the main takeaways. First, the need of positioning impact investing into a proper strand of research, distinguishing impact investing from other valuable initiatives – ESG, sustainability, sustainable finance–that can be beneficial for society but are partly different in nature and present different characteristics; second, the impact governance needs study advancements to avoid disputes or legal wrangles when firms fall short of their impact promises. As detected, the organizations that present lax impact governance report insufficient mitigation measures and potential undesired effects. Third, intentional or unintended misalignment of interests between stakeholders fuels agency problems that are detrimental for the initiatives and might lead to litigations. An in-depth investigation of these agency relationships might be helpful. Four, re-discovering the dictates of the Coasian view of the firm, which is seen as nexus of contracts, is a blooming desired era able to address many shortcomings in the impact investing existing schemes, through the internalization of future undesired issues (as litigations are).

From the practical perspective, bridging diverse knowledge and backgrounds, particularly between legal and management experts, is a necessary step toward effective solutions. In particular, "contractualization", tailored legal frameworks, structured accountability patterns – which starts with a measurement-based management – stronger internal auditing procedures and processes, governance tools, stakeholder representativeness and a proactive approach came out as the most urgent elements in which the impact investing stakeholder should focus to prevent litigations.

### Note

1. The size of the impact investing market is currently estimated at USD 1.164 trillion in assets under management.

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## Appendix

### Annex I – semi-structured interview protocol for impact investors

*Dear interviewee,*

Thanks for accepting to be interviewed for our research project. Here you can find a comprehensive but not exhaustive list of questions that we will ask during the interview:

Introduction

(1) How familiar are you with the concept of ESG and impact controversies/ESG and impact litigation, and their implications for financial organizations – specifically impact investors?

Initiations of litigations

(1) What are some of the challenges that impact investors might face when trying to navigate the risks and complexities of ESG and impact controversies and potential litigation? How do you plan to handle them?

(2) Who has the legitimacy to initiate the controversies and how can this influence the success or failure?

Governance processes

(1) What mechanisms do you have in place to monitor and assess the ongoing alignment of your organization's actions and processes with your stated ESG and impact objectives?

(2) Which governance characteristics of financial firms can prevent ESG and impact litigations? Can you share examples where your governance structure played a pivotal role in substantiating your ESG or impact claims if/when questioned?

(3) How do governance mechanisms facilitate ongoing reporting and accountability for your investment outcomes in terms of sustainability and impact?

(4) How do you involve key stakeholders, both internal and external, in the process of conveying your impact processes and achievements?

Future considerations

(1) How do you envision the evolving role of organizational governance in the field of impact investing in the coming years?

*Final remarks*

## Annex II – semi-structured interview protocol for impact lawyers

*Dear interviewee,*

Thanks for accepting to be interviewed for our research project. Here you can find a comprehensive but not exhaustive list of questions that we will ask during the interview:

Introduction

(1) Can you please introduce yourself and describe your role as an "impact lawyer" working in the context of impact investing?

(2) In your experience, what are some examples of ESG and impact controversies that impact investors might face?

Preventing and managing ESG and impact controversies: the role of impact lawyers

(1) Based on your experience, how do impact lawyers contribute to helping financial organizations prevent and manage ESG and impact controversies, such as accusations of impact washing?

(2) Could you share examples of specific strategies or legal mechanisms that you have employed to proactively mitigate the risk of ESG and impact controversies for your clients engaged in impact investing?

(3) Could you share a case where your involvement as an impact lawyer was instrumental in effectively responding to an accusation or dispute, resulting in a positive outcome for the financial organization?

(4) Can you provide insights into how you help organizations draft and communicate impact-related disclosures that are accurate, transparent, and aligned with their actions?

Governance characteristics

(1) Based on your observations and experience, which characteristics of organizational governance are necessary to handle ESG and impact disputes and litigation?

(2) Can you provide examples of specific governance practices that impact investors can implement to mitigate the risk of ESG and impact controversies?

Future considerations

(1) Given the novelty of these topics, how do you see the role of impact lawyers evolving in the coming years in the context of impact investing and management of ESG issues?

*Final remarks*

**Supplementary materials**

The supplementary material for this article can be found online.

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