

Client Alert

The New Equator Principles – Climate Change, US Application and What EP4 Means for You

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After a year of review and feedback, the fourth iteration of the Equator Principles (“**EP4**”) has arrived. Expected to take effect on October 1, 2020, EP4 will both broaden the Equator Principles’ reach, particularly with respect to Designated Countries¹ (including the United States) and increase the environmental and social assessment obligations placed on Equator Principles Financial Institutions (“**EPFIs**”) and Sponsors (such as strengthening climate change and human rights assessment requirements). In this alert, we provide an overview of EP4’s updates, highlight EP4’s impact on Projects located in the United States, suggest additional considerations for Sponsors and EPFIs and identify next steps in EP4’s implementation. As EP4 takes effect, we note several key impacts for transactions going forward. First, in addition to compliance with host country law, Projects can now be subject to additional requirements under EP4, including the IFC Performance Standards. Second, both EPFIs and Sponsors must also review the Equator Principle-related covenants and representations found in financing documents to ensure that compliance is practicable. Third, both EPFIs and Sponsors should be aware of the increased assessment and engagement requirements, which could require multiple consultants (beyond the Independent Engineer’s review) and pose significant timing considerations for transactions. Accordingly, EP4 should be discussed during the early stages of a financing. Fourth, Projects can be subject to more stakeholder engagement, including for indigenous peoples.

A. EP4: An Overview

EP4 increases the Equator Principles’ impact on all Projects and Project-related financings—particularly as it relates to which financings and how the Equator Principles will apply going forward. EP4 makes four key revisions:

1. broadening the scope of financings that will be subject to the Equator Principles (including Project-related acquisitions and refinancings);

¹ **Note:** A complete list of Designated Countries can be found on the Equator Principles’ website ([located here](#)).

2. eliminating the standard assumption for Projects in Designated Countries that compliance with law covenants are sufficient for environmental and human rights issues;
3. increasing assessment and risk management requirements with respect to Projects' impacts on human rights, biodiversity and climate change; and
4. strengthening the mandate for engagement with indigenous communities.

B. Increased Requirements for Projects Located in the United States and other Designated Countries

Under EP4, Projects in the United States and other Designated Countries no longer enjoy EP3's assumption that the Designated Country's laws satisfy four EP principles: EP4's Principle 2 (*environmental and/or social assessments*), Principle 4 (*management systems and plans*), Principle 5 (*stakeholder engagement*) and Principle 6 (*grievance mechanisms*). Accordingly, and in connection with EP4's additional requirements, the following items may now be required in connection with a Project located in the United States:

- **Environmental and Social Assessment:** EPFIs may now require assessments of a proposed Project's potential environmental and social risks, such as an Environmental and Social Impact Assessment ("**ESIA**"). The breadth of these studies will depend on the type of Project and may necessitate additional mitigation proposals, including an Environmental and Social Management Plan ("**ESMP**").
- **Environmental and Social Management System and Equator Principles Action Plan:** Sponsors may now be required to develop and/or maintain an Environmental and Social Management System ("**ESMS**") in addition to any necessary ESMP or applicable Equator Principles Action Plan ("**EPAP**").
- **Stakeholder Engagement:** Projects with potentially significant adverse environmental or social impacts must undergo effective stakeholder engagement processes with affected communities, workers and other relevant stakeholders (such as neighboring Projects or nongovernmental organizations). Such Projects will also be subject to a mandatory Informed Consultation and Participation process. In addition, Projects affecting indigenous communities are subject to a host of additional requirements (including satisfaction of applicable IFC Performance Standard 7, requiring the Free, Prior and Informed Consent of affected Indigenous communities) and should be reviewed in close consultation with all stakeholders and their respective counsels/consultants. Disclosure of environmental and social assessments may also be required in connection with the relevant engagement process.
- **Grievance Mechanism:** For all Projects with potentially significant adverse environmental or social impacts, EPFIs will require Sponsors to establish effective grievance mechanisms designed for use by affected communities and workers (scaled to the risks and impacts of the Project).
- **Climate Change Risk Assessment:** Climate change risks must be assessed for all Projects with material environmental and social impacts (a "**Climate Change Risk Assessment**") and specifically contemplates application of the 2015 Paris Climate Change Agreement. Such Climate Change Risk Assessments must contemplate the Climate Physical Risks and Climate Transition Risks of a Project and be conducted in accordance with the GHG Protocol.

- **IFC Performance Standards:** EPFIs may also evaluate a Project's specific risks and apply one or more of the IFC Performance Standards as a remedy, in addition to the host country's laws.²

C. Additional Considerations for Sponsors

1. **Due Diligence:** EP4's greatest impact on Sponsors will likely manifest in heightened diligence and assessment requirements. Due to the enhanced scrutiny surrounding human rights and climate change matters, Sponsors of Projects with potentially significant adverse environmental or social impacts will need to re-evaluate their assessment processes for these areas. Additionally, the human rights and climate change risks and impacts will need to be assessed at the development phase, with processes for mitigation and management introduced accordingly. It should also be noted that the climate change risk assessment will need to include physical risks, alternative technologies, transition risks, and quantification of emissions. To avoid delays at the financing stage, these steps should be considered early in the process.
2. **Stakeholder Engagement:** As noted above, EP4 requires greater stakeholder engagement. Any existing engagement strategies will likely need to be updated to contemplate both workers and EP4's additional requirements for the engagement of affected indigenous communities, which may well be more onerous than host country laws. Even where government institutions are leading on engagement, the Sponsors are responsible under EP4 for collaborating with governments to try and ensure IFC Performance Standard 7 compliance.
3. **Relevance of Host-Country Law:** Sponsors must develop greater governmental awareness in relation to the environmental laws of Designated Countries. Sponsors in these high-income OECD countries can no longer rely solely on compliance with host country laws when assessing whether the Equator Principles have been satisfied. As a result, Sponsors should identify divergences between host country laws and EP4, to ensure that additional steps necessary are provided for.

D. Additional Considerations for EPFIs, including ECAs and DFIs

1. **Financing Documentation:** EPFIs (including ECAs and DFIs who have adopted the Equator Principles) will need to familiarize themselves with the enhanced assessment standards imposed by EP4 and update or develop their own internal systems to evaluate such assessments. In order to ensure compliance, EPFIs should update their customary environmental and social representations, covenants and events of default requirements, as well as their environmental and social policies, to reflect the changes to the Equator Principles.
2. **Rights of Indigenous Communities:** In relation to IFC Performance Standard 7 (Indigenous People) compliance, as discussed above, EPFIs have a duty to require Sponsors to collaborate with the relevant government bodies in order to meet the standard, regardless of whether this is above and beyond their own laws.
3. **Reputational Risk:** NGOs, such as BankTrack and the International Union for Conservation of Nature, continue to monitor EPFIs' adherence to the Equator Principles and can be expected to pay particular attention to Projects located in the United States and other Designated Countries. EPFIs should be aware that potential case-by-case deviations from the market's

² **Note:** The IFC's Environmental and Social Performance Standards provide a framework for how IFC clients define and manage environmental and social risks. Among others, EP4 incorporates the performance standards relating to labor/working conditions, community health and safety, indigenous peoples and cultural heritage. The Performance Standards may be found [here](#).

EP4 requirements may result in negative press for the Project as well as all parties involved in its financing and construction.

E. EP4: Next Steps

Given EP4's introduction of new assessment and engagement requirements, increased scope of applicability and baked-in EPFI application leeway, we expect the Equator Principles Association to issue guidance on implementation. Such guidance will be particularly important in understanding EP4's impact, including whether a transition period will be incorporated into EP4's adoption. What is certain, however, is that all parties engaged in Project development and finance should anticipate a greater focus on each Project's impact to local and global communities, even in those nations and transactions which once existed outside of the Equator Principles' purview.

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