How to minimise the legal risks of green bonds

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There are a number of ways in which issuers of green bonds can minimise the legal risks attached to them, argues Aaron Franklin

Green bond issuances have grown quickly over the past several years. New issuances of green bonds have grown from $0.8 billion in 2007 to $92.8 billion in 2016*. According to some estimates, issuances in 2017 may exceed $200 billion. This growth is a product of both investor demand for green assets and the benefits green bonds provide to issuers. Green bonds allow a company to attract a more diverse investor base and can enhance a company's reputation for governance and ESG compliance.

Green bonds may also carry additional legal and reputational risks, in two ways. The first relates to the process of marketing and selling the green bond in the first place.

*Source: IFC"
The second relates to following through on what makes the bond “green” and complying with on-going obligations. These risks can be managed and mitigated as described below.

**Risks related to the marketing and sale of a green bond**

The marketing and sale of a bond (green or not) involves securities law and reputational risks, including most notably that an investor who purchases the bond can argue that it suffers a loss because the disclosure with respect to the bond was misleading.

Typically, this involves misleading disclosure with respect to, or a failure to disclose, a liability or risk to the profitability, cash flows or financial condition of a business.

The additional risk with respect to the marketing and sale of a green bond is that an investor who purchased the bond would argue that the issuer’s disclosure was misleading with respect to what made the bond green.

Although any such claim would be novel (like the green bond market itself) and the harm may be more reputational than legal, investors may well seek redress if they suffer losses because a bond turns out to be less green than advertised.

Issuers can avoid and manage these additional risks by adapting the general bond process in three ways.

**1) Avoid omitting relevant information by properly investigating ESG issues**

The general bond process includes a process of “due diligence” that is meant to flush out any material concerns that should be disclosed to potential investors.

The due diligence process involves investigations of the issuer’s affairs by the underwriters and legal counsel, usually through a series of question and answer sessions with company management, review of key company documents and discussions with accountants and auditors.

This process is weighted towards uncovering matters that could significantly affect the topics that an investor is likely to find material, such as the financial results or condition of the issuer.

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The diligence process generally includes review of an issuer's compliance with relevant regulations, including environmental, but the emphasis is generally on how such matters could affect the bottom line.

For a green bond issuance, the diligence process should encompass environmental, social and governance (“ESG”) outcomes and risks for their own sake because green bond investors, by their nature, are more likely to consider those topics to be material.

Take, for example, a green bond in which the issuer states that it will use the proceeds to upgrade buildings to be more energy efficient. The diligence process should encompass not only the cost of the investment but also the extent of potential benefits from the energy efficiency upgrades and any risks to realising those benefits.

Another example would be a “pure play” green bond in which an issuer's business is inherently green, such as a recycling facility. In that case, the diligence process should encompass not only the financial condition and risks of the issuer but also the extent to which the existing operations comply with ESG standards.

Regardless of the nature of the green bond, it would be advisable for the diligence process to investigate any underlying ESG risks or historical non-compliance with applicable regulations. The uncovering of such issues after the green bond issuance could have damaging reputational consequences, if not securities law implications.

2) Craft the disclosure to capture the relevant ESG issues

The second way to manage the additional risks related to a green bond is by including clear and complete disclosure on what makes the bond green and by adequately disclosing any unique risks that the green label presents.

Green bonds come in many shapes and sizes so the disclosure should clearly delineate what makes this bond green.

There are at least two aspects to take into account. First, the disclosure should include, most obviously, a description of to what underlying green activity the bond relates. Examples could include, among others, renewable power generation, climate change adaptation, pollution control or water management. The acceptable limits for these activities are not clearly demarcated and, outside of certain jurisdictions such as China, central authorities have not implemented mandatory rules. This makes it all the more important to disclose the underlying activity to investors and allow them to reach their own conclusion on its acceptability.
The second aspect of disclosing what makes a bond green is disclosing to what extent the proceeds of the bond are connected to the underlying green activity. Examples of these connections include:

- Financing greenfield development;
- Refinancing existing projects;
- Financing an acquisition of assets; and
- Pure play / no explicit connection between proceeds and projects.

For any of these connections, it is also advisable to disclose the extent to which the proceeds are so used. For example, if only 90% of the proceeds are used for green purposes, that may not satisfy the investment criteria for all green bond investors.

Another way in which the disclosure needs to be crafted to take into account the green nature of the bond is to make sure any ESG risks are disclosed. Bond disclosure typically includes a lengthy section disclosing all the material risks of which the investor should be aware. These risks typically include the business risks (e.g., we may not be profitable) and the debt risks (e.g., investors may not be repaid). One green-specific risk that many green bond issuers are now including is the risk that a putatively green bond will lose its status as such or that the bond may not meet the green criteria of all investors.

3) Second party opinion

The third way to manage the additional risks related to a green bond is by obtaining an opinion from a third-party consultant supporting the characterization of the bond as green, commonly referred to as a “second party opinion.”

Providers of second opinions will typically review the issuer’s environmental credentials and the way in which the issuer justifies the bond as green and state their view, often in a publicly available document.

Second party opinions will only be as reliable as the information provided to the second opinion provider.

The value of such a second opinion is that it ratifies the view of the issuer and underwriters that the issuance should be considered green. One caveat to such opinions is that they will only be as reliable as the information provided to the second opinion provider.

These consultants do not, in general, conduct an exhaustive audit of the issuer’s affairs so they rely on the information the issuer chooses to provide. Issuers can
maximise the value of these opinions by providing fulsome responses to any information requests.

**Risks related to following through and ongoing obligations**

Calling your bond green can also carry additional legal and reputational risks relating to following through on what makes your bond green and complying with on-going obligations.

Bond issuers are subject to certain obligations after issuance, regardless of whether they issued a green bond. Compliance with these obligations needs to be managed with reference to the green nature of the bond, in two principal ways.

1) **Follow through on your statements with respect to your green bond, not just your contractual promises**

All bond issuers have reporting obligations, which are typically based on national laws, securities exchange requirements and contractual undertakings. Typical reporting provisions include, for example, the requirement to provide audited financial statements.

Green bond issuers will be subject to the same reporting requirements but often include statements in their legal disclosure (but not contractual undertakings) about their intention in the future to publicly provide various information, such as details on how the green bond proceeds were allocated and environmental key performance indicators.

Although failure to follow through on such statements might be less likely to lead to claims of contractual breach or regulatory action, it could still render the legal disclosure misleading.

Statements with respect to expected reporting and transparency are highly scrutinised by green bond investors given that the vast majority of green bonds do not include covenants that bind the issuer to any green promises. This means that policing compliance with those promises is up to the green bond market, which includes a robust commentariat willing to raise the cry of “greenwashing” (disingenuously claiming environmental sustainability credentials).

2) **Remember your green investors when meeting your fair disclosure obligations**

Bond issuers are generally subject to “fair disclosure” obligations, which relate to promptly disclosing material developments to the market as a whole and avoiding situations whereby certain investors have access to important information not
available to the market as a whole (often called “inside information” or “material non-public information”).

The point of these obligations is to prevent those with material information from profiting at the expense of those who do not.

To meet these obligations, issuers need to constantly assess the materiality of information in their possession and when public disclosures are required. For example, issuers may post a press release if a major counterparty declares bankruptcy because that information will affect the issuer’s future revenue.

For green bond issuers to comply with these obligations they should take into account environmental outcomes and risks in determining what information is material or potentially inside information.

**Conclusion**

The risks of labelling a bond green should be taken seriously to avoid legal and reputation problems, but these risks can be managed as described above.

These risks are the natural accompaniment to the rewards of holding your bond to the higher standard associated with green bonds, but for issuers willing to hold themselves to this standard, green bonds can nonetheless be a valuable option.

* According to Environmental Finance's green bond database

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