

## FUND FINANCE FRIDAY

## Top 10 Items to Consider When Structuring Your ESG Facility

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ESG-focused investment funds raised a record amount last year – estimated at more than \$50 billion in new investor money. This trend is expected to not only continue but accelerate over the next few years. Some commentators have even noted that eventually, there may be no distinction at all between traditional investing and ESG investing as the latter cements its standing as the new normal for our modern-day society.

Green initiatives and social impact often drive the focus. Despite the pandemic and market volatility experienced in 2020, the social and political agenda has established a clear message in favor of societal change and investing for the greater good. A sustainable future and one that we can be proud of shaping has taken priority in the corporate and investment world.

Fund finance is no exception. Since last summer alone, we have closed 6 ESG fund finance facilities at Cadwalader, including the [largest one ever closed and syndicated](#).

ESG-linked technology is making its way into loan documents with more frequency. While a basic framework has been established, a lot of discretion remains with the lender and borrower on structuring considerations. Below are my top picks of the most important items to consider when launching your next ESG facility:

### 1. Facility type: Use of proceeds

Generally, a use of proceeds-focused facility will require that all investments funded via loan proceeds meet specific sustainability criteria. The LSTA, the LMA, the UN and others have published guidance on green loans and sustainability-linked loan principles. The borrower will typically have investment guidelines that sync with these principles and align with its overall investment strategy. The guidelines should be reviewed and agreed upon prior to closing the facility to establish an objective set of criteria that must be satisfied when facility proceeds are used for investment purposes. The borrower will provide reps and certifications related to the use of proceeds and satisfaction of the sustainability criteria each time it borrows for an investment. The asset class and projected usage by the fund must obviously

align for this type of structure to work. It's generally favored on green facilities, such as a fund using a facility solely for investment in renewable and alternative energy sources.

## 2. Facility type: Performance-based outcomes

Another popular method and the approach that can be employed for a variety of different fund borrowers, regardless of asset class or investment focus, is to measure the borrower against certain objective performance criteria – often referred to as “KPIs” or Key Performance Indicators. The KPIs should be established upfront and align with sustainability guidance. Satisfying or failing to satisfy KPIs will trigger a positive or negative, as applicable, outcome under the facility. The triggers can be negotiated and lead to a variety of outcomes, but should be set up in a manner that incentivizes the borrower to achieve real results.

## 3. Pricing adjustment

This has become the most common outcome for performance-based facilities, but is not a requirement and is certainly not seen in all facilities. Achieving the agreed-upon KPIs under this structure will lead to a pricing reduction – typically 5-25 basis points. The opposite can also be true with failure to meet KPIs as a trigger to a pricing increase in a corresponding amount. The pricing outcomes may also be tiered based on which KPIs are achieved. This type of framework provides a strong incentive for borrowers to work toward the sustainability-linked goals and also gives lenders a corresponding way to put some skin in the game.

## 4. How to set KPIs

Agreed-upon KPIs should be both ambitious and meaningful to the borrower's business but also achievable within certain time intervals of the facility. KPIs can be measured monthly, quarterly, semi-annually or annually and will yield the negotiated trigger outcomes. There is wide latitude on establishing specific KPIs, and care should be taken to ensure the goals are suitable and aimed at real change to advance the investment. KPIs can be measured at portfolio company or investment level or also at the fund level. Targets can include such items as reductions of greenhouse gas emissions or board diversity. Longer facility tenors may also be ripe for adjustments to KPIs or the ability of the parties to revisit the targets or request changes upon the occurrence of material events or set time periods.

## 5. Reporting

Once you set KPIs or use of proceeds targets, how will you ensure compliance? What reporting will be needed and from whom? Like the KPIs themselves, there is not a market standard on reporting. These are generally negotiated and will be specific to the borrower. Many times reporting will be provided quarterly and self-certified by the fund. This may be similar to the reporting that is provided to investors and may also require completion of a pre-agreed form compliance certificate provided by the borrower on the reporting date. Third-party reporting and certification may also be desired, particularly if not cost-prohibitive or the borrower uses an external review provider. A lot will depend on the fund's current practice, investor-driven requirements and how complex the KPIs are and the needed frequency of reporting.

## 6. Audit and dispute rights

Even where reporting is provided entirely by the borrower, negotiated audit rights are an option to provide a check – either as a matter of right by the lender upon a dispute or annually by the borrower as part of its regular reporting package. Another option is to avoid specific KPIs altogether but require a third-party sustainability ratings firm to provide a score for the borrower. The score can then be used to trigger the same outcomes as the KPIs. Frequency and costs of audits are all negotiated points. Where a third party provides the reporting, the audit right may not be necessary.

## 7. Role of sustainability agent

Will the lead bank alone or other banks collectively serve as sustainability agent? Will fees be paid for this role or will the benefit be title and discretion rights over negotiating and approving amendments to ESG criteria? Who will receive and monitor compliance with reporting? These are all questions that should be asked and are generally roles handled by the lead bank and any co-leads in the syndicate for a large facility. The sustainability agent role should be scoped into exculpatory clauses similar to other agent roles.

## 8. Defaults

What happens if the borrower fails to meet the KPIs? Will it trigger an event of default? Where a pricing toggle is tied to KPI satisfaction, generally there is no corresponding default for failure to perform. The borrower would fail to gain the benefit of a margin reduction or would be faced with a margin increase. For a use of proceeds facility or one that doesn't provide a pricing toggle, failure to comply may trigger a number of things that could include, but are not limited to: events of default (usually following a cure period); repayment obligations, particularly in situations where investments no longer qualify (materiality thresholds may apply); early maturity of facility or right for lender to restructure, particularly if the parties are unable to agree to suitable amended criteria if the defaults under the existing criteria cannot be cured; or automatic flip to a non-ESG facility with pre-agreed terms and loss of ability of parties to further market or make public statements regarding the facility as being sustainability-linked. It should be noted that, on the one hand, having an EOD can be helpful to deter bad behavior such as sustainability washing. However, an EOD may also have the effect of reducing meaningful impact by making the borrower reluctant to agree to take on ambitious sustainability targets.

## 9. Marketing benefit

The parties may want to consider certain changes to confidentiality sections that would permit them to publicly disclose certain elements of the facility, promote the greater good and market their roles. This should be discussed upfront in the transaction so that everyone is on the same page. In some cases, the parties may consider paying the benefits forward and donating any net income achieved from pricing reductions or increases to charities and causes related to the sustainability objectives.

## 10. Avoid sustainability washing

Sustainability washing can occur with misrepresentations, exaggerated claims or inaccurate reporting, which are ways that parties may take advantage of the market. It's important to have the right level of transparency, and to ensure that the targets are actually meaningful and the reporting and compliance is sound. Reputational risk considerations could come into play if material events occur that question the quality or veracity of the achievements. The parties may look to employ protective clauses that would unwind the ESG nature of the transaction if a material likelihood of washing behavior exists or a triggering event happens that could cause substantial likelihood of embarrassment for the parties. These clauses are often difficult to negotiate and so the concerns are commonly mitigated via other factors, such as sponsor selection, track record, audit rights and third-party verification.

At the end of the day, there is no secret sauce to structuring an ESG facility. The parties retain immense flexibility but should keep in mind the desired environmental or societal objectives and set up real meaningful ways to measurably achieve and reward this behavior. After all, doing some good feels good.