Baker McKenzie.

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GREEN BONDS - GROWTH & CHALLENGES IN THE 144A MARKET

Global Green Bond issuance in 2019 is projected to hit U.S.$200 billion. However, the issuance of Green Bonds in and into the U.S. under Rule 144A has not taken off. This newsletter considers some possible causes and offers a few suggestions. This newsletter supplements an article on Green Bonds published last week by the International Financial Law Review (IFLR) written by our colleagues Michael Doran and James Tanner available here.

What is a Green Bond?

While there is no one global standard as to what makes a bond a "Green Bond", the most established and commonly used set of criteria is that set out in the International Capital Market Association ("ICMA") Green Bond Principles ("GBPs"), which describe the product as follows:

Green Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects and which are aligned with the four core components of the GBPs.

A "Green Project", as defined in ICMA's GBPs, is a project with an environmental objective such as climate change mitigation or adaptation, environmental conservation or pollution prevention and control. The four core principles are: (i) use of proceeds, (ii) process of project evaluation and selection, (iii) management of proceeds and (iv) reporting. All four of these components are required for the characterization as a "Green Bond", but the key element is the underlying Green Project.

The label of Green Bond carries certain benefits, such as encouraging certain ESG focused investors to buy the bonds and the public relations benefits and opportunities of being seen to be aligned with sustainability (although to date there is scant evidence of any pricing benefit (or "green bond premium" or "greenium") for issuers). Such benefits are, however, accompanied by certain responsibilities and potential costs for Green Bond issuers, including (i) a high level of transparency and third party review at issuance and over the life of the bond (which, while not conferring directs rights are required if the issuer is to follow best practices for Green Bonds and non-compliance may result in reputational costs); and (ii) challenges arising from different market participants having different criteria for evaluating and addressing sustainability, as well as different rules and regulations between jurisdictions that pose additional standards and create potential liability for issuers (for example, Green Bonds are typically included in the Climate Bonds Initiative ("CBI") database, but the CBI employs additional criteria and, in limited cases, has rejected bonds from database inclusion that have otherwise met the GBPs and been approved by third party reviewers).

Growth of the Market

As investors and corporations embrace ESG considerations, Green Bonds have gained momentum as a source of funding and are now one of the capital markets' fastest growing segments. Many "green" renewable energy companies, sovereigns, supranationals and "brown" corporate issuers are seeking to transition some or all of their business to "green" operations as their stakeholders are holding them more accountable for their environmental footprint. Sustainability considerations have contributed to the increase of Green Bond issuances in a number of sectors, including in particular transportation (auto, airline and shipping) and natural resources (oil & gas, chemicals, mining & metals and renewable energy).

Global Green Bond issuance in 2019 is projected to hit U.S.$200 billion (up from approximately U.S.$170 billion in 2018). Green features have also expanded across the asset class of traditional corporate bonds to project bonds, asset-backed bonds and covered bonds, with 2018 witnessing the first green commercial paper programme. With the Paris Agreement and United Nations Sustainable Development Goals as the compelling double catalyst, and the United Nations stating that the world needs U.S.$90 trillion in climate investment by 2030 to achieve these, Green Bonds appear to have a very bright future.

However, the U.S. market has lagged significantly behind the rest of the world in the number and volume of Green Bond transactions, despite the world's largest issuer of Green Bonds in most years being Fannie Mae in the U.S. and a significant amount of U.S. municipality bonds being green. According to S&P Global, since 2013, North American non-financial companies have issued only approximately U.S.$19 billion of labelled green debt, far below the EU and other developed economies as a percentage of total debt issued.

This lag reflects two factors. On the sell-side, issuers and their underwriters remain wary of U.S. liability. On the buy-side, U.S. investors have by and large yet to prioritize ESG considerations in the way other investors have.

The 144A Liability Concerns

Offerings of securities into the United States are subject to certain U.S. federal securities and state anti-fraud laws that may create a higher level of liability than an issuance that is conducted solely outside of the U.S. In particular, Rule 10b-5 of the Securities Exchange Act of 1934 provides that an issuer (and potentially other parties to the transaction, including the underwriters and named experts) may be subject to civil liability if the disclosure documents used in connection with the transaction are found "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

Second Opinion Reviews - Diligence and Liability

Green Bonds are initially labeled as such by their issuers who also monitor compliance with ICMA's GBPs themselves and 'self-certify' in the disclosure documents. While self-labeling could lead to abuse, the Green Bond market has devised an oversight mechanism by which an independent third party provides an assessment of the framework and analyses/confirms the eligibility of the bonds under the GBPs. Such review is generally called a "Second Opinion Review" or a "Second Party Opinion" and may be included in the disclosure document connected with the sale of the Green Bonds.

These Second Opinion Reviews have become a cornerstone of Green Bonds offerings outside of the United States, but due to the heightened disclosure and related liability standards in the U.S., may have become an obstacle to offerings into the U.S. The fact that Second Opinion Reviews are included in the offer document means that they are subject to Rule 10b-5 scrutiny and therefore raise liability concerns for the third party providers who are consequentially less willing or unable to provide the proper assurances as to the accuracy of their conclusions. Issuer and underwriter counsel may have reservations about delivering their market-standard "10b-5 disclosure letters" in the context of a Second Opinion Review. They may also be hesitant as a result of related factors, for instance, the fact that sustainability and environmental standards are subject to certain subjective or changing criteria.

Given the critical nature of Second Opinion Reviews, it is worth reconsidering the basis on which they are sought: the point of a Second Opinion Review is not to shift liability to the third party reviewer. It is to assist in the diligence effort undertaken by offer participants. Independent third party due diligence bolsters the due diligence undertaken with respect to the planned and disclosed use of proceeds. As such, the Second Opinion Review is analogous to a number of well-established "third party" procedures that have long been associated with bond offerings in other contexts. Examples include third party Shariah compliance opinions in Islamic finance or "qualified persons/ competent person" reports in mining and oil & gas offerings. While these procedures vary from transaction to transaction, they provide a framework for contractual verification and certification designed to support a due diligence defense in a Green Bond offering. We expect that over time we will see some regulation of Second Opinion providers. While it is too early to say whether the shape of that regulation will be similar to the regulation of credit rating agencies or more like the determinations of "qualified persons/competent persons" under the various agreed standards adopted under regulations impacting extractive industries, in either instance it will benefit the market to clarify the playing field.

Otherwise, market participants should continue to use the approaches that have long been used in Rule 144A bond offerings to ensure disclosure of all material information: robust risk factors, a focus on verifiable fact rather than subjective characterization, and appropriate language in the context of forward looking statements.

Buy-side Incentivization

Despite Green Bonds representing only a small fraction of all bond issuances in recent years, as issuers and investors become more engaged with fast developing ESG considerations we expect that this proportion will grow in coming years. As the Green Bond market evolves and grows, so we believe will the mechanics available to provide investors with some comfort that their investments will remain "green" while imposing appropriate penalties on issuers. To date, no consistent framework has been established that gives investors the protections that the investment will stay 'green'. Michael and James make a number of useful suggestions on improving the product in their IFLR article.

Since this is our Leveraged Finance Newsletter, we think it worth considering technology commonly found in high yield and other debt securities transactions to address some of these concerns. Relevant terms include:

- **Contractual Representations and Warranties, and Indemnification:** Include provisions in the Purchase Agreement that would give rise to a contractual claim for failure to continue to meet the GBPs.
- **Interest Rate Ratchet:** Automatic increases in the interest rate during any period in which the issue does not meet the criteria (similar to Eurobond provisions for a rate increase upon a ratings decline and a strategy used in "sustainability-linked" loans for several years). Enel's recent sustainability-linked bond shows just one of many possible variations.
- **Investor Put:** Allowing the investors to decide whether to not to stay in the issue (similar to a change of control offer or asset sale offer).
- **Issuer Call:** Allowing the issuer to call the Green Bonds if the reason for non-compliance is outside of their control (similar to a tax redemption).
- **Default:** Default trigger requiring repayment of the bonds at par (or even including a "make-whole").

While we believe a default trigger on its own would be too harsh a penalty for Green Bond non-compliance to receive widespread acceptance by issuers, some combination of the above may be appropriate to maintain the balance between issuer flexibility and investor protections.

An interest rate ratchet would likely be the most appropriate remedy, potentially together with the issuer call, in particular if non-compliance were due to events outside of the issuer's control. Similarly, in certain circumstances, a default coupled with an issuer call might be appropriate, but cross-default considerations would need to be evaluated.

All of the above would require robust and consistent post-deal reporting, which is generally felt to be lacking in the market.

These improvements would benefit the market as a whole, but perhaps particularly help improve the lagging U.S. market by providing opportunities for additional upside for investors focused solely on yield.

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