September 28, 2021

RESPONSIBLE INVESTING

# ESG-Linked Fund Finance: Distinctions From Typical Subscription Facilities and Trends in Adoption (Part One of Two)

By Helen Kim, *Private Equity Law Report*

As interest in environmental, social and governance (ESG) investing grows, PE market participants are seeking different ways to incorporate ESG principles and criteria into various aspects of fund formation and operation. One trend that has started to blossom in the U.S. involves attaching ESG targets to financing facilities for private funds, allowing sponsors and lenders to further their respective ESG goals while also affording sponsors rate discounts on their subscription credit facilities.

To explore that development, the Private Equity Law Report spoke to lawyers who worked on two of the most prominent ESG-linked credit facilities in the U.S. to date:

- the one for KKR's $1.3-billion Global Impact Fund, which invests in lower mid-market companies contributing to meeting the United Nations' Sustainable Development Goals (KKR Facility); and
- The Carlyle Group's $4.1-billion ESG-linked credit facility (Carlyle Facility).

This first article in a two-part series describes the trend and delves into the characteristics of ESG-linked fund financing that differ from traditional fund financing, including the pricing benefits and use of ESG metrics. The second article will review the two most common approaches – performance-based and use-of-proceeds facilities – and the challenges that fund counsel may encounter when using them.

See "The Convergence of ESG Regulatory Alignment and Corporate Responsibilities in the U.S. (Part One of Two)" (May 25, 2021).

## A Nascent Trend

ESG-linked facilities (also known as ESG-linked loans, sustainability-linked loans or sustainability facilities) have begun to crop up in the U.S. fund financing markets lately. "We started getting calls about ESG-linked facilities in the summer of 2020, and the pace quickly accelerated," recalled Cadwalader partner Wesley A. Misson, who led the team that advised Bank of America for the Carlyle Facility.

Interest is strong from both borrowers and lenders. "Sponsors are definitely raising the issue at the term sheet stage for new deals. They are asking questions about how they can potentially include ESG in the facility," observed Simpson Thacher partner Julia Kohen, who worked on the KKR Facility. "Most institutional banks are very open to the idea of ESG-related financing in the U.S.," added

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Latham & Watkins partner Manu Gayatrinath, who led the finance team that advised Carlyle for the Carlyle Facility.

Although both parties are interested in the facilities, experts agreed that private fund LPs are largely driving the trend. Societal shifts in 2020 naturally led to money flowing into ESG strategies, Misson opined. "Fund managers are pivoting to align strategies to meet investor desires, so many ESG and impact funds are coming online this year and over the next few years," he said. "That will create a huge demand for lenders in our space."

See "Survey Gauges Global Trends in Impact Investing, Anticipates Continued Growth Despite Pandemic" (Sep. 15, 2020).

## Differences From Typical Credit Facilities

Although the tenor and size of ESG-linked facilities are similar to traditional facilities, they differ in a few material ways. First, an ESG-linked facility is driven in part by the desire for social change. "An ESG facility is not just another subscription facility," Misson said. "It's about the parties working together to achieve the greater good and a more sustainable future."

In addition, many – but not all – ESG facilities feature a pricing benefit if the borrower meets its targets. Reporting obligations are also specific to the ESG targets set, and third-party verification is common. Finally, both sponsors and lenders need to use ESG specialists to set the targets and review reporting.

See our three-part series: "Subscription Facilities Provide Funds With Needed Liquidity But Require Advance Planning by Managers" (Jun. 2, 2016); "Financing Facilities Offer Private Funds and Managers Greater Flexibility" (Jun. 9, 2016); and "Operational Challenges for Private Fund Managers Considering Subscription Credit and Other Financing Facilities" (Jun. 16, 2016).

### Mission-Driven

Although the economic benefit to the borrower of meeting its ESG metrics is helpful, experts agreed it is not the primary driver behind ESG fund financing. "The bigger incentive is reputational," Kohen said. "If the borrower does not meet its metrics, it will need to disclose and explain that failure to its investors. For an ESG-focused fund, that's a significant issue."

ESG-linked facilities act as a kind of accountability method for borrowers, Gayatrinath mused. "The step-down is the benefit the borrower receives from a pure numbers perspective, but the overarching benefit is ensuring the fund meets the social and environmental priorities it has developed. Institutions like to have accountability to meet those kinds of goals, and ESG-linked financing serves that purpose."

### Pricing Benefit

ESG facilities can be structured without a pricing adjustment, even if the borrower achieves the key performance indicators (KPIs) or targets. It is more common, however, to see some kind of adjustment – usually a reduction, Misson said. "The rationale is that the lender is incentivizing the borrower to promote meaningful change and actually try to achieve the targets." The pricing adjustment varies greatly but typically falls between 2.5-25 basis points, he added.

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The facility could also be structured with a toggle up and down, so the rate increases if the borrower does not achieve the target, although that is relatively uncommon. "There can be some facilities where the borrower's rate starts in the middle," added Latham & Watkins partner Benjamin Berman. "If the borrower hits its targets, it receives the lower pricing. If the borrower misses, its pricing actually increases."

In some cases, instead of having a pricing adjustment or any economic incentive, the parties can donate money to a charity or cause associated with the overall goal, Misson noted.

## ESG Metrics and KPIs

Typically, financing terms require the borrower to establish certain internal policies and attain specified metrics, but ESG facilities "flip that on its head," Gayatrinath noted. "Borrowers are already building out tracking mechanisms and focusing on ESG metrics and goals, which winds up being translated into terms in the credit facility."

KPIs and targets should align with the ESG policies of the manager and the strategy of the fund, Misson confirmed. Accordingly, they vary dramatically.

See "ILPA Subscription Credit Facilities Guidance: Reiterating the Need for Increased Disclosures on the Use of Facilities and LP Obligations (Part One of Two)" (Aug. 25, 2020).

### Establishing KPIs

Experts agreed that negotiation of ESG facilities is generally collaborative. "Banks are open minded about what the KPIs and indicators can be," Gayatrinath observed. "They are willing to talk through what is possible and how to craft documents around what the fund is already doing internally, but it needs to be a target that takes some effort to be achieved and has a measurable outcome."

Parties should focus less on the quantity of KPIs and more on how meaningful the goals are, Misson recommended. "There are times when putting together KPIs or other structuring components of the deal when people can lose sight of the fact that we are trying to work toward achieving something ambitious and positive: a change that aligns with the borrower's policy and broader societal goals."

For more on impact measurement, see "Tactics for Incorporating Impact Investing Principles Into Private Fund Terms, Structures and Compensation" (May 25, 2021).

Sponsors, not banks, should be spearheading the development of meaningful KPIs, Kohen suggested "Metrics and goals need to come from the top down within the fund, as opposed to being pitched by the bank."

### Consequences of Failing to Meet Targets

A periodic review of KPIs is advisable because it may be challenging to sustain alignment with a longer-term facility. "Many facilities provide flexibility in terms of revising KPIs," Misson continued. Unfortunately, sometimes the goal set out at inception may become unattainable. "If the goals are no longer achievable, for example, the parties can come together and mutually agree to reset KPIs to something that will achieve the intent."

See "SEC Officials Clarify the Commission's Stance on ESG Investing and the Role of Disclosure" (Aug. 11, 2020).

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If a borrower still fails to meet KPIs or other performance indicators despite that flexibility, it is important to note that is not usually an event of default (EOD). "Lenders want to incentivize the borrower," Misson explained. "If the borrower knows there will be an EOD for failure to achieve the goals, it may not set goals that are ambitious. Rather, it may set goals it knows it can achieve."

Instead of an EOD, failure to achieve KPIs may result in a pricing adjustment. Most often, satisfaction of the target results in a pricing reduction. Some facilities respond to a failure to achieve KPIs with a pricing increase. If the borrower initially achieved its goals but then failed to do so in subsequent periods, the pricing could reset itself to the original deal pricing.

If the borrower fails to meet KPIs for an extended period of time, the deal should be restructured or "the facility could remove its ESG label," Misson commented. "That is certainly what should happen if the parties are no longer working in good faith toward an achievable, sustainable goal."

Losing the ESG label on a funding facility can have a reputational impact, Kohen pointed out. "Among the reasons why banks are participating in ESG facilities – and why they are becoming more popular – is that they can be a powerful marketing tool for both the sponsor and the bank to demonstrate their dedication to ESG."

## Tracking and Reporting

Tracking and reporting requirements for an ESG-linked facility are generally more onerous than for a traditional financing facility, but typically, the fund already has a reporting structure and policy in place to meet investor demands and its own internal ESG policies, Misson said. The fund may also already have its own third-party ESG reporting vendor or verification party.

Typically, the borrower submits the same reporting to its lenders that it provides to its investors. "Usually the lenders ask to get the same reporting that the investors get," Misson said. Upon receipt of the reporting prepared by the borrower, the bank will evaluate it against the minimum standards under the guidance and to ensure it satisfies the bank's internal ESG standards and credit and risk policies.

As there is no globally accepted methodology for reporting on targets, parties may renegotiate how often the borrower should report; what details the report should include; and whether internal or external parties will track metrics and assess the results.

See "Emerging Trends in LP Demands for Standardized ESG Reporting and How GPs Have Attempted to Comply" (Jul. 20, 2021).

## ESG Coordinator

Typically the lead bank's internal ESG coordinator (sometimes called the ESG agent, or sustainability agent or coordinator) leads the structuring and negotiation of the terms, structure and KPIs with the borrower, Misson said. The ESG coordinator may also take a role in monitoring performance; engaging with external reviewers; and communicating with the borrower and the lender group about verifying the targets.

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The ESG coordinator is also responsible for communicating the details to other lenders on the deal to approve or disapprove, Misson elaborated. "In most cases, the syndicate banks offer comments around certain technical matters or reporting matters, but the integrity of the initial agreement typically holds. A lot of care goes into the process, so there are few objections."

# Future Trends

## Enactment Across the Industry

Experts agreed that linking ESG to fund financing will continue to grow as a trend. "We are going to see a lot more demand. The number of sustainability-linked facilities in the U.S. will probably double by the end of 2021, and that will roll right into 2022 and beyond," Misson predicted. "As funds become more socially conscious, we will see more ESG financings because the funds will be tracking ESG metrics internally anyway," Gayatrinath added.

Some experts suggested that as the ESG movement matures, ESG metrics might become standard in fund financing. "There may be a point where there will be no distinction between ESG investing and traditional investing," Misson said. "Once an ESG metric is incorporated into one facility for a borrower, it's unlikely to be removed from future facilities. It may just continue to be part of the structure for fund financings, going forward," Berman mused.

Further, as social and environmental consciousness overall continues to increase, so does the interest in finding ways to incorporate ESG goals into business settings. "Making sure that business partners are focused on ESG aspects of the business and doing their parts is becoming increasingly important," Gayatrinath observed. "PE sponsors, companies and banks are all taking note of that and putting ESG goals in place for themselves. ESG fund financing keeps borrowers accountable in addition to helping from a numbers perspective."

## Adoption by Sponsor Type

At first, the trend may remain more prevalent among larger institutional funds. "These aren't the kind of facilities you can set up two weeks before closing by putting some ESG metrics in," Berman clarified. "It definitely takes some thought and a lot of time for the funds themselves to develop their priorities in this area."

Larger funds have internal ESG teams that can develop the KPIs and targets necessary for setting up ESG-linked facilities. "The bigger players have been thinking about those issues for a number of years and are now really starting to implement their strategies," said Berman, who worked on the Carlyle Facility.

Increasingly, mid-market managers are also responding to investor demands and establishing internal ESG policies, with outside help from consultants or lawyers if an internal ESG team is infeasible. "As more ESG facilities are put into place and more metrics are available, they will probably trickle down to the smaller funds," Berman speculated.

See our two-part series on the SEC's ESG risk alert: "Why the SEC Distinguishes ESG From Other Strategies and How to Prepare for a Potential Exam" (Jun. 8, 2021); and "Inadequate Controls, Policies and Procedures Concern SEC About ESG Practices Inconsistent With Disclosures" (Jun. 15, 2021).

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October 5, 2021

RESPONSIBLE INVESTING

# ESG-Linked Fund Finance: Two Most Prevalent Structures and Challenges With Use (Part Two of Two)

By Helen Kim, *Private Equity Law Report*

Subscription credit facilities have become a standard part of the PE landscape, with little in the way of contention after years of market participants working out terms. With the intense interest and focus on environmental, social and governance (ESG) principles, however, lenders and borrowers have begun to incorporate ESG targets and metrics into facilities, partly to demonstrate their commitment to ESG goals. The result is that the industry has adopted two types of approaches – performance-based and use-of-proceeds – that each weaves ESG into the subscription facility framework.

This second article in a two-part series describes the two main facility structures currently in use and certain challenges with linking ESG targets to financing, such as the difficulty of putting an internal ESG program in place and avoiding abuse through greenwashing. The first article outlined the trend generally and how ESG-linked fund financing differs from traditional fund financing, including the role of an ESG coordinator in the negotiation process and requirement of tracking ESG performance.

For more on alternative financing facilities, see "How Management Company Facilities Offer Liquidity for Sponsors' Working Capital Needs" (Apr. 28, 2020); "Streamlined Borrowings and Longer Loan Durations With Hybrid Facilities" (Mar. 3, 2020); and "How GP and Co-Investment Facilities Increase Sponsors' 'Skin in the Game'" (Feb. 11, 2020).

## Two Types of Financing Structures

The two ways in which ESG-linked facilities are currently being structured are use-of-proceeds and performance-based facilities. "The market is still in the very early stages," noted Cadwalader partner Wesley A. Misson, who led the team that advised Bank of America on the Carlyle Group's $4.1-billion ESG-linked credit facility that closed in February 2021 (Carlyle Facility). "In terms of what's being done today, however, those are the two ways of structuring financing with ESG components."

Both types of structures have similar tenors to typical subscription lines, falling between one and three years on average, according to Misson. For both structures, tracking and reporting on key performance indicators (KPIs) are key obligations.

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## Use-of-Proceeds ESG-Linked Facilities

Use-of-proceeds facilities require the borrower to use all loan proceeds for investments that qualify under agreed ESG criteria. "The main focus is whether the loan proceeds are going to be used to make ESG-qualified investments," explained Simpson Thacher partner Julia Kohen, who worked on the revolving credit facility for KKR's $1.3-billion Global Impact Fund, which closed in June 2020 and featured the first use-of-proceeds ESG facility in the U.S.

"The key takeaway is that the manager needs to make sure the asset class and investment strategy of the borrower sync with the agreed use of the loan proceeds," Misson agreed. "Otherwise, the facility simply does not work."

### For ESG Funds Only?

Use-of-proceeds facilities are often used for funds aimed at a specific ESG goal, such as clean energy, renewable energy or climate change. "A use-of-proceeds facility lends itself naturally to an ESG-focused fund because the purpose of the fund and the nature of the investments are already linked to ESG," Kohen noted. "It would be very difficult to set up a use-of-proceeds ESG facility for a non-ESG fund."

A use-of-proceeds facility could potentially be used for a fund that is not solely focused on one ESG asset class if it were tranched, Misson commented. "A fund can set up a sustainability tranche, for example, in which 100 percent of use-of-fund loan proceeds must be applied to sustainable assets," he explained. "At the same time, the fund could set up a regular corporate or other investment purpose tranche where loan proceeds can be used for assets that would not qualify under the agreed ESG criteria."

Dividing a use-of-proceeds loan into tranches could be a way for the market to make it more flexible, Kohen mused, although separate loans could also be used in that situation.

### KPIs and Targets Should Follow Internal Standards

For the borrower, it is important that the obligations under the use-of-proceeds ESG facility match those under the limited partnership agreement (LPA) without surpassing them. "Deals involving use-of-proceeds ESG facilities should tie the terms of the facility to the fund's organizational documents," Kohen elaborated. "If the fund has agreed with LPs that it will be making certain types of investments, then the obligations under the credit facility should not be more onerous than those negotiated with the investors."

Negotiating KPIs for a use-of-proceeds facility should be a straightforward process because an ESG-focused fund should already have KPIs, metrics and reporting obligations in its organizational documents, Kohen stated. "Performance targets and KPIs in the financing should piggyback off the negotiations the sponsor has had with LPs. The bank should not be in a position to impose additional compliance obligations."

See "ESG Risk Alert: Inadequate Controls, Policies and Procedures Concern SEC About ESG Practices Inconsistent With Disclosures (Part Two of Two)" (Jun. 15, 2021).

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### Tracking and Reporting Should Follow Internal Policies

An ESG-focused fund should already have processes and procedures in place to measure, verify and report to its LPs, including auditors and third-party opinion providers. “Setting up an ESG-focused fund requires a high level of sophistication,” Kohen noted. “It requires resources to conduct the appropriate audits, perform due diligence, create the right system and prepare detailed reporting.” Compared to a performance-based facility, it is easier for a bank to verify results.

Reporting and verification obligations may be the most strenuously negotiated points. Credit agreement reporting obligations should be tied to the reports the fund is already providing its LPs; borrowers should not have to provide more information about the fund or investments than they provide the LPs, Kohen advised.

If the lender does require additional audits, verifications or other obligations beyond what is required for LPs, however, the borrower must consider the cost of those additional requirements, Kohen said. “Borrowers want to ensure the cost of meeting lenders’ additional obligations does not outweigh the economic incentive of putting the facility in place.”

Once the lender has received the borrower’s reports, it must be able to audit them if there is a perceived mismatch between the stated goal and the results reported, Kohen continued. Borrowers may want to limit how often the lender can verify the report to once a year, for example, or only when an event of default occurs.

### Guidance

The most relevant guidance for use-of-proceeds ESG facilities is the Green Loan Principles (GLP) and accompanying guidance published jointly by the Asia Pacific Loan Market Association, Loan Market Association and the Loan Syndications and Trading Association (Lending Authorities). The GLP applies to a variety of loan instruments, including revolving credit facilities and focuses on environmentally sustainable economic activity.

The core GLP components are:

1. use of proceeds;
2. process for project evaluation and selection;
3. management of proceeds; and
4. reporting.

See “Emerging Trends in LP Demands for Standardized ESG Reporting and How GPs Have Attempted to Comply” (Jul. 20, 2021).

## Performance-Based ESG Facilities

Experts agreed that performance-based ESG facilities are more flexible than use-of-proceeds facilities. “Performance-based facilities can be structured for any type of fund with any asset class,” Misson noted. “Unlike a use-of-proceeds facility, it is not necessary for the fund investment strategy to align 100 percent with the ESG goal. The flexibility is the reason why we have seen more performance-based facilities to date than use-of-proceeds facilities.”

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Performance-based facilities can also be set at different levels of a fund structure – management, fund or portfolio-company level, Misson said. In Europe, ESG-linked fund financing has been happening at the portfolio company level for some time. In the U.S., the trend appears to have begun at the fund level but is starting to move into the acquisition level.

"We are now finding that we can get preferential financing pricing based on ESG metrics in connection with LBOs in the U.S., and it is going well beyond just fund-level financings, green bonds, etc.," observed Latham & Watkins partner Manu Gayatrinath, who led the finance team that advised Carlyle for the Carlyle Facility.

See "Adoption of ESG Voluntary Standards By Fund Managers to Overcome U.S. Regulatory Shortcomings and Bolster ESG Defensibility (Part Two of Two)" (Jun. 1, 2021).

### Any Type of Fund

The flexibility of performance-based facilities extends to the types of managers, assets and funds to which they can apply. As long as the manager has an ESG policy and interest in finding a way to measure ESG performance at the investment, fund or management level, then a performance-based facility can probably work, Misson said.

The ability to monitor and report on KPIs may be the most significant gating item for funds that wish to put an ESG facility in place. "There is no particular type of fund that is better suited for a performance-based facility than another," Gayatrinath noted. "Any fund that has the capacity to do the reporting and tracking of metrics can potentially set up a performance-based facility, subject to the underlying investment thesis of the fund, of course."

See "Five Steps for PE Sponsors to Establish ESG Policies at Their Portfolio Companies to Suit the Present Moment" (Nov. 17, 2020).

Documenting a management-level ESG facility is similar to documenting a fund-level or portfolio company-level facility. "There isn't a ton of difference in the drafting, but there will be differences in how targets are established and how KPIs are structured," Misson said. "That will flow through to reporting and verification on reporting."

### Guidance

The Sustainability Linked Loan Principles (SLLP) and accompanying guidance published by the Lending Authorities are the main tools used in creating performance-based ESG facilities.

"If the facility will be broadly syndicated within the market, most folks use the SLLP because the Lending Authorities are widely respected," Misson explained. "Using the SLLP enhances the marketability of a deal to other lenders and lends credibility to the structure because it follows what most in the market recognize as the authoritative and accepted guidance."

Excluding the cover page, the SLLP is five pages long. "It lists the key issues to consider while still providing a lot of flexibility," commented Latham & Watkins partner Benjamin Berman, who worked on the Carlyle Facility. The SLLP provides a definition of sustainability-linked loans and sets out a framework of five core components:

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1. selection of KPIs;
2. calibration of sustainability performance targets (SPTs);
3. loan characteristics;
4. reporting; and
5. verification.

See our two-part series on the E.U. sustainable finance initiatives: "Preparing to Apply the Taxonomy Regulation and Other Proposed ESG Regulations" (Oct. 27, 2020): and "Exploring the Different Application Levels of the SFDR Based on a Firm's ESG Practices" (Nov. 3, 2020).

**KPIs and Targets**

Negotiating KPIs in a performance-based facility may not be as straightforward as a typical use-of-proceeds facility because if the fund is not focused on ESG, then it may not have ESG metrics or reporting obligations in its fund documents. "The targets are set up in the credit agreement as opposed to the LPA," Kohen said. KPIs, however, are typically hammered out by the ESG specialists on either side of the table before legal teams come into the deal, Misson said.

According to the SLLP, the borrower's performance is measured using predefined SPTs, as measured by predefined KPIs, which can include external ratings or metrics. Targets should:

1. represent a material improvement in the KPIs, beyond business as usual;
2. be compared to a benchmark or external reference where possible;
3. be consistent with the borrower's overall ESG strategy; and
4. be determined on a predefined timeline, set before or concurrently with the loan origination.

According to the SLLP, KPIs should be:

1. relevant, core and material to the borrower's overall business, and of high strategic importance to the borrower's operations;
2. measurable or quantifiable on a consistent methodological basis; and
3. able to be benchmarked.

## Comparative Popularity

At the moment, use-of-proceeds ESG facilities appear to be less popular than performance-based ESG facilities, in part because the number of ESG-focused funds remains relatively low. According to Misson, however, looking at pipeline and existing deal work, the two types of structures appear largely balanced in terms of prevalence.

A performance-based facility can be equally as rigorous as a use-of-proceeds facility, but the latter tends to be more complicated than the former because ESG funds already use a complicated set of ESG metrics. "A fund that isn't set up to make ESG-qualified investments will likely prefer to look at performance-based metrics," Kohen suggested. "Those facilities have very different metrics, covenants and reporting obligations."

As more ESG-focused funds come to market, experts expect growth in use-of-proceeds facilities. "The vast majority of LPs are looking for ESG-linked investment opportunities. That will lead to changes in how sponsors select assets, fundraise and set up their funds," Kohen noted. "In the future, we will see more demand for funds that are better suited for a single ESG purpose and therefore better suited for use-of-proceeds facilities," Misson said.

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# Challenges

## Creating the Internal ESG Program

For a borrower, one of the greatest challenges to setting up an ESG-linked facility is fully developing its own priorities, including what metrics it wants to track, Berman said. "Once the manager is able to develop its ESG program, it's not terribly difficult to transfer those priorities into a piece of financing. Coming up with the priorities is not always easy, however."

Approximately 70 percent of fund managers have ESG policies or are working on establishing them, Misson observed. "When setting up an ESG-linked facility, the facility's goals should be consistent with the borrower's overall sustainability and ESG strategies."

One logistical hurdle is coordination between the ESG specialists who work for the fund and the financing professionals. "The people at the fund who are, for example, tracking emissions at a portfolio company or diversity at the fund level are rarely involved in the financing process," Gayatrinath said. "That coordination is something new that needs to be worked out."

## Mitigating Greenwashing Concerns

**Set Ambitious Standards**

"Broadly speaking, the biggest challenge is ensuring ESG-linked facilities are actually accomplishing their purpose," Misson observed. To prevent greenwashing, facility terms need to address transparency and accountability in reporting and include ways to measure change, he continued. "We need to make sure we are not simply slapping labels on something that would have been achieved in any case."

The ESG linkage in a subscription facility needs to be more than just window dressing, Kohen agreed. "Change represents a material improvement in the respective KPIs and goes beyond the business-as-usual trajectory of the borrower," Misson explained. "It's something that would not have been achieved without the parties coming together, setting the goal and working toward achieving it."

See "Adoption of ESG Voluntary Standards By Fund Managers to Overcome U.S. Regulatory Shortcomings and Bolster ESG Defensibility" (Jun. 1, 2021).

Guidance suggests that, when possible, borrowers should compare their goals with benchmarks or other external references. Targets should be measured based on benchmarks from the borrower's prior track record, Misson recommended. "Measure targets over a set time period (e.g., quarterly, biannually or annually) and then report back to see if the KPIs are actually being met."

**Use Third-Party Verifiers**

Another way to prevent greenwashing is to employ third-party verification. The May 2021 version of the SLLP actually requires third-party verification when putting a sustainability linked loan together, Misson pointed out. Previously, it was simply a recommendation.

Third-party verification may come from a qualified auditor, rating agency or consultant that reviews the borrower's reporting to

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ensure the underlying assumptions and benchmarks are reasonable. ESG officers housed at the lender also review reports.

"Experts at the borrower, experts at the lender and third-party specialists all look to ensure the goals are indeed ambitious and meaningful, as well as that the borrower is achieving the progress the parties set out to accomplish," Misson summarized. Lenders then take that verification into account when judging whether the targets or KPIs were satisfied.

See our two-part series on mitigating climate risk: "Mitigating Climate Risk: Advantages to PE Firms Pursuing Climate Risk Programs and Pitfalls to Avoid" (Jun. 30, 2020); and "Solutions for PE Firms to Develop a Physical Climate Risk Program" (Jul. 14, 2020).

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