CLIENT MEMORANDUM

Sustainable Finance: Implications of Equator Principles 3.0 for Financiers and Developers

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The third iteration of the Equator Principles ("EP 3.0") took effect January 1, 2014, thereby altering the sustainability lens applied by Equator Principles Financial Institutions ("EPFIs") for new projects and significant expansions or upgrades to existing projects. Significantly, EP 3.0 expands the types of covered projects and raises the bar for both due diligence and reporting. This briefing examines the latest revisions to the Equator Principles ("EPs") regime and highlights some of the most notable changes from the perspective of financiers and borrowers, including developers and related enterprises.

Expanded Scope of Covered Projects

EP 3.0 could well increase the number of projects made subject to formal review. EP 3.0 augments the types of activities covered under EP 2.0, i.e., Project Finance and Project Finance Advisory Services, with the addition of Bridge Loans[1] and

[1] Bridge Loans are defined as interim loans "given to a business until the longer term stage of financing can be obtained." EP 3.0, Exhibit I: Glossary of Terms. EP 3.0 applies only to Bridge Loans with a term of less than two years that are intended to be refinanced by Project Finance or a Project-Related Corporate Loan that is anticipated to meet the relevant criteria, described *infra*.

Project-Related Corporate Loans.[2] The regime will apply to corporate loans, however, only when all of the following circumstances are present:

- The majority of the loan relates to a single Project over which the client has direct or indirect operational control;[3]
- The total aggregate loan amount is equal to or greater than US$100 million;
- An EPFI's individual commitment is equal to or greater than US$50 million; and
- The loan term is two years or longer.

Less certain is how EP 3.0's definitional changes to key terms will ultimately impact the scope of application. Formerly, the EPs stated that the assessment process in "High-Income OECD Countries" was an acceptable substitute for the International Finance Corporation's ("IFC") Performance Standards. EP 3.0 instead refers to "Designated Countries,"[4] and clarifies that the assessment process in these countries, while still an acceptable substitute for the IFC Performance Standards in most cases, is merely the minimum standard to be adopted by EPFIs. Practically speaking, this means that EPFIs *could* decide to apply IFC Performance Standards to a Designated Country project. Whether heightened international standards emerge as the requirement for compliance with EP 3.0 in particular countries, and for what types of projects, bears monitoring.

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[2] Project-Related Corporate Loans are defined as "corporate loans, made to business entities (either privately, publicly, or state-owned or controlled) related to a single Project, either a new development or expansion (e.g. where there is an expanded footprint), where the Known Use of Proceeds is related to a single Project in one of the following ways: (a) The lender looks primarily to the revenues generated by the Project as the source of repayment (as in Project Finance) and where security exists in the form of a corporate or parent company guarantee; (b) Documentation for the loan indicates that the majority of the proceeds of the total loan are directed to the Project. Such documentation may include the term sheet, information memorandum, credit agreement, or other representations provided by the client into its intended use of proceeds for the loan. It includes loans to government-owned corporations and other legal entities created by a government to undertake commercial activities on behalf of the government, but excludes loans to national, regional or local governments, governmental ministries and agencies." EP 3.0, Exhibit I: Glossary of Terms.

This category does not, however, include export finance in the form of Buyer Credit. Nor does it cover other instruments that do not finance an underlying Project (e.g., asset finance, acquisition finance, hedging, leasing, letters of credit, general corporate purposes loans, and general working capital expenditures loans used to maintain a company's operations). EP 3.0, *Scope* at 3, n.2.

[3] "Direct control" and "indirect control" are defined under the term "Effective Operational Control" as follows: direct control is where the client acts as the operator or major shareholder of the Project; indirect control is where a subsidiary of the client operates the Project. EP 3.0, Exhibit I: Glossary of Terms.

[4] At the present, the list of "Designated Countries" is identical to those previously identified as "High-Income OECD Countries."

Greater Transparency and Heightened Accountability

In response to ever-increasing calls for more transparency from stakeholder groups, EP 3.0 raises the bar for financiers and developers alike in the areas of reporting and public disclosure. Previously, EPFIs needed only to comply with "high level" reporting requirements, which entailed reporting on the number of transactions (screened and closed), the "category" under which a project was classified, and a general description of the implementation process. Under EP 3.0, EPFIs must now report, at a minimum:

- The number of "Projects Closed," including: category, sector, region, and whether an independent review was performed;
- Project Names for Project Finance deals;[5]
- Information on the EPs' implementation process for which an annual report must be posted online, detailing: roles and responsibilities, staffing, and policies and procedures; and
- Details on mandatory training during the first year following the adoption of the EPs.

Significantly, EP 3.0 also requires developers to complete an online environmental and social impact assessment, and to report greenhouse gas ("GHG") emissions for projects that emit more than 100,000 tons of CO_2 annually.[6] The GHG reporting requirement can be satisfied by following applicable regulatory requirements, or through reporting consistent with voluntary platforms such as the Carbon Disclosure Project.

Finally, EP 3.0 enhances accountability with the addition of heightened stakeholder engagement obligations and by requiring covenants that borrowers comply with the environmental and social laws, regulations, and permits of the host country, regardless of the "category" under which a project is classified. The framers believe effective engagement should not only encompass communities directly impacted by a project, but other interested parties, such as national and local authorities, non-governmental organizations, and those involved with neighboring projects. Further, consistent with 2012 changes to Performance Standard 7[7] of the IFC Performance Standards, projects with adverse impacts on indigenous

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[5] Subject to client consent.

[6] GHG reporting is also encouraged, though not required, for any projects emitting more than 25,000 tons of CO_2 annually.

[7] Performance Standard 7 states that FPIC applies: (1) when the project is likely to have an impact on the land and natural resources subject to traditional ownership or under customary use; when the project involves the relocation of Indigenous Peoples from land and natural resources that are subject to traditional ownership or under customary use; (2) when the project is likely to have significant impact on the cultural heritage essential to the identity of the Indigenous Peoples; and (3) when the project involves the use of the cultural heritage of the Indigenous Peoples, including their knowledge and customs, for commercial purposes.

peoples must obtain the "Free, Prior and Informed Consent" ("FPIC") of the affected community.[8] For the FPIC to be valid, the developer must establish two things: (i) that the process by which the FPIC was obtained was acceptable to both the indigenous community and the developer, and (ii) that the FPIC resulted from this negotiation process. However, FPIC does not necessarily require unanimity; thus, FPIC may be achieved despite disagreements between individuals or groups within the indigenous community.[9] When evaluating whether, and to what degree, FPIC of the affected community has been sufficiently obtained, financiers and developers should know that satisfying the requirements of "consent" under Performance Standard 7 and EP 3.0 may not be sufficient to demonstrate compliance with other relevant international instruments, such as the *ILO Convention 169 on Indigenous and Tribal Peoples* (1989), the *UN Declaration on the Rights of Indigenous Peoples* (2007), and the Organization for Economic Co-operation and Development's ("OECD") updated *Guidelines for Multinational Enterprises* (2011). Therefore, it is important for developers to consider seriously the impact a project will have on a community, and whether the process by which FPIC was obtained satisfies not only EP 3.0, but also the above-mentioned treaties and guidelines.

Emphasis on Human Rights and Climate Change

EP 3.0 focuses more directly than its predecessors on human rights, as well as climate risks and impacts. The EPs now require projects with a "high risk"[10] associated with human rights issues to complete a human rights due diligence assessment. Such diligence should be performed consistent with the "Protect, Respect and Remedy Framework for Business and Human Rights" and associated "Guiding Principles on Business and Human Rights." However, EP 3.0 stops short of proscribing a mandatory framework to allow for flexibility and collaboration between the developer and EPFIs. Because human rights assessments are not commonly conducted by corporations or developers, financial institutions may need to assess how deeply to involve themselves in advising others involved in this process. EP 3.0 also focuses on climate impacts, bringing them into the actual due diligence process. Finally, as discussed above, EP 3.0 calls for GHG reporting by projects with a substantial GHG emissions footprint.

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8 The IFC's prior standard simply required that a company *consult* with the indigenous community on FPI, not that the company obtain FPI *consent*.

9 Determining validity of consent is further complicated by the following factors: (1) there is no universally accepted definition of FPIC; (2) in some situations a company cannot negotiate with the indigenous community because the government controls the allocation of assets; and (3) fear and uncertainty surrounding the use of a community veto.

10 EP 3.0 does not define what constitutes "high risk," instead stating that "in limited high risk circumstances . . . specific human rights due diligence[]" may be required. EP 3.0, *Principle 2: Environmental and Social Assessment* at 5.

Since their introduction in 2003, the Equator Principles have informed definitions of sustainability in the project finance setting, and expanded the breadth and depth of sustainable practices in the broader financial services sector. EP 3.0 continues this pattern by building on lessons learned, ever-increasing demands from stakeholders, and heightened awareness of risks associated with human rights issues and climate change. With EP 3.0, more projects will likely come under review, though just how many more depends on variables that defy prediction. It is clear, however, that covered projects will be subjected to deeper and broader scrutiny than before, and thus financiers and developers should refine their environmental and social risk management practices accordingly.

If you have any questions regarding this memorandum, please contact William Thomas (202 303-1210, wthomas@willkie.com), Annise Maguire (202 303-1162, amaguire@willkie.com) or the attorney with whom you regularly work.

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