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Key Risks For Green Bond Issuers When Plans Change

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As the COVID-19 pandemic brings global economic disruption, businesses are reevaluating their upcoming capital expenditures. Capital expenditure plans adopted even weeks earlier may no longer be feasible or appropriate for a dramatically altered business, economic and regulatory landscape.

A company's decision to delay or forego planned capital expenditures may entail consequences that range from minimal internal discussions to significant breach of contract claims. Green bond issuers may face unique risks that arise from having in some cases explicitly connected their bond offering to planned capital expenditures in environmentally beneficial activities. This article discusses how green bond issuers in such circumstances can navigate these additional complexities.

Green Bonds 101

Green bonds have the same financial characteristics as non-green bonds (interest payments, principal repayment, etc.), but are connected to designated business activities associated with environmental benefits.

The issuer makes the connection by creating a green bond framework, which typically states that the issuer will allocate an amount equal to the net proceeds of the offering to eligible green projects. To provide accountability for this connection, the green bond framework normally states that until full allocation, the issuer will report at least annually to investors on the allocation of proceeds.

By issuing bonds pursuant to a green bond framework, an issuer can create a security that investors can categorize as green, even if the issuer's business is not entirely green. For instance, some of the first green bonds were issued by development banks that fund projects with high greenhouse gas emissions in the interest of developing less industrialized countries.

Issuers like green bonds because they highlight to stakeholders the positive contribution the issuer's business makes with respect to the eligible green projects, among other reasons. Institutional investors like green bonds because their stakeholders (including asset owners) want to see their investment capital deployed for more than just financial returns, among other reasons.

Green bonds typically provide similar yields to non-green bonds, however, so investors are not necessarily sacrificing returns by investing in green.

Key Risks When Plans Change

A green bond framework usually states that the issuer intends to allocate an amount equal to the net proceeds of the bond within a specified period, generally one to two years. Such statements are supported in most cases by board-approved capital expenditure plans and budgets. Those plans are inevitably based on assumptions about a reasonably predicable operating environment.

Now that an unreasonably unpredictable event has upended those assumptions, many green bond issuers will need to reassess whether they will be able to allocate proceeds as they originally anticipated in the green bond framework.

The next section discusses what risks the issuer could face from deviating from the green bond framework.

Contractual Risk in the Event the Issuer Fails to Adhere to Its Green Bond Framework

An issuer would generally face only a limited risk of investors successfully claiming breach of contract or alleging that the issuer defaulted under its contract for the green bond.

Although an issuer will usually state in its green bond framework how it intends to allocate proceeds, the relevant contracts — such as the indenture, trust deed, or terms and conditions — do not include covenants obligating the issuer to follow the green bond framework.

Investors thus lack any contractual right to force the issuer to repay the bond, which may trigger cross-defaults with other debt instruments that leave the issuer insolvent or forced to refinance its entire capital structure.

Securities Law Risk in the Event the Issuer Fails to Adhere to Its Green Bond Framework

An issuer would potentially face incremental U.S. securities law risks, but those risks should be manageable. The most prominent U.S. securities law risk for both issuers and underwriters is a claim alleging that the offering disclosure was materially misleading.

Although this claim can be raised directly by the U.S. Securities and Exchange Commission, investors can also bring these claims directly by alleging securities fraud under the Securities Exchange Act, using Rule 10b-5.

In general, a plaintiff is entitled to damages under Rule 10b-5 if a bond issuer or underwriter misrepresented or omitted a material fact in connection with the purchase or sale of the bond, with the intent to deceive or with recklessness, and the plaintiff lost money by relying on that misrepresentation or omission.

Issuers can take several steps to limit the risk of misleading disclosure that could give rise to securities law claims. When drafting the offering documents and marketing the bond, an issuer should:

- Include robust green bond-related risk factors addressing why the issuer may not be able to adhere to the green bond framework and the lack of contractual covenants requiring that it do so. In general, issuers should be able to argue that at the time of issuance, they had a good faith intention to adhere to the green bond framework, even if changing conditions made that impossible.

- Include forward-looking statement disclaimers. To mitigate the securities law risk in making statements about future actions that could later prove false, issuers often rely on the safe harbor provisions of the Private Securities Litigation Reform Act. These provisions protect issuers for forward-looking statements that are (1) identified as such and (2) accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."

Reputational Risks in the Event the Issuer Fails to Adhere to Its Green Bond Framework

Even if costly legal battles can be avoided, an issuer may potentially suffer some reputational damage from failing to adhere to its green bond framework. Although extraordinary circumstances may excuse the issuer's lack of adherence, issuers are likely to lose some of the positive reputational benefits from the green bond.

For instance, many green bond issuers seek to improve the visibility of their green bond by listing it on a green-bond-specific segment of a stock exchange, like the Luxembourg Green Exchange. Depending on the applicable listing rules, it is possible that a stock exchange could remove a green bond upon learning that the issuer would not be able to adhere to its framework.

This consequence is mostly reputational in that corporate bonds generally trade in over-the-counter transactions outside of listing venues.

Options to Respond When Plans Change

This section describes possible options for an issuer who has determined that it cannot adhere to it green bond framework as they had originally intended or at all.

Options That Retain the Green Label

Retain the green label by evaluating whether an alternative allocation could salvage adherence.

Although each issuer must evaluate its own green bond framework, market practice for green bonds allows for certain flexibility that may be useful when plans change.

Green bond investors understand that cash is fungible and are less concerned with controlling the investment of the physical proceeds raised in the offering and more concerned with an overall assurance that each green bond dollar raised is associated with unique eligible green project expenditure.

For this reason, many green bond frameworks permit the issuer to allocate the proceeds toward:

- Refinancing external debt that had been used to finance past investment in eligible green projects; and

- Refinancing (as an internal cash management decision) prior eligible green projects expenditures.

Green bond frameworks often define eligible green projects to go beyond cash capital expenditures and include ancillary or supporting expenditures, such as research and development and, for certain assets, operating expenditures.

By reevaluating their prior and ongoing expenditures with a broader lens, green bond issuers may be able to avoid any of the above risks and stay the course on their green bond framework.

Retain the green label by reducing the quantum of green bonds outstanding.

Adherence to a green bond framework can be compared to balancing an equation: X is the amount of the net proceeds from the bond, Y is how much the issuer will allocate to eligible green projects, and adherence means that X equals Y.

When X is greater than Y, one option issuers can consider is reducing X. In other words, the issuer can redeem or repurchase the bonds until the principal amount of bonds outstanding equals the amount allocated to eligible green projects.

Issuers generally have limited rights to redeem outstanding bonds, but investors cannot reject a redemption made in compliance with those rights. Redemptions are typically expensive, however, since the issuer must pay a premium to investors to compensate them for losing future interest payments.

Issuers can also reduce the quantum of bonds outstanding by repurchasing the bonds through a tender offer or open market purchases. The benefit of a tender offer is that it can be far less costly, as the tender price will be driven by the market price of the bonds.

The downside of a tender offer is that investors may not accept the tender and frustrate the issuer’s objective. Partial tender offers in the US generally are required to stay open for twenty business days. Open market purchases are not subject to any minimum duration, but must be structured carefully to avoid being re-characterized as an unlawful tender offer.

An issuer should note that redemptions, tenders, and repurchases are largely untested as a response to departures from green bond frameworks, and require the issuer to have sufficient excess cash or borrowing capacity.

Retain the green label by revising the existing green bond framework.

An issuer that cannot adhere to its existing green bond framework might be able to adhere to an alternative green bond framework that investors would find acceptable.

Revisions could include:

- Expanding the eligible green projects definition: For instance, an issuer might have defined eligible green projects to include only greenhouse gas emission-reducing projects, but might have already made ample expenditures related to circular economy products that could be included in an expanded definition. Or, the issuer might have focused only on operational improvements with environmental benefits and add a category for expenditures related to products that have downstream environmental benefits.

- Adding permissible flexibility: As described above, green bond frameworks often permit look-back periods and refinancing of prior expenditures. Issuers may wish to add these features if they were omitted at the time of issuance.

The market's reaction to an issuer announcing an amendment to the original green bond framework, pursuant to which bonds had been issued, will depend on how well the revised framework addresses common investor concerns.

Investors will want to know whether the amendment was due to factors beyond the issuer's control, whether the issuer's sustainability strategy remains in place, and whether the amended framework is credible. The credibility of the new framework depends, in part, on whether an amount equal to 100% of the proceeds will still be allocated to eligible green projects.

An issuer should consider addressing these concerns by obtaining an updated external review, if relevant, confirming that the new framework would qualify had it been in place originally.

Other Options

Change the label from green to green striped.

As described previously, when bond issuers lack sufficient Eligible Green Project expenditures, they may consider amending their existing framework to incorporate an innovative approach called "green striping." This process involves an issuer adhering to its green bond framework for a specific, stated fraction of the total principal amount of a series of green bonds. In other words, instead of adherence being defined by the green bond formula that X (proceeds) must equal Y (expenditures), the green striping formula would be that ½ X (or whatever fraction applies) must equal Y. Relying on the issuer's commitment, investors could account for their investment in a green striped bond not as 100% environmentally sustainable, but based on the stated fraction. The entire principal amount of the bond would be both green and conventional, rather than have two nonfungible tranches.

Amending the existing green bond framework to be a "Green-Striped Bond Framework" would be a middle-ground approach relative to the final, option, discussed below, of foregoing the green label entirely. Market acceptance of revising to be green striped would likely turn, in part, on the non-green funds being allocated to business activities that are not highly objectionable to ESG-focused investors.

Forego the green label.

For the reasons described above, issuers will likely view abdication of the bond's green label as a last resort when the alternatives discussed in this article are not viable. Nevertheless, issuers should ensure that efforts to retain the green label do not compound the risks through misleading disclosure or promises they may not be able to fulfill.

Issuers should balance green with various other considerations, and carefully weigh any additional risks.

Conclusion

In the face of an extraordinary economic downturn, green bond issuers struggling to adhere to their green bond framework face difficult decisions. Issuers should prioritize clear, timely communication with investors consistent with their obligations under securities laws such as Regulation FD in the U.S. and

the Market Abuse Regulation in Europe, as well as any applicable contractual reporting obligations or listing rules.

The best path forward may not be immediately apparent, but an issuer should proceed only after careful and thorough consideration of the concerns and alternatives laid out above.

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