Financing Development of Contaminated Properties

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In the late 1980s and early 1990s, many financial and institutional lenders became reluctant to finance the acquisition and development of contaminated property out of concern that they could become directly liable for the cleanup costs associated with their collateral. Lenders also feared that environmental contamination would affect their borrowers' ability to repay their loans as well as severely impair the value of their collateral.

With the passage of federal and state lender liability legislation and the proliferation of state voluntary cleanup programs (VCPs), financial institutions have shown an increasing willingness to finance the acquisition and redevelopment of contaminated property located in desirable locations. However, environmental issues continue to be a major deterrent for development of contaminated properties in economically depressed areas. Moreover, because many banks will not approve loans where the remediation costs exceed 25 percent of the fair market value of the property, usually only smaller properties with rather limited contamination may be financed through traditional bank lending. As a result, federal, state and local financial incentives have begun to play an increasingly important role in the development of marginally profitable contaminated properties. This article surveys the principal financing mechanisms available to developers for these properties.

During the past few years, private venture capital groups have been formed to invest in contaminated properties. These groups generally do not provide financial assistance to developers nor do they intend to develop or operate the sites. The strategy of these groups is to purchase, remediate and then quickly resell contaminated properties.

Venture capital groups raise their own equity from institutional investors. Because returns of 30 percent or more are sought in its investments, there are only a limited number of sites that meet the needs of these funds. These properties are usually found in attractive locations, such as waterfronts or near highways, are deeply discounted because of their environmental conditions and can be quickly remediated. Other categories of properties on which the funds have recently focused are mothballed corporate-owned facilities. The investment funds hope that their commitment to remediate the sites and to provide insurance against future liability will help persuade corporate owners to sell these potentially highly profitable properties.

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Real estate investment trusts (REITs) also may be a financing source for contaminated properties, particularly contaminated shopping centers that are often not sufficiently discounted to be attractive to the brownfield venture funds. REITs have traditionally offered investors a high rate of return and have been attractive investment vehicles for insurance companies, pension funds, and other capital investment entities. Consequently, REITs will tend to look for sites that have already been remediated or that have minimal contamination. Moreover, because the federal Securities and Exchange Commission requires disclosure of material environmental liabilities, many publicly traded REITs will shy away from contaminated properties out of concern that disclosure of environmental liabilities associated with their properties could scare away investors and lower their stock. The existence of state dry cleaner solvent trust funds (discussed below) have provided critical financial incentives for the purchase and expansion of contaminated shopping centers. Because the dry cleaning funds will pay for the cleanups and relieve shopping center owners of liability, REITs may not have to disclose these potential liabilities in their offerings.

Nonprofit organizations also may be used to fill financing gaps for contaminated properties that have a rate of return below the level required by most venture capital investment groups. Many developers and local governments do not want to waste their limited resources investigating a contaminated site only to find out eighteen months later that it cannot be developed. Nonprofit organizations can help eliminate that early uncertainty by providing financial assistance for site investigation and cleanup with no inherent time constraints.

The nonprofit groups take a variety of approaches to financing redevelopment of contaminated properties. Some may purchase options on contaminated property, perform a site investigation and then enter into a contingent VCP agreement with the state that quantifies the cleanup costs for the site. The nonprofit will then seek to

sell its option to purchase to a developer and also assign the VCP agreement to the developer. Other nonprofits will take an equity position in the property. This can be a particularly important financing tool for sites where the cleanup costs can be as much as 50 percent of a project, but a lender will only agree to finance the non-cleanup phase of the project. The funding provided by the nonprofit can be used as the equity to perform the cleanup and reduce the risk ratio of the project. One nonprofit will provide 100 percent financing, which can be used to pay for the costs of property acquisition, environmental assessments and remediation, and environmental insurance premiums. The loans may have a maturity of eighteen to twenty-four months with a single payment at the end of the loan term.

Federal Financing Tools for Contaminated Properties

A number of federal agencies have agreed to invest more than $300 million in communities with contaminated properties that qualify as brownfield sites. These agencies also will make an additional $165 million available in the form of loan guarantees.

EPA has announced two financial assistance programs to facilitate the cleanup and reuse of brownfield properties. Under its Brownfields Assessment Demonstration Pilot (BADP) program, EPA has been issuing two-year $200,000 grants to local communities that may be used to conduct preliminary response activities, such as identifying sites that have releases or threatened releases of hazardous substances, conducting site assessments to evaluate the nature and extent of the contamination, or identifying or planning cleanup activities at the sites. 42 U.S.C. § 9604(d)(1). BADP grants may not be used to pay for actual cleanups or other response activities associated with cleanups, may not be used for sites that have been placed on the National Priorities List (NPL), and may not be used for assessment activities at sites that are contaminated with petroleum. However, if a site contains petroleum that is co-mingled with other hazardous substances or contaminants, such as a site containing used oil, the site would be eligible for the BADP program.

While private developers are not eligible to participate in the BADP program, they could seek program funding for site assessment activities through a local government agency's application to the program. The BADP program has been used as an important source of start-up funds for a number of brownfield projects.

A Brownfields Cleanup Revolving Loan Fund (BCRLF) was also established by EPA to fund cleanups of eligible brownfield sites. 62 Fed. Reg. 24,915 (May 7, 1997). BCRLF funds may not be used to conduct preliminary response activities, such as site assessments, nor may the funds be used to pay for nonenvironmental redevelopment activities, such as construction of a new facility or marketing of a property. However, up to 10 percent of the total loan may be used to cover administrative and cleanup response planning costs. In addition, the lead agency may be authorized by EPA to use up to 5 percent of the total award to pay administrative and legal costs, such as loan processing, professional services, audits, and state program fees.

The only brownfield sites that are eligible for the BCRLF program are the BADP projects awarded prior to October 1995. Eligible applicants must be local government entities. Successful applicants will be designated the "lead agency" and will be responsible for selecting site managers to supervise cleanups and approving recipients for BCRLF grants.

Private parties may be borrowers under the BCRLF program so long as they are not PRPs. For example, a party who was a generator or transporter of hazardous substances that caused the contamination at a particular brownfield site may not be a borrower for that site. However, an owner/operator of a brownfield site may be eligible to receive BCRLF grants if the lead agency determines that the owner/operator would fall under a statutory exemption or that EPA would not pursue a CERCLA enforcement action against the party because of an administrative policy (e.g., owners of property with contaminated aquifers where the contamination is coming from an off-site source.)

The BCRLF may be used at sites that are owned by government agencies or a quasi-public entity, such as an industrial development agency, as well as privately owned properties that are to be acquired by an "innocent prospective purchaser." However, there must be a mechanism for recouping BCRLF expenditures, such as through a guarantee from the owner or the imposition of a lien on the real property.

Like the BADP program, BCRLF may not be used to clean up sites contaminated with petroleum unless the petroleum is co-mingled with other hazardous substances or contaminants. BCRLF also may not be used at sites that have been listed or proposed to be listed on the NPL, where a "removal" action was taken by a federal or state agency during the prior six months, or where a federal or state agency is planning or conducting a response or enforcement action.

BCRLF proceeds also may not be used to clean up hazardous substances that are part of the building structure, such as lead-based paints or asbestos, nor to upgrade public or private drinking water supplies that have deteriorated through normal use. Additional prohibited uses of the BCRLF include post-remedial operation and maintenance costs and the cost of gathering information for obtaining or complying with environmental permits unless the permit is required as a part of the funded cleanup. The cleanup activities must not only comply with state and federal environmental requirements but also must qualify as a "removal" action. The borrower must also comply with the public participation requirements of the NCP and meet all fed-

eral and state requirements for worker health and safety.

One of the primary drawbacks of this program is the limited size of the grants that are estimated to range from $200,000 to $400,000 per site. For many contaminated sites, this sum will simply be inadequate to satisfactorily remediate the site.

The Department of Housing and Urban Development Corporation has used a number of programs to stimulate redevelopment of contaminated properties. Under the Community Development Block Grant (CDBG) program authorized by the Housing and Community Development Act of 1974, local governments can obtain CDBG funds to help finance the acquisition, construction, renovation or rehabilitation of privately owned buildings, properties and public facilities. 42 U.S.C. §§ 5301 *et seq.*; 24 C.F.R. Part 570. Many of the construction-related activities eligible for CDBG funding also may be used to clean up and redevelop brownfields. 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. The kinds of environmental conditions that could require such a review include issues related to air quality, contamination of drinking water, and disparate environmental impacts to residents of low-income communities.

Federal, state and local financial incentives have begun to play an increasingly important role in the development of marginally profitable contaminated sites.

Because many projects take more than one year to complete, communities often cannot use their CDBG allocations in one year. When this occurs, communities may accrue their allotments until the funds are needed or tap these funds on an interim basis to finance short-term, low-interest loans for projects that will create jobs. Developers and not-for-profit agencies may apply for these CDBG "float" loans, which may be used to help pay for remediation costs. However, these float loans are limited to terms of not more than two and one-half years.

Another HUD funding source is the Section 108 Loan Guarantee Program. 24 C.F.R. Part 570, subpart M. This program is ideal for large-scale projects with upfront expenses that exceed a local government's annual CDBG allotment. Under the Section 108 program, the local government will issue HUD-guaranteed debentures and pledge its future CDBG grants as collateral for the HUD guarantee. The Section 108 proceeds may be used to finance an 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 nonprofit organizations; and (4) site preparation, including construction, repair or installation of infrastructure improvements, utilities, and other public facilities. The funds may be used to perform lead-based paint and asbestos abatement activities that are associated with building renovations or rehabilitation.

In 1996, HUD approved $50 million in Section 108 loan guarantees to finance brownfield redevelopment activities in Chicago. The loan will be used to acquire, remediate and redevelop abandoned industrial properties over a three-year period. Proceeds collected from the sale of the properties, tax incremental financing, interest earned on the loan balance and settlements with PRPs will be used to repay the loan.

In 1998, Congress approved $25 million for Brownfields Economic Development Initiative (BEDI) grants and HUD has requested an additional $50 million for fiscal year 1999. Unlike the previously discussed HUD programs, BEDI grants are specifically intended to help cities redevelop contaminated industrial and commercial sites. BEDI funds may be used to finance any eligible activity under Section 108 that meets 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. Because the BEDI grants are used as additional security for Section 108 loan guarantees, communities do not have to pledge their future CDBG allocations.

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 NPL are not eligible for BEDI funds. HUD has cautioned applicants against proposing projects for sites where the environmental conditions are not fully understood or for sites that are the subject of ongoing litigation or enforcement actions.

BEDI grants will be awarded on a competitive basis. Eligible applicants for BEDI grants include local governments (and their agencies) for communities that may receive Section 108 loan guarantees. A request for new Section 108 loan guarantees must accompany each BEDI application. HUD anticipates that the average BEDI grant size will be $1 million and that the program will leverage an additional $200 million in brownfield investments.

The Small Business Administration (SBA) provides financial assistance and facilitates venture capital financing to small businesses that are unable to secure financing on reasonable terms through normal lending channels. To be eligible for SBA financial assistance, a small business must actively conduct operations for profit in the United States, must demonstrate a need for credit, must demonstrate that it cannot obtain financing from nonfederal sources on reasonable terms, and must state that funding is not available from any owner who holds 20 percent or more of the equity in the business. 13 C.F.R. § 120.100-102. The SBA will require that such owners use their personal resources to reduce the amount of the loan to be funded or guaranteed by the SBA when the liquid assets of those owners exceed certain thresholds. The thresholds are relative to the size of the loan.

A small business may use SBA financing for: (1) the purchase of real estate that will be used to operate the business; (2) site improvement such as grading, landscaping, streets and parking lots; (3) construction of new buildings and renovation or expansion of existing buildings; and (4) acquisition of machinery and equipment. Loan proceeds cannot be used to purchase real estate that will be held primarily for investment purposes. However, a holding company of the borrower may use the proceeds to acquire, improve or renovate real or personal property that it leases to the borrower provided that: (1) both the holding company and the operating company/borrower are small businesses that would independently qualify for the loan; (2) a lease exists between the two companies equal to the term of the loan that is subordinate to the SBA's lien and an assignment of the rent payable under the lease to the SBA; (3) each holder of 20 percent or more equity in both companies must guarantee the loan; and (4) the operating company must co-sign or guarantee the loan with the holding company.

There are primarily two SBA lending programs that may be used to help redevelop contaminated properties. Under the 7(A) Loan Program, SBA will guarantee up to 80 percent for loans that are $100,000 or less and 75 percent of loans up to $750,000. 13 C.F.R. § 120.200-222. Direct loans under this program are limited to $150,000. The term of a direct loan or the loan that is being guaranteed will generally be less than ten years unless the loan is used to finance real estate or has a useful life exceeding ten years, in which case the maximum life of the loan will be twenty-five years. The interest rate for these loans with terms of less than seven years is the prime rate plus 2.25 percent, while loans over seven years will carry an interest rate of the prime rate plus 2.75 percent.

In addition to the general purposes listed above, a borrower may use 7(a) loan proceeds to purchase inventory, supplies, raw materials, working capital, as well as to consolidate, refinance or repay debts. SBA is authorized to guarantee loans of up to $1 million to help small businesses plan, design and install pollution control equipment, such as air pollution control equipment and water treatment facilities. It is possible that this program may be used to pay for the installation and operation of groundwater treatment systems to remediate contaminated groundwater beneath a brownfield site.

Under the Section 504 Certified Development Company Program, nonprofit corporations known as certified development companies (CDCs), are established to provide technical and financial assistance to small businesses located in designated geographical areas. 35 C.F.R. § 120.800-.991. To qualify for the 504 program, a business must first meet the general SBA definition of a small business, have a tangible net worth of less than $6 million and have an average net income of less than $2 million after taxes the preceding two years.

The financial assistance package must consist of three parts. The first component is the 504 loan, which may not exceed 40 percent of the project costs. Another 50 percent must be financing from a private-sector lender that is not guaranteed by the SBA. The remaining 10 percent must be an equity contribution by the borrower in the form of cash or property. The total outstanding balance of all SBA financial assistance to the borrower and its affiliates cannot generally exceed $750,000.

Project costs that may be paid with 504 funding include the acquisition of long-term, major fixed assets with a useful life of at least ten years such as land, buildings, improvements, and machinery and equipment. The loan proceeds also may be used to pay for a variety of professional fees that are directly attributable and essential to the project including the costs of performing environmental site investigations and legal fees. However, Section 504 loans may not be used to pay for working capital, debt refinancing, and short-term fixed assets such as furniture, furnishings and motor vehicles.

The federal Economic Development Agency (EDA) provides financial assistance to local governments and public or private nonprofit organizations to spur economic development. EDA has made $17 million available for brownfield redevelopment. There are three principal EDA programs that may be used to fund brownfield redevelopment.

Under the Title I public works program, EDA provides financial assistance for projects located within designated redevelopment area or economic development centers. 42 U.S.C. §§ 3131-3137. The financial assistance may

be in the form of grants, loans, guarantees of loans issued by private banks, and the purchase of debt. Recipients may use the financial assistance to purchase and develop land, obtain facilities and equipment for industrial or commercial uses including construction of new buildings, and for rehabilitation of abandoned or unoccupied structures as well as the alteration, conversion or enlargement of existing buildings. In addition to acquisition and development costs, the financial assistance may be used to secure working capital loans, guaranteeing rental payments and satisfying liens against property that is intended to be developed.

The Title IX Economic Adjustment Assistance program provides funding to communities that experience, or that may be reasonably foreseen to experience, severe economic dislocations or long-term economic deterioration as a result of actions of the federal government (e.g., military base closings). 42 U.S.C. §§ 3241–3145. To qualify, the local area must either: (1) have experienced or anticipate a change in economic conditions that will result in the loss of a significant number of permanent jobs relative to the area's employed labor force or (2) suffer from very high unemployment, low per-capita income or fail to keep pace with national economic growth over a five-year period.

The Taxpayer Relief Act of 1997 established federal tax incentives for owners of sites that qualify as brownfields.

The Taxpayer Relief Act of 1997 established federal tax incentives for owners of sites that qualify as brownfields. While the Internal Revenue Code allows businesses to deduct remediation costs, there has been some confusion as to whether the cleanup costs could be deducted as an expense in the year that the costs were incurred or whether the remediation expenses had to capitalized over the useful life of the contaminated property. *See* 26 U.S.C. § 126; *compare* Rev. Rule 94-38, 1994-1 C.B. 35 (holding soil remediation costs deductible as expenses but groundwater treatment costs as capital expenditures) with Tech. Adv. Mem. 95-41-005 (Oct. 13, 1995) (requiring taxpayer to capitalize environmental investigation costs, as well as consulting and legal costs) and Tech. Adv. Mem. 95-41-005 (PLR 9627002) (Jan. 1996) (revoking earlier Tech. Adv. Mem 95-41-005 ruling). The Taxpayer Relief Act allows brownfield owners to deduct "qualified remediation expenditures" in the year they are incurred or paid. 26 U.S.C. § 198. "Qualified remediation expenditures" are defined as costs paid or incurred in connection with the abatement or control of hazardous substances after August 5, 1997. It does not include costs to remediate petroleum contamination unless the petroleum is co-mingled with other hazardous wastes. It also does not apply to releases from products that are part of a building structure, such as asbestos-containing materials, nor releases into public drinking water supplies where the release is due to the deterioration of the system through ordinary use.

The costs must be associated with a "qualified contaminated site." To fall within this definition, a site must have had a release of hazardous substances, must be held by the taxpayer for use in a trade or business, or to produce income, and must be located in a "targeted area." A site that is listed or proposed to be listed on the NPL may not be considered a "qualified contaminated site." Taxpayers will not be allowed to treat remediation expenses as deductible expenses in the year they are incurred after December 31, 2000. Remediation costs that are treated as deductions will be subject to recapture as ordinary income when the property is sold or disposed.

State and Local Financial Incentives

Nearly all states have financing programs that have been used to encourage redevelopment. A number of states have begun to use these traditional programs to target brownfield redevelopment.

Most states issue economic development loans through Industrial or Economic Development Authorities (IDA/EDA). Some IDA/EDA will allow a portion of the loan facility to be set aside to pay for the assessment and cleanup of the property. However, because these agencies have the same liability concerns as private lenders, these agencies will often require the developers to enter into voluntary cleanup agreements with the state environmental agency and obtain a complete release for the authority for any contamination at the site.

Revolving loan funds (RLFs) administered by IDA/EDA are another source of funding. Under this approach, the IDA/EDA will acquire and remediate contaminated property using RLF money. Upon the completion of the remediation, the IDA/EDA may sell or lease the property. Some states allow the IDA/EDA to provide prospective landowners with indemnities and releases from liability. The proceeds from the sale or lease of the properties may then be used to replenish the RLF. Revenue collected from property taxes, the sale of bonds, federal EDA financial assistance and sums collected from cost-recovery actions filed against PRPs for those sites also have been used to restock RLFs.

Business Development Corporations (BDCs) may also

be used as an alternative to direct loans or loan guarantee programs when state constitutions prohibit the use of public funds for assisting private businesses. BDCs raise their capital by issuing stock to institutional investors such as banks, pension funds and insurance companies. Because BDCs are not subject to the same financial performance requirements as chartered banking institutions, BDCs can handle higher risk loans.

Approximately forty states have established tax incremental financing (TIF) mechanisms that create a source of funding for development by using the anticipated growth in property taxes generated by a redevelopment project as collateral to secure bonds issued to pay for site acquisition and development. The incremental increases in tax revenue from the redeveloped properties are captured by the TIF fund to pay off the principal and interest costs of the bonds. A number of states also have used TIF specifically to pay for remediation costs of brownfields. TIF bonds are then used to pay for site assessments and remediation with the increased tax revenues earmarked to retire the bonds.

Nearly all states have financing programs that have been used to encourage redevelopment.

State and local governments have long offered property tax abatements to attract or retain business and industry. Some states have extended this tool to foster redevelopment of brownfields. The property tax abatements help reduce the cash flow requirements of a project that has to incur remediation costs. The particular approach varies, but typically the property tax for the property to be redeveloped may be frozen at its pre-improved value or the tax may be reduced for a certain period of time.

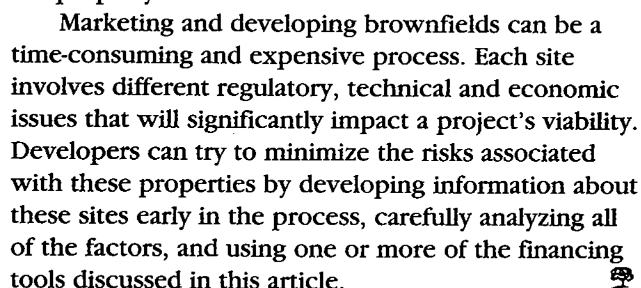
Some states allow developers of brownfield sites to take Remediation Tax Credits (RTCs), which can drive down project costs and make the project more attractive to private lenders. Usually, RTCs may be claimed in the year the remediation costs are incurred. States usually limit the amount of RTCs that may be claimed in any one year. In addition, a number of states also allow corporate income tax credits for new jobs created by the project.

A number of states issue cleanup or assessment grants that may be used to finance the assessment and, in some instances, the cleanup of brownfields. The eligibility requirements of these grants vary as well as the amount of the grants. For example, some states may match up to a certain dollar amount of site assessment costs. Other states only allow the grants to be used by local governments while other states allow non-PRPs to be eligible for the grants.

Similarly, a number of states offer low-cost remediation loans to parties who are not otherwise responsible for the contamination as part of their voluntary cleanup programs. The terms and conditions of these loans vary from state to state, as well as the kinds of parties and sites that may qualify for the loans.

Many states have established Underground Storage Tank (UST) Trust Funds that can be used to help pay for the cleanup of contamination associated with releases of petroleum from USTs. The eligibility requirements for these state trust funds vary as do the deductibles that may apply. For example, most state UST trust funds may only be used if the USTs are in compliance with the state UST design and operating standards. Many UST trust funds do not apply to inactive USTs. Usually, the owner of the USTs must first incur response costs and then apply for reimbursement, although some states have taken over direct responsibility of UST cleanups because of fraudulent claims. Most states limit reimbursements to owners or operators of the USTs at the time the leak is detected. If the site has contamination that is associated with USTs and the state has a UST trust fund, prospective developers and owners should determine if the remediation costs would be eligible for reimbursement under the state UST program. In some cases, it may be necessary for prospective purchasers to obtain assignments of rights of reimbursement from the seller.

Finally, a handful of states have enacted dry cleaner solvent trust funds that can be used to help pay for the remediation costs associated with releases of solvents from dry cleaning operations. The scope of the programs vary in terms of the parties who are eligible to participate, the amount of the deductibles, and the eligibility requirements. Some programs apply only to operators of existing dry cleaning establishments while others also extend to prospective owners of properties like shopping centers that may have been contaminated by inactive dry cleaning operations. Some programs require the operators to comply with certain dry cleaning operating standards before they may be eligible for the program. A number of programs insulate participants from liability for property damage and personal injury resulting from exposure of solvents migrating off the property.



Marketing and developing brownfields can be a time-consuming and expensive process. Each site involves different regulatory, technical and economic issues that will significantly impact a project's viability. Developers can try to minimize the risks associated with these properties by developing information about these sites early in the process, carefully analyzing all of the factors, and using one or more of the financing tools discussed in this article.