Private Credit & Special Situations

WHAT CAN I DO?

Drafting Guidance for Sustainability-Linked Loans and Sustainability Structuring Agent Engagement Letters

Sustainable finance products, including sustainability-linked loans ("SLLs"), social loans and green loans continue to evolve, with diverging issuance rates in the US and European markets. As reported by Covenant Review, the European markets started off 2022 strong, with a majority (53%) of leveraged loans including an ESG-margin ratchet in Q1 of 2022, rising to 67% in Q2 of 2022. Following Russia's invasion of Ukraine and other headwinds that resulted in decreased issuance of leveraged loans generally, ESG-margin ratchets dropped to 40% of new paper in Q3 of 2022 and dropped (sharply) even further in Q4.[1] Although US leveraged loans are not similarly tracked, a review of available public company filings for 2022 indicate that the number of public issuers entering into new facilities with an ESG-margin ratchet or including amendment mechanics for future ESG-margin ratchets (commonly referred to as "sleeping SLLs") decreased over the course of the year. In fact, in December 2022, there was only one publicly-reported SLL issuance -- the $150 million first lien term loan issued by Clean Energy Fuels Corporation (NASDAQ:CLNE).

Despite the overall headwinds and industry concerns related to greenwashing, the dedicated members of the ESG Committee of the Loan Syndication & Trading Association ("LSTA"), comprised of a group of stakeholders made up of sponsors, borrowers, lenders, investors and their counsel that advise the LSTA on ESG matters, embarked on a year-long process to prepare guidance on SLLs and the engagement of sustainability structuring agents. The members carefully evaluated evolving standards, the importance of transparency and the economic nature of the provisions (as opposed to creation of new default risks for borrowers).

[1]Source: Covenant Review: ESG Trendlines 2022: Year in Review (published December 19, 2022).

Starting Points: Drafting Guidance for Sustainability-Linked Loans and Sustainability Structuring Engagement Letters (cont'd)

On February 17, 2023, the LSTA published its **Drafting Guidance for Sustainability-Linked Loans** (the "SLL Guidance") and **Sustainability Structuring Agent Engagement Agreement Inserts (the "SSA Inserts";** together with the SLL Guidance, the "February 2023 SLL Provisions"). The SLL Guidance and SSA Inserts build on the LSTA's Guidance on Sustainability-Linked Loan Principles (the "SLLP"; together with the February 2023 SLL Provisions, collectively, the "ESG Guidance"), originally published in March 2019, revised in May 2021, and most recently updated **this month**.

This piece is intended to provide an overview of key components of the February 2023 SLL Provisions and complements our prior **article** on credit agreement provisions in SLLs, authored by Jennifer Daly, Christopher Boies and Erica Aghedo.

The SLL Guidance

The SLL Guidance offers key considerations, examples and starting points for sections of SLL documentation, including:

1. Definitions: The SLL Guidance offers suggested definitions of key terms such as "Applicable Rate", "ESG Standards", "Sustainability Certificate" and "Sustainability Metric Auditor", each of which is to be tailored to the loan facility as needed.
2. Sustainability Adjustments: This section is integral to the SLL and the credit documentation relating thereto, and outlines a road map for the ratcheting of the applicable interest rate in connection with the borrower's implementation of the sustainability performance targets ("SPTs") and key performance indicator ("KPI") metrics and compliance with the Sustainability Certificate by the borrower. Here, the SLL Guidance clarifies that a Sustainability Certificate Inaccuracy (which the SLL Guidance defines as material inaccuracy in the rate adjustment, sustainability commitment fee adjustment or KPI metrics) will not constitute a default or an event of default as long as the borrower complies with the provisions to make payments and meet any gaps of fees and interests as a result of such Sustainability Certificate Inaccuracy.
3. Representations and Warranties. In any SLL, the borrower should represent and warrant to the lenders that all its information about its sustainability initiatives and strategy are true and accurate in all material respects. The SLL Guidance offers a sample of such a representation and warranty. Notably, the SLL Guidance suggests that a breach of this representation and warranty, however, will not constitute a default or event of default or a failure to meet a condition precedent to any loan advance or letter of credit issuance.
4. Affirmative Covenants. The borrower should covenant to (i) providing the agent and lenders with all sustainability-related information reasonably requested by the agent and the lenders and supplement the information promptly from time to time to ensure continued accuracy of the representation and warranty in Section 3 above, (ii) providing written notice of a Sustainability Certificate Inaccuracy to the agent within a negotiated time frame, and (iii) notifying the agent of any change in the its sustainability strategy or initiatives or its internal policies related to

[2]The SLL Guidance suggests 5 business days

Sustainability. As with the representation and warranty described in Section 3 above, the SLL Guidance suggests that any breach of the SLL affirmative covenant will not constitute a default or event of default or a failure to meet a condition precedent to any loan advance or letter of credit issuance.

5. Agent Exculpatory Provisions and Non-Reliance. No agent, including the sustainability structuring agent ("SSA") will be responsible or liable for the completeness or accuracy of any sustainability-related information, and the lenders are not to rely on any agent, including the SSA, for any credit analysis appraisal or decision to take action in relation to the loan facility.

In addition, the SLL Guidance offers as a form exhibit to the credit agreement, a Sustainability Certificate by an officer of the borrower certifying to the KPI metrics calculations, the borrower's sustainability report and a Sustainability Metric Auditor report. It is important to note that in developing the SLL Guidance, the LSTA has not included specific guidance on the range for appropriate sustainability margins or the number of KPIs (though the SLL Guidance continues to contemplate multiple KPIs). Accordingly, we expect such matters to continue to be negotiated between counterparties on a deal-by-deal basis.

SSA Inserts

The existence of an SSA, Sustainability Coordinator or Sustainability Structurer is not an uncommon feature of SLLs. While practice around how these parties (normally commercial lending entities) are engaged may vary, the SSA Inserts offer sample provisions relating to the SSA role that can be included in a US-style engagement letter if one is executed in connection with the applicable loan facility.

1. Exclusivity: The SSA Inserts provide that no other SSA will be appointed, awarded a title or compensated in connection with sustainability matters under the loan documentation, and no other SSA can enter into other agreements or side letters with respect to sustainability matters under the loan facility, in each case, without the written consent of the existing appointed SSA. Note that this language is not intended to prohibit multiple SSAs from being appointed; rather, it suggests that they ought to be appointed with the approval of any existing SSA (with such appointment to be effectuated via a separate engagement letter or, alternatively, an amendment to the existing SSA's engagement letter).
2. No Financing Commitment: Similar to provisions commonly found in a financing engagement letter, the SSA Inserts include a provision that expressly states that the SSA's engagement is not an agreement or commitment to provide financing in connection with the loan facility.
3. No Responsibility and Disclaimers. The SSA Inserts include important disclaimers of responsibility intended to protect and clarify the role of the SSA. For example, an SSA typically makes no assurance as to (i) if the loan facility meets any institutional, regulatory or other expectations as to sustainability factors at the borrower, the lenders or any other person,

[3]The three terms are interchangeable, and each title may be used as an alternative to the other titles with no intended significance based on the title selected.

(ii) whether the set of KPIs that the borrower chooses meets any set industry standards, (iii) the attainability of the KPIs or SPTs in the loan documentation. The SSA Inserts provide language that clarifies that (w) the SSA does not serve in an advisory capacity for the borrower, (x) the SSA is an independent contractor, (y) the SSA shall have no fiduciary duty to the borrower, its management, its board, its stockholders or any of its affiliates and (z) the borrower is responsible for making its own independent investigations and judgments with respect to the KPIs and SPTs related to the loan facility.

3. Fees and Expenses. The SSA Inserts lay out language to address the payment of an SSA's fees and expenses by the borrower. The suggested "Sustainability Structuring Fee" is a negotiated amount payable at the closing of the loan facility (and, in certain cases, on a recurring basis thereafter for so long as the subject loan remains outstanding). The borrower is also responsible, on an ongoing basis, for reimbursing the SSA's additional reasonable and documented out-of-pocket fees and expenses.

4. Resignation and Termination. The SSA Inserts include additional terms and provisions that can be included in any SSA engagement letter providing for resignation of the SSA and termination of any SSA's engagement. The SSA Inserts provide that the SSA may resign by written notice to the borrower and conversely, the borrower can terminate the SSA's engagement with prior written notice, subject, in either case, to the payment of accrued fees and expenses of any such SSA.

Conclusion

Since 2019, the SLLP has provided a framework for thinking about SLLs, and the February 2023 SLL Provisions aim to provide market practitioners with further clarity and practical guidance on how to approach and apply the SLLP in a harmonized, streamlined manner. That said, particularly given the recent decrease in SLL issuance both in the US and Europe, the ESG Guidance may be viewed as conceptual foundational documents only and not as statements as to prevailing market practice. To that end, the LSTA has taken care to classify the publications as guidance only and not as Model Credit Agreement Provisions ("MCAPs"), as MCAPs represent standard, well-established market practice. We will continue to monitor the adoption of the February 2023 SLL Provisions as economic conditions evolve.

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