Canadian Financial Institutions to Assume New Human Rights Obligations

November 25, 2019

Canadian financial institutions will soon be mandated to assess the human rights consequences associated with their project finance loans. The requirement is arising through revisions to the Equator Principles (EP), a series of 10 principles that guide financial institutions engaged in project finance for large infrastructure and industrial projects. Most of Canada's major banks, as well as Export Development Canada and Manulife, are EP members, also known as Equator Principle Financial Institutions (EPFIs).

The EP Association approved a revised draft of the EP (EP IV) on November 18, 2019 following a consultation period on an earlier draft. EP IV takes effect on July 1, 2020. The revisions require EPFIs and their clients to place greater emphasis on assessing the potential impacts projects may have on human rights, Indigenous peoples, and climate change as a condition for project finance.

EP IV will also impact more clients and projects than previous EP. EP IV applies to project finance with total project capital costs of USD $10 million or more and project-related corporate loans with a threshold loan value of USD $50 million (down from USD $100 million).

EPFI project finance agreements include covenants that require compliance with the EP. Clients will bear the onus to demonstrate that a project will not have adverse impacts in target areas, or that adverse impacts can be sufficiently mitigated. The text of EP IV permits EPFIs to call an event of default if clients fail to meet their environmental and social covenants.

Companies whose business relates to infrastructure and industrial projects must take note of these developments in order to maintain secure access to project finance.

Changes go beyond current Canadian law

EP IV imposes standards that go beyond current Canadian legal obligations in relation to assessing impacts on human rights and Indigenous peoples. This means the EP will play a larger factor in domestic project finance considerations than previously.

On human rights, EP IV will require EPFIs and their borrowers to assess the human rights impacts projects have on individuals and communities more broadly. This goes beyond adhering to the company's Canadian labour and human rights obligations to its own workers.

On Indigenous peoples, EP IV will require EPFIs and clients to operate according to concept of free, prior, and informed consent (FPIC), the international standard for consultation with Indigenous populations pursuant to the UN Declaration on the Rights of Indigenous Peoples. This goes beyond the Canadian legal requirement of the duty to consult (the Canadian government cites FPIC as a principle that guides its approach to reconciliation).

Human rights

EP IV adds the requirement for EPFIs to fulfill their responsibility under the UN Guiding Principles on Business and Human Rights (UNGPs). The UNGPs require businesses not to cause, contribute to, or be directly linked to human rights abuses.

Providing loans to support projects that lead to severe adverse human rights abuses contravenes the UNGPs. The obligation to refrain from providing such loans will also influence EPFI project finance decisions.

Potential clients will have to engage in human rights impact assessments to satisfy an EPFI that provision of project finance will not bring the EPFI offside its UNGP obligations (this is in addition to the client's own obligations under the UNGPs). The EPFI can also conduct its own impact assessment as part of its transaction due diligence.

Indigenous peoples

Enhanced recognition of Indigenous rights is a major feature of EP IV. EP IV requires EPFIs to determine if projects obtained the FPIC of impacted Indigenous communities before supporting the project.

To achieve this, EP IV requires EPFIs to hire an independent consultant to evaluate the consultation process with Indigenous communities to determine if the process satisfied national laws and FPIC. However, achieving FPIC is not an absolute requirement. EP IV permits "a justified deviation" from FPIC on the advice of the independent consultant when good faith efforts to achieve FPIC have not succeeded.

EP IV directs EPFIs to the International Finance Corporation Performance Standards for guidance on achieving FPIC. The text also clarifies that there is no uniform definition of FPIC and that it "does not require unanimity, does not confer veto rights to individuals or sub-groups and does not require the client to agree to aspects not under their control."

Climate change

Another change in EP IV is a requirement to include a climate change assessment for certain projects. Thresholds for this requirement relate to the risk of adverse

environmental effects and a project's level of combined scope 1 and scope 2 emissions. Scope 1 emissions are those emissions from sources owned or controlled by a company. Scope 2 emissions are those emissions resulting from the generation of a company's purchased electricity.

Liability for human rights impacts?

Membership in the EP evidences an EPFI's understanding that it cannot finance major projects without assessing the impacts those projects have on others, in Canada and abroad.

This does not mean EPFIs could be automatically liable for human rights violations that occur in their funded projects. However, concerns around liability for human rights violations are real. Four civil actions currently before Canadian courts claim a Canadian corporation should be liable for human rights violations that occurred in its supply chain (the cases all concern acts committed abroad). Legal efforts by the companies to have the cases dismissed have so far failed. A fifth case was recently settled.

Canadian EPFIs that do not take their EP obligations seriously and do not engage in human rights impact assessments or operate in accordance with FPIC risk being accused of failing to abide by best practices they themselves have ascribed to, thus setting up potential tort claims.

Preparing for EP IV

Businesses engaged in large infrastructure and industrial projects have until July 2020 to develop internal processes that will enable them to meet requirements imposed through the EP. EPFIs and potentially impacted project borrowers should:

- Implement processes to carry out the required due diligence for determining potential adverse impacts of projects; and
- Familiarize themselves with the expectations established by the UNGPs, and other relevant instruments such as the OECD Guidelines for Multinational Enterprises and the International Finance Corporation Performance Standards.

Businesses already taking steps to enhance their human and environmental performance in line with those instruments can align this process to the new EP. Businesses that are not yet examining human and environmental impacts in line with these best practices can use the next several months to initiate a process to comply with the new project financing requirements.

*** November 25, 2019: An earlier version of this blog was published on October 21, 2019, before the EP Association approved the final text of EP IV and set the date for EP IV to come into force.*

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