Using Brownfields to Satisfy Lender's CRA Requirements

by Larry Schnapf

During the past few years, the federal government and many states have adopted programs designed to encourage the redevelopment of contaminated properties. These statutory and administrative reforms have helped to address lenders' concerns about environmental liabilities associated with contaminated property. This article will review these so-called "brownfield" programs and discuss how lenders may use these regulatory incentives to satisfy their obligations under the Community Redevelopment Act (CRA).[1]

Overview of Lender Liability

The principal federal environmental laws of concern to financial institutions have been the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)[2] and the Resource Conservation and Recovery Act (RCRA).[3] Most states have enacted versions of these statutes.

CERCLA imposes strict and joint liability on four classes of potentially responsible parties (PRPs) for the cleanup and reimbursement of costs associated with releases of hazardous substances. The four classes of PRPs include: (1) past and current owners of facilities and vessels (*i.e.*, tanks, equipment, etc.); (2) past and current operators of facilities and vessels; (3) generators of hazardous substances; and (4) transporters of hazardous substances. The definition of "owner or operator" does contain a secured creditor's exclusion, which states that any person who "holds indicia of ownership primarily to protect his [or her] security interest" in a vessel or facility will not be liable as an owner or operator if that person does not "participate in the management" of the facility or vessel.[4]

RCRA regulates the generation, storage, handling, transportation, and disposal of hazardous waste. Owners or operators of RCRA-regulated facilities must comply with certain operating standards and are also required to undertake corrective action to clean up contamination caused by hazardous or solid wastes. RCRA contains a secured creditor's exemption similar to the CERCLA provision except that it is limited to underground storage tanks (USTs).[5]

Initially, the CERCLA and RCRA secured creditor exemptions provided little guidance to lenders regarding what actions they must take to immunize themselves from liability. As a result, a number of banks found themselves embroiled in lawsuits or enforcement actions for the cleanup of contaminated properties. Congress subsequently clarified the scope of the CERCLA and RCRA secured creditor exemptions when it enacted the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996.[6] The amendments essentially provided that a lender must exercise actual day-to-day control over a borrower's operation before it will be considered "participating in the management of a facility." Moreover, lenders were allowed to foreclose on property without becoming liable as an owner so long as they expeditiously took steps to sell the property and comply with environmental laws while they were in possession of the property. Many states have enacted their own lender liability provisions.

The Brownfield Problem

Brownfields are sites where reuse or redevelopment is hampered by concerns over environmental contamination. Although many brownfields are contaminated with hazardous substances from prior uses, the contamination is usually not serious enough to require a cleanup under CERCLA or RCRA. Many developers have been reluctant to purchase these properties, however, because they have been concerned that they will be responsible for pre-existing contamination at a site. They are also hesitant because of the uncertainty over the extent of the contamination and the difficulty in ascertaining cleanup costs. Indeed, many corporations that own brownfield sites associated with discontinued operations have warehoused these properties instead of placing them on the market. These companies have felt it is better to idle these properties and incur passive holding costs, such as prop-

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erty taxes, security, and repairs due to vandalism, rather than take the risk that contamination would be discovered during the environment due diligence phase of a transaction, which would draw attention to the sites and expose the owners to uncertain cleanup liability. The owners have also been concerned that, once they dispose of a property, they may become vulnerable to a contribution action filed by future landowners. Lenders have also been hesitant to finance brownfield redevelopment projects because of concerns that cleanup costs may affect the ability of borrowers to repay their loans, as well as uncertainty over the value of the contaminated properties.

The existence or mere perception of contamination has been an obstacle to redevelopment of brownfields despite the fact that these sites have access to a skilled work force, mass transportation, and other infrastructure features. As a result, development has often been steered away from urban sites to undeveloped rural or suburban "greenfield" properties. This economic pattern has not only had a devastating impact on the economy of the nation's cities but also has contributed to urban sprawl, increased air pollution, and loss of wildlife habitats. Indeed, according to a recent report issued by the US General Accounting Office,[7] there may be over 450,000 brownfields across the country.

Federal and State Response to the Brownfield Problem

To minimize obstacles to brownfield redevelopment, Congress enacted the Small Business Liability Relief and Brownfield Revitalization Act (Brownfield Amendments) in December 2001.[8] The law made sweeping changes to CERCLA including the creation of a *bona fide* purchaser defense allowing developers to knowingly acquire contaminated property after January 11, 2002, without incurring CERCLA liability. The Brownfield Amendments also clarified that owners of property contaminated from an off-site source will not be liable for the contamination.

To take advantage of these new defenses, property owners or tenants must establish that they have: (1) not caused or contributed to the contamination; (2) conducted proper due diligence; (3) taken appropriate care regarding the contamination; (4) cooperated with the Environmental Protection Agency (EPA); (5) provided access to responsible parties conducting investigations and cleanups; and (6) ensured that they did not interfere with or impair any institutional controls imposed on the site as part of the cleanup. The law also bars federal enforcement actions for sites remediated under qualified state cleanup.[9]

The Brownfield Amendments expand on the current EPA grant and loan program for brownfields. The new law increased the available funds for brownfield investigations and remediation from $96 million to $250 million a year. The Brownfield Amendments authorize the EPA to issue grants of up to $350,000 to local governments and non-profits to identify, characterize, and investigate brownfields, as well as to fund planning activities. The EPA may also award remediation grants of up to $1 million to these entities. The grant recipients may use the remediation grants to cleanup brownfield sites they own or to establish cleanup revolving funds that would provide loans to developers to remediate and redevelop brownfield sites. The remediation funds may also be used to pay for insurance premiums.

Approximately 40 states have established their own voluntary cleanups (VCPs) or brownfield programs to encourage the reuse of contaminated properties. The VCPs vary from state to state, but they generally: (1) include liability protection to prospective purchasers and lenders; (2) establish streamlined cleanup procedures; (3) authorize the use of risk-based cleanup standards that take future land use into account; and (4) provide for the issuance of a No Further Action (NFA) letter and a Covenant Not to Sue letter after a cleanup has been satisfactorily completed.

Nearly all VCPs permit prospective purchasers and current property owners to leave residual contamination in the ground provided that the persons performing the cleanup implement institutional and engineering controls.[10] Because they can dramatically lower remediation costs, institutional controls are playing an increasingly important role in cleanups. For example, instead of removing contaminated soil, a volunteer may be permitted to encapsulate the contaminated soil with an impermeable cap and then file a deed restriction preventing that portion of the property from being used. In addition, instead of remediating groundwater to drinking water standards, a volunteer may be required to file a deed restriction precluding water under the site from being used for drinking purposes.

Many states' brownfield programs have also established financial assistance programs for developers of brownfields. This assistance may be in the form of grants, loans, and tax credits. Unlike the federal program, these grants or loans may be awarded directly to the developer.

Brownfields and CRA

Although state and federal brownfield financial assistance can help defray the costs to investigate and remedi-

ate brownfields, the funding is often insufficient to cover all of the environmental-related costs at a site. Moreover, since the application process can be time-consuming, the funds may not be available during the time period required by the developer.

The reforms adopted by federal and state governments have not eliminated all of the financial disincentives to brownfield redevelopment since these sites still have to be remediated, which places them at a competitive disadvantage to pristine greenfield sites where a developer will not have to incur cleanup costs and where a lender will not be concerned about potential liability.

Private lenders can fill in this gap and at the same time satisfy their CRA obligations. CRA was enacted to improve access to credit in low and moderate-income neighborhoods.[11] In 1995, the CRA regulations were substantially amended to change the way regulated financial institutions demonstrate compliance with CRA. Under the amended regulations, regulated financial institutions can meet these tests by making loans that support activities that have community redevelopment as their primary purpose. The CRA regulations specifically provide that one of the qualifying activities include "loans to finance environmental cleanup or redevelopment of an industrial site as part of an effort to revitalize the low-or moderate-income community in which the property is located."[12] To qualify for the CRA credit, the project must not only remove the contamination but must also lead to redevelopment.

It was hoped that the changes to the CRA regulations would provide incentives to banks to finance brownfield redevelopment that would not ordinarily meet a lender's credit requirements since banks could obtain their CRA credits by financing cleanups of brownfield sites. Indeed, a number of banks have worked with local communities to provide financing for brownfield projects that have qualified for CRA credit. Lenders have helped communities and non-profits build new housing on brownfield sites and also fund mixed-use developments that have created jobs and economic activity in low-income communities. Usually, the local government will use the EPA brownfield fund money to identify brownfield sites and create a redevelopment plan for the brownfield. They will then turn to private banks to help provide financing for the rest of the project.

Another way that lenders may be able to obtain CRA credits is by participating in brownfield projects sponsored by the Department of Housing and Urban Development (HUD). Under the Community Development Block Grants (CDBG), local governments can use CDBG funds to finance the acquisition, construction, renovation, or rehabilitation of privately owned buildings, properties, and public facilities. Many of the construction-related activities eligible for CDBG funding may also be used to clean up and redevelop brownfields. For example, Bridgeport, CT used $2 million in CDBG funds to finance the assessment and cleanup of a brownfield.

In addition, recipients of HUD assistance may request funding to perform environmental site assessments or impact statements for activities that could have a significant impact on the environment or when environmental conditions could have a significant impact on users of the project.

Another important funding source is the Housing and Community Development Act of 1974's Section 108 loan guarantee program.[13] The loan guarantee program can be used when the upfront expenses of a project are too large for a local government's annual CDBG allotment.

Under this program, the local government will issue debentures that are guaranteed by HUD. The local government will pledge its future CDBG grants as collateral for the HUD guarantee. The Section 108 proceeds may be used to finance a broad array of activities including: (1) acquisition costs to buy or lease vacant or improved property; (2) clearance, demolition, removal, and rehabilitation of buildings and improvements; (3) rehabilitation of buildings or construction of real property improvements carried out by public or non-profit organizations; (4) site preparation including construction, repair, or installation of infrastructure improvements, utilities, and other public facilities. For example, HUD approved $50 million in Section 108 loan guarantees to finance brownfield redevelopment activities in Chicago, IL. The loan proceeds will be expended over a three-year period to acquire, remediate, and redevelop abandoned industrial properties. The loan will be repaid using proceeds collected from the sale of the properties, tax incremental financing, interest earned on the loan balance, and settlements with PRPs.

The agency has also established its Brownfield Economic Development Initiative (BEDI). Unlike the other HUD programs, the BEDI grants are specifically intended to help cities redevelop contaminated industrial and commercial sites. The BEDI funds must be used to enhance or improve the viability of projects that have to be financed with new Section 108 loan funds. Since the BEDI grants are used as additional security for Section 108 loan guarantees, communities do not have to pledge their future CDBG allocations.

BEDI funds must be used to finance any eligible activity under Section 108 and meet the national CDBG objectives. For example, a local community can use BEDI funds to perform site remediation or to acquire contaminated property and convey the site to a private developer at a deeply discounted price. The activities must support projects that will provide near-term results and demonstrable economic benefits, such as job creation and increases in the local tax base.

There are a number of limitations on how the BEDI funds may be used. The money may not be used to reimburse or fund cleanup activities by private or public entities that are responsible for the contamination. Sites that are listed, or proposed to be listed on the federal Superfund list, are not eligible for BEDI funds. HUD has cautioned applicants against proposing projects for sites where the environmental conditions are not fully understood or that are the subject of on-going litigation or enforcement actions.

The BEDI grants are awarded on a competitive basis. Applicants that are eligible for BEDI grants include local governments (and their agencies) for communities that may receive Section 108 loan guarantees. A request for a new Section 108 loan guarantee must accompany each BEDI application. The BEDI grants average around $1 million and the program will leverage an additional $200 million in brownfield investments.

The Brownfield Amendments should help create synergistic opportunities for local communities to redevelop brownfield sites and for lenders to obtain CRA credit. The new law specifically provides that brownfield grants may be available for sites even if other sources of financial assistance are available. Thus, a local community can obtain EPA and HUD funding that can be used to help pay for a significant portion of the investigation and remediation costs of a brownfield, thus minimizing the environmental risks of financial institutions providing additional funding for the project.

Practical Tips for Lenders Contemplating Financing Brownfield Projects

Lenders that finance brownfield redevelopments will usually impose a number of conditions on the financing. First, lenders usually require developers to have at least 25 percent equity in the project to make sure that the borrower has sufficient capital at risk. Because owners with low equity interests abandoned property during the last decline in the real estate market, many lenders will require owners to maintain sufficient equity to ensure an owner's commitment to the project.

Second, the rule of thumb used by many banks is that the remediation costs cannot exceed 25 percent of the fair market value of the unimpaired property.

Third, many banks often stipulate that the loan proceeds cannot be used to finance the cleanup. Instead, the borrower is expected to use its own equity or find other sources to fund the site investigation and cleanup. Because of these requirements, usually only the smaller properties, with limited contamination, have been financed through traditional bank lending. In addition, the nature of the contamination can influence the availability of financing. For example, a site with soil that is contaminated with petroleum may be easier to finance than a site with groundwater contaminated with chlorinated solvents.

The expedited cleanup procedures and NFA letters that are available under the VCPs can help lenders quantify the risks posed by a site. Many financial institutions require pre-approval of a remediation action plan (RAP) and remediation schedule by the state environmental authority as a condition of the loan commitment. In some cases, banks may also require the developer to enter into a VCP agreement in which the state will issue an NFA and covenant not to sue in favor of the borrower and the lender. If there is concern that the EPA may be interested in the site, some lenders may also request that the borrower enter into a prospective purchaser agreement with the EPA, which can insulate the developer, lender, and seller from future liability.

Special Note Regarding Brownfields with Institutional Controls

Lenders that are contemplating taking 30-year mortgages on remediated sites may be concerned that the state standards may change in the future or that the institutional control may not work effectively (*e.g.*, a construction project inadvertently compromises the integrity of the impervious cap). The state could then require a borrower to perform additional cleanup under the reopener clause in the VCP agreement, which can affect a borrower's ability to repay its loan.

Another problem with institutional controls is that many states have not established sufficient oversight controls for ensuring compliance with the institutional controls. Once a VCP agreement is signed, many states leave enforcement of the restrictions to local govern-

ment that, in turn, often relies on the good faith of the borrower.

Lenders should be aware that institutional controls often require that the owner be responsible for post-remedial operation and maintenance activities (O&M), such as groundwater monitoring, which can last as long as 30 years. Although they can result in an initial reduction in remediation costs, O&M costs often are severely underestimated. As a result, some lenders will not extend financing for sites where remedial actions involve the use of engineering or institutional controls. Instead, they are continuing to insist that the contamination be remediated using the traditional or residential cleanup standards as a condition of the loan.

Thus, it is extremely important for lenders to carefully scrutinize institutional controls that may have been implemented for a site to be developed or financed. These restrictions may be of particular concern when there is a soil treatment system installed to remediate contamination caused by volatile organic compounds, since the restrictions may prevent excavation of soil, which would preclude construction or other development activities. Unless the restrictions can be removed, the property may not be able to be developed in accordance with its highest and best use, or even according to the project development plans. Removal of existing restrictions will require approval of the regulatory agency, the owner or PRP responsible for the remediation, and the local community. When a non-owner, such as a former site operator or owner of an adjacent property, is responsible for the remediation, the developer may have a difficult time obtaining the approval of the non-owner PRP since removal of the restrictions will likely result in a more costly cleanup for which the non-owner PRP will want to be reimbursed.

Notes

1. 12 U.S.C. §§ 2901(a) & (b).
2. 42 U.S.C. §§ 9601(1)–(38).
3. 42 U.S.C. §§ 6901(a)–(d).
4. 42 U.S.C. §§ 9601(20)(E)-(G).
5. 42 U.S.C. §§ 6991b(h)(9).
6. Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009-462 (1996) (codified as amended at 42 U.S.C. § 9601).
7. Community Development: Reuse of Urban Industrial Sites (GAO/RCED-95-172) (June, 1995).
8. Small Business Liability Relief and Brownfields Revitalization Act, Pub. L. No. 107–118, 115 Stat. 2356 (2002) (codified as amended at 42 U.S.C. § 9601 (2002)).
9. The author has written an article describing the provisions of the Brownfield Amendments in more detail. This article is available from the Schnapf Environmental Law Center Web site at *www.environmental-law.net.*
10. Institutional controls are non-engineering mechanisms that are designed to limit activities at a site so as to minimize exposure of contaminants to people. The purpose of the institutional controls is to minimize exposure to people working or living in the area. There are basically two types of institutional controls. First, proprietary controls are contractual mechanisms placed in deeds or other documents that transfer property. They usually consist of covenants such as deed restrictions, which can prohibit certain types of development, use as construction property or parts of construction property, or easements, which allow another party to restrict the uses that the landowner may allow on the property. A common form of easement is a conservation easement in which landowners agree that their land may not be developed. The second type of institutional control is government controls, such as zoning restrictions or groundwater classification systems that require permits before a drinking water well can be installed.
11. *Supra* n.1.
12. Community Reinvestment Act Regulations, 60 Fed. Reg. 22156, 22160 n.1 (May 4, 1995) (codified at 12 C.F.R. pt. 203).
13. Housing and Community Development Act of 1974, Pub. L. 93-383, 88 Stat. 633 (1974) (codified as amended at 42. U.S.C. § 5308.

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