Environmental, Social and Governance Alert

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Green and Sustainability-Linked Private Placements by EU and UK Issuers

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Environmental, social and governance (ESG) factors are becoming increasingly relevant across a range of financial investments. This has been driven in part by changes in the legal and regulatory landscape, including increased focus on ESG reporting and in part by investor demand for ESG-friendly investments.

Two principal ESG debt products have developed as a result of the above:

- **"green" loans and bonds**, the principal feature of which is that the proceeds of the loan or bond are used for "green purposes"; and
- **"sustainability-linked" loans and bonds**, under which certain of the terms (typically pricing) applicable to the loan or bond are tied to the borrower's performance against certain pre-determined sustainability-linked key performance indicators.

Not surprisingly, we are seeing increasing interest from both issuers and investors in green and sustainability-linked private placements, and we expect this trend to continue.

Industry Standards

The Loan Market Association (LMA), Asia Pacific Loan Market Association (APLMA) and Loan Syndication & Trading Association (LSTA) have jointly developed a set of Green Loan Principles (GLP) and a set of Sustainability-Linked Loan Guidelines (SLLG) to help standardize—and maintain the integrity of—the green and sustainable loan market.

In parallel, the International Capital Market Association (ICMA) has developed similar sets of principles underlying green and sustainability-linked bonds to assist both in publicizing and standardizing the underlying instruments.

In the U.K. and European markets, we have seen private placement issuers primarily looking to follow the LMA/APLMA/LSTA principles rather than the ICMA principles. Both sets of principles are easily translated into the private placement market, but many issuers in the private placement market considering green or sustainable private placements already have, and are interested in replicating the terms of, existing green

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or sustainable bank facilities. As such, in this alert we have focused on the GLP and SLLG developed for use in the loan market.

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Green Private Placements

Following the GLP, there are four core components of a green private placement:

- Use of proceeds.
- Process for project evaluation and selection.
- Management of proceeds.
- Reporting.

From a structural, documentation and creditors' rights perspective, a green private placement need not result in any fundamental changes from a conventional private placement. In particular:

- The features that qualify a private placement as "green" are additional obligations of the issuer that can be incorporated into a conventional private placement with fairly minimal changes, without adding additional obligations on the part of the investors to monitor compliance and without impacting the investors' rights as creditors.
- The issuer may elect not to have a breach of any of the additional green features of the private placement constitute an event of default, so ultimately the issuer's compliance with its green private placement framework is voluntary.
- A green private placement would not typically provide for any ongoing adjustments to the coupon based on the issuer's compliance with the green terms (though depending on investor appetite, issuers may seek to price green tranches of their private placements with tighter spreads than non-green tranches of the same tenor).

A green private placement will require a specific commitment from the issuer to apply the proceeds of the issuance to "green projects"—projects that provide clear environmental benefits—with the eligibility of a project and its benefits to be assessed and (if applicable) quantified by the issuer. The GLP provide a non-exclusive list of categories of projects that contribute to environmental objectives, including renewable energy, energy efficiency, biodiversity conservation, clean transportation and pollution prevention and control.

A green private placement that follows the GLP will also provide for the issuer to report on the use of proceeds and, where applicable, on the green projects funded with proceeds of the notes.

The issuer may, but need not necessarily, seek external review and verification in respect of a green private placement in order to benchmark against either external or the issuer's internal standards.

Sustainability-Linked Private Placements

By contrast to the relatively light touch, use of proceeds-related terms required to qualify a private placement as "green," a "sustainability-linked" private placement:

- need not specify a sustainability-linked use of proceeds; but

- must incentivize the issuer to achieve agreed sustainability objectives.

The issuer's sustainability objectives would typically be measured through negotiated key performance indicators to be assessed against pre-defined sustainability performance targets. Sustainability performance targets are required to be both material and ambitious (i.e., above "business is usual"), and meeting those targets would have an impact on the terms of the sustainability-linked notes, typically in the form of a downward coupon adjustment. In many (but not all) cases, an issuer's proposed sustainability performance targets and its ongoing performance against those sustainability performance targets will be evaluated by an external third party.

Given the economic implications for issuers and investors, the more detailed and ambitious performance metrics to be agreed and complied with and the incremental cost of negotiating and monitoring compliance, to date we have seen much more appetite from issuers and investors for green private placements rather than sustainability-linked issuances. We do, however, expect sustainability-linked products to become more and more common over time.

US Investor Considerations

- *ERISA* – In November 2020, the U.S. Department of Labor issued a final rule on Financial Factors in Selecting Plan Investments (the "Final Rule"). The Final Rule precludes ERISA fiduciaries from sacrificing investment returns or taking on additional investment risk to promote non-pecuniary benefits or goals.

  The Department of Labor under former-President Trump, by promulgating the Final Rule and emphasizing its general belief that ESG benefits are non-pecuniary, has effectively increased the burden on an ERISA fiduciary to prove why the investment was made solely for financial purposes based on sound investment principles. On January 25, 2021, President Biden, through Executive Order 13990, directed U.S. federal agencies, such as the Department of Labor, to review existing regulations promulgated, issued or adopted between January 20, 2017, and January 20, 2021, that are or may be inconsistent with or present obstacles to the promotion and protection of public health and the environment. On March 10, 2021, the Department of Labor issued a notice that, until it publishes further guidance, it will not enforce the Final Rule. We note that, notwithstanding the Department of Labor's notice, an ERISA fiduciary has a duty to act with the exclusive purpose of providing plan benefits and defraying plan expenses, which, under existing statutory and case law, means only considering pecuniary factors when making plan investments.
- *Hedging* – In the context of a sustainability-linked private placement in a currency other than U.S. dollars, U.S. investors will have to consider how they wish to hedge an investment with a coupon subject to adjustment based on the issuer's performance against its sustainability performance targets and whether the investment will qualify for hedge accounting treatment to the extent it cannot be perfectly hedged.

Conclusion

We have presented above some of the high-level characteristics attached to a green or sustainability-linked private placement. Although green and sustainability-linked products have their roots in the bank and public bond markets, recently we have seen increased interest from both issuers and investors in green and sustainability-linked private placements.

There are a number of factors that will likely impact the rise of green and sustainability-linked private placements in the near future, including macro influencers such as greater emphasis on ESG disclosure and regulation. In addition, it is evident that the events of the COVID-19 pandemic have raised awareness of health and social factors globally, and as a result there is an ongoing shift towards emphasis on ESG considerations in the investment decision process. We expect that this trend will likely continue to be embraced by the private placement market, particularly as there is real scope for pushing market boundaries and advocating both green and sustainability-linked principles for the long-term benefit of both the investor and the issuer.

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