A Guide to ESG Preparedness

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When surveying the finance market landscape over the last couple of years, one thing is certain: ESG has been on the rise. Few topics have trended as hotly in recent memory, and our expectation is that environmental, social and governance dealmaking will only continue to grow in the year to come. Driven by investor advocacy and supported by enhanced outcomes when structured properly, it is increasingly important for fund finance practitioners to be well-versed in ESG. We regularly receive questions on what individuals and organizations need to do to be prepared for the long-term opportunities and challenges that ESG presents. This is your guide to ensure that you and your teams are ready for your first (or next) ESG deal.

Expectations

Before diving into the specifics of ESG preparedness, it's important to recognize the current state of play in our industry. The global pandemic has accelerated the adoption of ESG in fund finance. Market forces are driving the change, as investors and funds shift their focus to greener investments with positive impacts on people and planet. Banks have taken to the cause to book sustainability-linked loans, as industry pressure on reputation, compliance and financial risks grows. Studies have shown that companies that integrate ESG meaningful to their business perform better financially and create more long-term value than firms that don't. Some pundits predict that ESG will soon become part of the fabric of all fund finance deals, with credit facilities incorporating some form of values-based metrics and compliance generally. In an era when funds and banks are seeking to set themselves apart from competition, true ESG preparedness can be a real differentiator.

Evaluation

ESG preparedness in fund finance is about more than merely being able to negotiate key performance indicators (KPIs) or uses of proceeds (UoPs) in a credit agreement. It's about incorporating environmental, social and governance practices into your DNA and the DNA of your organization over time in a way that meaningfully moves the needles toward improved outcomes.

To initiate ESG integration, whether individually or into your team structure, we recommend starting with an evaluation of where you are currently. This assessment can be broken down into the following categories: ESG policy, credit facility documentation, data monitoring and collection, data analysis and literacy, disclosure and reporting, avoidance of sustainability washing and continued readiness by monitoring trends. You can incorporate additional items or swap out any inapplicable elements based on your or your organization's values and directives.

For proper evaluation, assess what factors you would need to enhance your capabilities in each category. For each domain, this would begin by considering what it will take to achieve basic results, such as putting an ESG policy in place, having a working knowledge of the pricing mechanics in ESG facilities or implementing procedures for data reporting and analysis. It could also include tangential components that broadly impact ESG competence, like investing in sustainability training, technology solutions, hiring subject-matter experts and related risk management. Seek open dialogue and honest input from others in your organization to appropriately appraise your present proficiencies.

By benchmarking to your current status on these various items, you'll determine existing strengths and weaknesses, and key areas for improvement. This can aid in goal-setting across ESG preparedness factors. We then suggest developing a timeline for periodic reevaluation of your progress. Initially, you might reassess monthly or quarterly. Once you discern sufficient strides toward your ESG targets, moving to a less frequent review could make sense.

After you've established the baseline of your ESG know-how, you're ready to develop your ESG preparedness in earnest. To do so, we recommend below a number of tools and practices to have all of your ESG bases covered.

Policy

Policy guides practice. As such, we suggest starting with a deep assessment of your values and objectives to craft policy that informs decision-making. This can be a living document that evolves over time. Good ESG policy should consider your approach to identifying and administering ESG matters and the standards you'll use to quantify them.

Great ESG policy is shaped by your overall strategy to drive value creation and risk mitigation in a way that can be integrated in your daily routines. You may want to formally adopt a set of published ESG industry standards and actively participate in pushing for ESG adoption in fund finance. You'll want to routinely review your ESG policy with key stakeholders to ensure that it lives up to your mission and standards.

To pivot from policy to practice, you should implement systems that operationalize your policy. ESG-focused hiring, training and technology can help. If implementing it in your organization, determine who has ownership of ESG oversight and accountability. Look for opportunities to not only do ESG-linked financing deals, but also for you and your constituents to engage with others in the fund finance market on sustainability and green issues.

Facility Documentation

Without a rock-solid knowledge of how to document ESG in fund finance facilities, you won't be playing with a full deck of cards. A good place to start would be our prior articles: **ESG Loans – The Next Big Wave in Fund Finance**, **Top 10 Items to Consider When Structuring Your ESG Facility** and **The ABCs of ESG**. Each provides tips, tricks and tactics that are immediately actionable for your next ESG deal.

As a basic primer, the LSTA, LMA and APLMA have published Sustainability Linked Loan Principles (SLLP) and Green Loan Principles (GLP) that will assist in your structuring of ESG deals. Depending on the aims of the fund and its ESG capabilities, the parties may use KPIs or UoPs as the fundamental factors underpinning the ESG methodologies in a credit facility. The basic mechanism in our transactions is a pricing toggle. After the borrower and lender set KPIs or UoPs, the applicable margin for pricing the loans is adjusted downward, upward or both. Recently, we're seeing a move to a two-way ratchet, which gives both parties skin in the game depending on whether the fund hits its preselected ESG targets.

The specifics of each deal will depend on the ESG philosophy and strategy of the borrower and the lender. The policy considerations listed above will influence those. But every ESG-based fund finance facility will require some form of monitoring, data literacy, reporting, regulatory guidance and sustainability-washing prevention. Our ESG preparedness suggestions for those are highlighted below.

Data Collection

Data collection begins with investment due diligence. The fund will want to ensure its chosen portfolio aligns with its ESG edicts under the credit facility. It will also want information to be collected via means that ease communication of the data to the lender. The sponsor may conduct its initial review via a third-party service provider, with a focus on maintaining compliance and mitigating any associated risks of the investments. To enhance its data collection, the fund should either be intricately involved in this process or, better yet, lead the upfront ESG due diligence. Data inputs should include what opportunities the investment elicits for value creation, material impact on selected goals and long-term sustainability. Data collection considerations may be included in investment committee or credit committee criteria.

Data collection also includes ongoing information-gathering over the course of managing each investment. Rather than being solely reactive to issues that arise, proper ESG monitoring requires systematic processes from investment inception to sale. Quarterly, semiannual and annual reviews by the fund can coincide with reporting under the credit agreement, with KPI or UoP compliance being the cornerstone of the diligence. To collaborate on this, the borrower and the lender might think about preparing a due diligence matrix or questionnaire that provides the framework for continued data calibration.

Data Analysis

Data collection begets data analysis. The borrower and the lender should each develop capabilities and methodologies for quantifying and assessing data. The critical component is materiality. The evaluator needs to understand which ESG risks are relevant to the fund's sector and to its global operations. This materiality assessment should uncover the issues that are most central to the KPI or UoP outcomes.

Data analysis should also be tailored toward the borrower's and the lender's respective risk appetites. If using KPIs, the data analysis should include both quantitative and qualitative metrics, where applicable. These may comprise statistical and regression analysis to understand the strength of the relationship between ESG variables, as well as predictive models of future success. If using UoPs, the data analysis is much simpler, as the rubric is merely tied to whether loan proceeds were used for ESG investments.

Disclosure

Disclosure is also part of fund finance ESG's core. It first flows from data collection and analysis. With KPIs, at minimum, this will include basic reports of whether the fund met its measured targets and be delivered with the fund's quarterly financial statements. Better KPI disclosure combines quantifiable measurements with narratives, examples and case studies of investment success, including linkage to the borrower's chosen ESG policies and principles. With UoPs, reporting should occur with each borrowing if the related investments are then known, or once the use is certain if that's at a time subsequent to the loan. In negotiating the credit facility, it can be helpful for the borrower and the lender to settle on exactly what information should be provided in the compliance certificate.

Disclosure should also encompass incident reporting for any unusual or deleterious events. This will be required for KPI or UoP breaches. Outside such breaches, reporting of other circumstances that are materially adverse to the fund's ESG protocols can foster open communication and transparency between the parties. The borrower and lender can discuss at the outset of the facility what types of incidents may rise to this level. When disclosing these occurrences, the borrower can not only detail the event, but also explain how the situation is being resolved and what the fund plans to reduce repetition in the future.

Regulatory

As well-detailed in the **ESG: Regulatory Reform on the Horizon?** article by our colleague Katie McShane, Europe is now subject to an ESG regulatory regime, the Sustainable Finance Disclosure Regulation (SFDR). Fund finance practitioners located in or that do deals in Europe will want to learn the inner workings of SFDR to prevent any violations. There are no equivalent statutes or rules in the United States or Asia yet. It's left to be seen if and when any governmental reforms will be coming.

Sustainability Washing

The other side of the ESG coin is protecting against sustainability washing (also known as "greenwashing"). This can occur when a market participant exaggerates its ESG claims or provides inaccurate or misleading information. It can be implicitly encouraged if a lender does not insist on adequately ambitious and meaningful ESG goals by the fund. While noncompliance with ESG covenants and failure to meet sustainability goals can lead to unfavorable outcomes under the credit facility, greenwashing poses reputational risk that would be far worse. Moreover, if sustainability washing were to grow, it could pose an existential threat to the advancement of ESG in fund finance.

To avoid greenwashing, KPIs and UoPs that are material to the fund's business and meaningful to its mission should be selected and tightly overseen. By following the above guidelines on policy setting, data analytics, reporting and regulatory compliance, the parties can further ring-fence ESG in their deals from sustainability washing.

Trends

With online information at our fingertips, there is no excuse today for being ESG-naive. The LSTA, LMA and APLMA regularly publish updates on the evolution of ESG loans. ILPA has developed a framework and roadmap to advocate ongoing ESG initiatives between LPs and GPs. The UN's Sustainable Development Goals are intended to be reached by 2030. Government entities and other industry working groups are proactively promoting sustainability causes.

To be truly ESG-prepared, it is imperative to watch for related trends. We recommend attending fund finance roundtables, listening to industry podcasts, and participating in trade groups to stay apprised of the latest and greatest. Of course, we'll be keeping our pulse on ESG developments so we can bring them to you in our *Fund Finance Friday* pages.

Conclusion

Whether you're just starting your path on sustainability in fund finance or you're a seasoned player in the ESG space, preparedness will enhance your ability to increase value and drive long-term, socially beneficial results. By using the above as your guide, you'll be prepared to influence ESG as we enter the next phase of sustainability growth in our industry.

LP Givebacks Anyone?

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This article follows the considerations set out in Chad Stackhouse's *Fund Finance Friday* article, "Getting It Right: Recallable Capital Provisions," published on 9 July 2021.

LP Givebacks

We agree that almost all long-form partnership agreements (and the ILPA Model Limited Partnership Agreements) include a "return of distributions" provision, whereby limited partners are required to contribute capital to the partnership to cover obligations of the partnership out of distributions previously made by the partnership (the "LP Giveback"). The LP Givebacks are heavily negotiated between sponsors and seed investors and usually limited by cut-off times and/or percentage amounts of distributions or commitments. The general partner of the partnership may only exercise its right to "clawback" distributions from the limited partners under the LP Giveback where the partnership agreement explicitly authorises the general partner to do so.

LP Giveback provisions in partnership agreements can cover different things. In some cases, the limited partners' obligations to contribute capital to the partnership as an LP Giveback is limited to fund the indemnity obligations of the partnership, whilst in other cases, the obligations are broader and the limited partners are required to fund any liability of the partnership, including indebtedness (the "Liability"). Naturally, the general partner may only operate the LP Giveback provisions where the uncalled capital commitments of the limited partners (the "Uncalled Capital Commitments") are exhausted. The contractual obligation of the limited partners to contribute capital to the partnership under the LP Giveback provisions is distinct from the obligation to fund Uncalled Capital Commitments. Indeed, some partnership agreements expressly establish that amounts contributed by limited partners as LP Givebacks are not treated as capital contributions.

Recallable Capital

We must distinguish LP Givebacks from recallable commitments. For the purpose of this article, recallable commitments means the unused capital contributions of the limited partners returned to them by the general partner and the recycled distributions of the partnership which are liquidity proceeds of realised investments distributed to the limited partners with a provision that they could be recalled later (the "Recallable Capital"). Recallable Capital, once it is returned to the limited partners, is added back to the limited partners' uncalled capital commitments, thus increasing the Uncalled Capital Commitments. As set out above, the obligations of the limited partners to inject capital to fund Liabilities as an LP Giveback would not increase (nor, if paid, discharge) their Uncalled Capital Commitments.

Security considerations

Lenders of capital call financing (the "Facility") lend against the Uncalled Capital Commitments of the limited partners. Most partnership agreements describe the Uncalled Capital Commitments of the limited partners as the capital commitments which are available to be called by the general partner, including capital commitments that have never been contributed to the partnership, as well as returned or recallable capital commitments. From this definition, it is clear that Recallable Capital is part of the Uncalled Capital Commitments.

In order to secure the obligations of the partnership under the Facility, a security interest (usually by way of an assignment) is created over the general partner's right to call Uncalled Capital Commitments from the limited partners of the partnership. Most security assignment agreements fail to create security over the general partner's right to demand capital contributions from the limited partners beyond the Uncalled Capital Commitments. As Uncalled Capital Commitments decline during the life of the Facility, lenders may wish to consider requesting the general partner to grant a security interest over its right to demand funds from the limited partners under LP Givebacks (and in *Shaw v Lighthousexpress Ltd* [2010] EWCA Civ 161, the English Court of Appeal concluded that indemnities are freely assignable). If under the partnership agreement the limited partners are required to provide capital to the partnership as an LP Giveback in order to fund Liabilities of the partnership (including its obligations under the Facility), lenders may wish to be in a position to request the injection of capital under the LP Giveback provisions to fund the Liabilities of the partnership under the Facility once the Uncalled Capital Commitments are exhausted. The fact that LP Givebacks are not part of the borrowing base of the Facility should not necessarily mean that the LP Givebacks are excluded from the collateral package. Lenders would, of course, prefer to be overcollateralised for typical reasons that are beyond the scope of this article.

Practical considerations

Most partnership agreements do not expressly envisage the creation of a security interest over the general partner's right to demand the limited partners to fund LP Givebacks. Silence does not necessarily mean that this is impossible; however, close review of the relevant provisions of the partnership agreement will be required for the smooth implementation of a security package over the right to demand LP Givebacks. In order to avoid uncertainty of interpretation (and create a potential misalignment between the commercial interests of partners of the partnership), the partnership agreement should expressly stipulate the possibility of the general partner creating a security interest over its rights to demand the funding of the LP Givebacks, with associated mechanics such as provisions around demand notices, if that is the commercial intention. The wording can be carefully crafted to ensure that such security interest could only be granted in favour of a fund finance lender, and other provisions of the partnership agreement should also be adjusted to support this. For example, wording around limited partners honouring the demand of the lender to fund LP Givebacks without any set-off or defences would be expanded, as would certain third-party rights provisions in favour of the lender. It is also worth highlighting that LP Givebacks invariably are time-limited by applicable cut-off dates (perhaps by reference to the date of a prior distribution), thus security may be of critical importance where speed of enforcement is essential.

Fund formation and finance lawyers should be attuned to these considerations as the market moves on with pace.

FFA Call for Award Nominations

November 12, 2021 | Issue No. 152

FUND FINANCE association

INDUSTRY AWARDS

The FFA opened nominations earlier this week for its prestigious annual Industry Awards. These awards include the Diversity in Fund Finance Association Award, the Annual Contribution to the Industry Award, the Julian Black Lifetime Contribution to the Industry Award, the Dee Dee Sklar Women in Fund Finance Award, and the Next Gen Member of the Year Award. To learn more about the selection criteria for each award, read about past recipients and submit nominations, please click **here**. The nominations will remain open until December 31.

Fund Finance 2021 PLI Program

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Register now for Fund Finance 2021. This half-day program features a discussion of the latest trends and developments in fund finance. Learn about current developments in subscription, hybrid, and NAV facilities, as well as how insurance companies are transforming fund finance. Available November 17 in-person and online. **Click here** for program schedule, CLE credit details and registration.

Private Equity Law Report on Preparing for LIBOR Transition

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With the end of LIBOR approaching, most lenders will use a new, non-LIBOR benchmark for any loans issued between now and the last day of the year. In this part one of a two-part article, the *Private Equity Law Report* spoke to three lender-side counsel – including Cadwalader's Mike Mascia and Jeff Nagle – and four borrower-side counsel about what the end-of-year deadline means and the state of readiness in the PE subscription facility space. To access the subscription-required article, **click here**.

5 Minutes with… Rory Smith, Founder of Brickfield

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The Drawdown published an article earlier this week titled, “5 minutes with … Rory Smith, Brickfield,” in which Smith, the founder of Brickfield Recruitment, discusses his journey into fund finance and why it is such a special market to work in. The subscription-required article is available **here**.

Fund Finance Hiring

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Fund Finance Hiring

Truist has an opening for an Associate in its Asset Securitization Group. The recruit would support the origination, underwriting and portfolio management efforts of the Subscription Finance team. The position is based in Atlanta, and requires a minimum of two years of experience. Contact **John Malone** for further information.