Reuters Legal News

ESG in the credit agreement: a closer look at sustainability-linked loan mechanics

By Andrew T. Budreika, Esq., Benjamin Stango, Esq., and Elizabeth Goldberg, Esq., Morgan, Lewis & Bockius LLP

JUNE 10, 2022

Environmental, social, and governance (ESG) issues continue to dominate business and investing news. In this article, after providing some recent context, we examine some key credit agreement provisions governing one of the hottest banking products in ESG — sustainability-linked loans (SLLs).

Global annual sustainable debt issuance continues its exponential growth, more than doubling from $769.1 billion for 2020 to $1.689 trillion in 2021, with the largest volume increases in sustainability-linked loans.

ESG appears omnipresent in recent months. The Securities and Exchange Commission (SEC) continues to scrutinize ESG claims: on May 25, it proposed disclosure rules (https://bit.ly/3aK5ayg) "to promote consistent, comparable, and reliable information for investors concerning funds' and advisers' incorporation of environmental, +social, and governance (ESG) factors." Earlier, on March 21, it proposed rules to enhance and standardize climate-related disclosures for investors. We previously covered the March 21 proposal in "SEC proposes a change in disclosure climate," Reuters Legal News, April 7, 2022.

In addition to regulators, business leaders, rating agencies, and other stakeholders continue to debate the meaning of ESG and what characteristics should qualify products to be covered under its positive mantle. Looking specifically at loan and debt markets, global annual sustainable debt issuance (including sustainability-linked bonds and loans and green and social bonds and loans) continues its exponential growth, more than doubling from $769.1 billion for 2020 to $1.689 trillion in 2021, with the largest volume increases in sustainability-linked loans.

The Loan Syndications and Trading Association (LSTA), Loan Market Association (LMA), and Bloomberg charted these trends at a recent conference of loan-market experts on May 11 in New York.

Readers interested in ESG in the finance space will benefit from an understanding of sustainability-linked loan products, both in their principles and in the linguistic details of a credit agreement. According to the Sustainability-Linked Loan Principles (SLL Principles), jointly published by the LMA, LSTA, and Asia Pacific Loan Market Association (APLMA), "[t]he sustainability-linked loan product enables lenders to incentivize the sustainability performance of the borrower."

Lenders are heavily marketing sustainability banking solutions to institutional investors and borrowers. Institutional investors who wish to support companies focused on ESG are seeking products to combine with evolving ESG-related due diligence and investing strategies. As a result, banks are looking to facilitate those investments through bond and loan markets. Banks also want to find ways to help borrowers showcase their commitment to ESG initiatives, and loan market participants are using the tool of SLLs with increasing frequency to fulfill that objective.

Ford Motor Company's publicly available SLL from fall 2021 serves as a useful example of how these principles are installed deep in the verbose plumbing of a corporate credit agreement.

While the SLL Principles cover this framework in more detail, in essence, a borrower and its lenders select meaningful key-performance indicators (KPIs) of an E, S or G variety, and then they set sustainability performance targets (SPTs) tied to those indicators. If the borrower achieves or exceeds its SPTs, it is typically rewarded with lower interest and fees. If the borrower falls short of the SPTs or some minimum threshold, it can be penalized with higher interest and fees.

The loan's proceeds are used for general corporate purposes, which distinguishes SLLs from green or social loans and bonds that specifically finance certified green or social projects. As a result, SLLs signal a borrower's commitment to sustainability by

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

establishing ambitious SPTs for the overall business without a requirement to earmark proceeds for specific purposes.

Ford Motor Company's (Ford's) publicly available SLL from fall 2021 serves as a useful example of how these principles are installed deep in the verbose plumbing of a corporate credit agreement. On Sept. 29, 2021, Ford updated and publicly announced its $13.5 billion corporate credit facility and $2 billion supplemental revolving credit facility to link the amount of interest and fees that Ford is required to pay to three sustainability KPIs:

(1) **Global manufacturing facility greenhouse gas emissions**. These are the total annual emissions of CO_2 in million metric tons from (a) stationary and mobile sources at Ford's global manufacturing facilities (known as "Scope 1" emissions) and (b) the generation of electricity, heating, cooling, and steam that is used, but not generated, at these facilities (known as "Scope 2" emissions).

(2) **Renewable electricity consumption**. This means locally or regionally sourced renewable electricity — such as wind, solar or hydro power — consumed by Ford's facilities, either directly or through the local distribution utility and expressed in kilowatt hours (kWh).

(3) **CO_2 tailpipe emissions for Ford's European fleet of passenger vehicles**. This means the average tailpipe emissions of Ford's European fleet of passenger vehicles first registered in the year of measurement, expressed in grams of CO_2 per kilometer (g/km).

Ford can be penalized or rewarded with higher or lower interest and fees depending on its KPI performance. Ford can even overperform its targets and further reduce its interest and fees as a bonus — a true incentive model. In general, pricing adjustments tend to range from 5 to 25 basis points (0.05%-0.25%), with the SLL market in the United States on the lower end of the range and the SLL market in Europe on the upper end of the range.

In its financial reporting to its lenders, Ford must submit a "sustainability pricing certificate" each year telling its lenders how it performed against its targets. Ford has some time to measure its performance and deliver its certificate: one full year, until Dec. 31, 2022, for 2021; and then 10 months, until Oct. 31, after the end of 2022 and subsequent years.

Ford also is required to engage an auditor to audit its greenhouse gas emissions and renewable electricity metrics and submit that auditor's report with its certificate. Independent, external verification became mandatory under the APLMA/LMA/LSTA's SLL Principles as part of its May 2021 updates, and the APLMA/LMA/LSTA followed up in March 2022 with Guidance for External Reviews.

Ford plans to draw these metrics from its annual integrated sustainability and financial report. For the CO_2 tailpipe-emissions metric, Ford will use the manufacturer error notification that it submits to the European Environmental Agency each year. Ford's interest and fee adjustments for its performance take effect prospectively, five business days after Ford submits its sustainability pricing certificate.

Many other well-known companies are leaning into this trend of sustainability-linked debt. On Nov. 3, 2021, Teva Pharmaceutical Industries Ltd. (Teva), the generic medicines company, issued and publicly announced a $5 billion bond linked to three targets, including a 25% reduction in Scope 1 and Scope 2 greenhouse gas emissions and a 150% increase in access to essential medicines for patients in low- and middle-income countries by the end of 2025.

Teva's use of a social goal (the "S" of ESG) made this bond the first of its kind, and, in its announcement, Teva emphasized that bond would help it expand access to, and accelerate the impact of, its medicines, showing its "commitment to society." Teva provides its sustainability-linked bond framework and second-party opinion on its website for public viewing, which is encouraged by the APLMA/LMA/LSTA's principles and guidance.

We know that the use of SLLs is exponentially increasing in the loan market. We know that SLLs add complex legal provisions to credit agreements, requiring precisely defined, bespoke ESG metrics; intricately drafted formulas adjusting the interest rate and fee provisions based on the borrower's performance; and added sustainability reporting and auditing. We know that SLLs are designed to help incentivize a borrower to achieve or even exceed its sustainability goals.

Time will tell if these economic incentives drive actual ESG results. Goal setting through objectives and key results, or OKRs for short, as described in John Doerr's book "Measure What Matters" (2017), is a tried-and-true approach that has helped many companies and their teams achieve ambitious goals over the years.

Writing down goals, making targets measurable, and honestly assessing performance on a regular basis has a way of driving results. Given this general truth, we believe that embedding these goals in credit agreements and bond indentures can be a powerful way for a borrower to commit itself — and legally bind itself — to work to achieve its ESG goals, and we are excited to continue to participate in these collaborative efforts with borrowers, lenders, and other loan-market participants and to continue to monitor the impact of these efforts.

John Hreno, a partner at the firm, contributed to this article.

Elizabeth Goldberg is a regular contributing columnist on ESG and investing for Reuters Legal News and Westlaw Today.

©2022 Thomson Reuters

About the authors

Andrew T. Budreika (L) is a partner at **Morgan, Lewis & Bockius LLP** and serves as legal counsel and trusted advisor across a broad spectrum of banking, credit, and capital markets transactions on all levels of a company's capital structure. He advises public companies, private equity sponsors and venture capital firms, portfolio and other privately held companies, and joint ventures on debt financings, mergers and acquisitions, strategic investments, and other corporate and financing transactions. He is resident in the firm's Philadelphia office and can be reached at andrew.budreika@morganlewis.com. **Benjamin Stango** (C), an associate at the firm, guides clients through debt financings, mergers and acquisitions, strategic investments, and other corporate and financing transactions. He is a lead associate in the firm's borrower finance practice, supporting borrowers across a broad spectrum of banking, credit and capital markets transactions. He is resident in the firm's Philadelphia office and can be reached at benjamin.stango@morganlewis.com. **Elizabeth Goldberg** (R), a partner at the firm, advises employee benefit plan sponsors and service providers to those plans (including financial service firms) on ERISA U.S. Department of Labor (DOL) enforcement investigations, DOL ERISA regulatory matters, and ERISA fiduciary counseling and compliance. She is a key member of the firm's environmental, social, and governance (ESG) and sustainability team. She is resident in the Pittsburgh office and can be reached at elizabeth.goldberg@morganlewis.com.

This article was first published on Reuters Legal News and Westlaw Today on June 10, 2022.

© 2022 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.