

Brownfields In Kentucky: A New and Innovative Approach (Part I)

By: Adam T. Goebel and Lea Pauley Goff

The reuse and development of contaminated property, referred to as brownfields, has always posed unique and challenging issues. The Commonwealth has a strong interest in promoting the development of such properties. Brownfield revitalization can have positive economic impacts beyond just one site; entire corridors of property can be transformed to beneficial use for the communities that Kentucky banks serve.

Conversely, the Commonwealth has the obligation to enforce environmental laws, and the potential liability associated with brownfields has always hindered their development. Environmental liabilities are inherently complex and uncertain. Uncertainty has been compounded by the fact that Kentucky's Energy and Environmental Cabinet (Cabinet) has not had the authority to provide, in writing, any assurance to a potential purchaser concerning the scope of that purchaser's liability. To complicate the matter further, even if a purchaser could begin to feel at ease with a particular transaction, there would always be an outstanding question as to whether certain actions by the purchaser while it owned the property could unintentionally expose it to greater liability.

Fortunately the landscape concerning brownfields is changing. In 2012, Kentucky passed a new statute creating a brownfield redevelopment program, which addresses the liability of purchasers of contaminated property. The Cabinet issued interim guidance in June 2013, which was revised in September 2013, concerning transactions under the statute. The Cabinet also issued draft regulations in September 2013 adopting many of the concepts contained in the revised interim guidance. These new developments in Kentucky law have significant implications for both purchasers *and lenders* with respect to transactions involving brownfields. A number of transactions have already proceeded under the new statute and properties that may have otherwise remained vacant due to the existing environmental liability are now being redeveloped. Importantly, both current owners and prospective purchasers can take advantage of the liability protection offered by Kentucky's new program.

Kentucky's Brownfield Statute and Key Improvements Over Prior Law

Kentucky's brownfield program is codified as KRS 224.1-415. Under this statute, an owner of contaminated property shall not be liable for responding to contamination if the property owner can certify, and the Cabinet finds, that the contamination predates the acquisition and the owner (1) performed "all appropriate inquiry" (*i.e.*, an

appropriate Phase I) before acquisition; (2) has provided all legally required notices concerning the contamination at the site; (3) is in compliance with all land use restrictions and will not impede any institutional controls required for the property; (4) has complied with any information requests from the Cabinet; (5) is not affiliated with any responsible party; and (6) has not caused or contributed to any release and will provide access for the Cabinet or responsible party to respond to the contamination. These requirements are very similar to the requirements to be a bona fide prospective purchaser (BFPP) under Kentucky's "Superfund" statute, KRS 224.1-400(25), and the federal Superfund Statute, 42 U.S.C. § 9601. To date, the Bona Fide Prospective Purchaser (BFPP) defense has been the main defense available to protect a purchaser of contaminated property from liability.

There are three significant improvements between the existing BFPP defense and Kentucky's new brownfield redevelopment program. These improvements should be of particular interest to lenders and purchasers. First, with respect to the BFPP defense, the Cabinet was not able to provide any assurance in writing that the new owner would not incur liability if it purchased the property. The Cabinet would instead remain silent on the issue, thereby creating uncertainty and likely chilling interest in the property. Under the new statute, the Cabinet will provide a purchaser written assurance that the purchaser will not have liability for responding to contamination at the site upon acquisition. The written assurance will be in the form of a "Notice of Eligibility" that the prospective purchaser may participate in the brownfield redevelopment program and a "Notice of Concurrence," which the Cabinet will issue after title passes to the new purchaser.

Second, a party is now able to obtain certainty before closing on the transaction that it will not have liability for responding to contamination once it acquires the property. A purchaser may submit its application to the Cabinet before closing and the Cabinet will inform the purchaser, via the Notice of Eligibility, that it will not incur liability for the contamination upon its acquisition of the property.

The third improvement concerns an owner's continuing obligations at the site. A prospective owner can now define its post-acquisition obligations at the site to minimize the chance that its conduct might inadvertently cause it to lose liability protection. This is achieved by the owner developing, and the Cabinet approving, a Property Management Plan (PMP). In general, the PMP will be a governing document for managing activities at the site to ensure such activities are protective of human health and the environment.

The PMP is an attempt to solve a fundamental problem with the BFPP defense: a BFPP has little direction concerning the care it must take at a site to avoid losing liability protection. Court decisions on the care that must be exercised by a BFPP are more helpful in demonstrating risks involved with acquiring contaminated property than with providing solutions on how to avoid litigation and adverse determinations. For example, if any construction is to take place at the property, lack of certainty concerning whether particular techniques will be considered protective is a significant impediment to redeveloping the property. Under the PMP, the Cabinet and the new owner can agree in writing on the manner in which the property owner will conduct activities at the site including, for example, construction management. Under the proposed regulations for KRS 224.1-415, discussed in Part II, so long as the property owner complies with the PMP, it will retain liability protection.

Concerning the interests of lenders, all bankers know that environmental contamination is not just a property owner issue. Lenders with a good loan prospect may see underwriting stopped in its tracks by an environmental issue. In addition, if the loan is near or in default, lenders face a number of issues in deciding how to move forward with contaminated property. For example, the presence of contamination raises uncertainty about the value of the property and ability to market it. The existence of contamination also creates uncertainty with respect to the actions that a lender make take in asserting ownership and control over the property without incurring liability.

For lenders, the new statute offers two new benefits in transactions involving brownfields. The first benefit is the ability to obtain from the Cabinet, in writing, a determination that the property owner will not have liability for addressing existing contamination. This guidance allows lenders to evaluate with more certainty the potential liabilities associated with the transaction. In addition, lenders will be able to evaluate with more certainty the appropriate manner of addressing a borrower's potential default. If a lender knows that the property is capable of being sold to a potential purchaser free from the existing environmental liability and with an understanding of any continuing obligations, then it can have more confidence in the value of the asset.

A second benefit is that Kentucky's new brownfield statute may reduce the risk of taking ownership of the collateral after default. For example, under the federal secured lender exemption from liability, a secured lender is required to take reasonable steps to market the property in order to maintain its exemption. While case law exists that discusses "reasonable steps," this requirement is murky and "reasonableness" could be determined by a Court with the benefit of hindsight. In addition, a secured lender must be careful not take any action that may be deemed to cause a release. Kentucky law is even more uncertain, it provides that in order for a financial institution to be exempted from liability, it cannot know or have reason to know,, "at the time it acquired the site," that contamination existed at the site. Read literally, if the borrower performed a Phase I environmental assessment and the lender knows that the Phase I identified contamination, then the financial institution arguably does not qualify for the exemption.

By utilizing Kentucky's new brownfield statute and a Property Management Plan, a financial institution can address the uncertainties that exist in pre-existing federal and state law. Instead of being forced to question whether each action it takes at a site is appropriate, a lender can reach an agreement with the Cabinet in writing concerning its protection from liability and the actions it may take at the site without losing its exemption from liability. In many ways, the statute and proposed regulations have been drafted with lenders in mind because participation by a community's lenders is crucial to the program.

Watch for Part II

In November's Issue

Of Kentucky Banker

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The process to avail oneself of the liability protection afforded by Kentucky's new Brownfield statute is straightforward. At the present time, the Cabinet is applying its interim guidance to transactions under the new statute. The public comment period for the proposed regulations is open until October 31, 2013, and the regulations should become final by early next year. For issues not specifically addressed by the Cabinet's interim guidance or the regulations, it is anticipated that the Cabinet will follow EPA guidance developed for the BFPP defense.

In general, if the subject property is a Brownfield and the potential purchaser wants to take advantage of Kentucky's Brownfield program, it will complete a Brownfield Liability Relief Eligibility Form. Under the proposed regulations, a Brownfield is defined as property where a release of hazardous substances or petroleum occurred before acquisition, or there is a "potential or perceived" presence of such a release. Both the applicant and a professional engineer or a professional geologist must sign the application form. The applicant must certify that it satisfies the eligibility requirements set forth in KRS 224.1-415. It is important to note that the existence of a promissory note and a mortgage between a lender and a responsible owner is not deemed to be a contractual affiliation that would disqualify the lender under KRS 224.1-415(6).

With respect to the certification by the professional engineer or geologist, he or she must certify that, after conducting "all appropriate inquiry" (e.g. a proper Phase I), (1) all known releases predate acquisition, (2) all appropriate inquiry was performed in accordance with industry standards, and (3) the intended future use of the property will not interfere with characterization and remediation. The applicant must include with the application a copy of the Phase I and the Property Management Plan (PMP) for the site

The Cabinet has provided guidance on the contents of the PMP. The proposed regulations also address the contents of the PMP. In general, the PMP must provide a reasonable description of the planned future use of the property, a description of any remedy in place, a

description of engineering controls or institutional controls, a plan for construction management, if applicable, and a description of the methods employed to ensure that the property use will not interfere with any remediation or expose the public or the environment to an unacceptable risk of harm.

The anticipated value of the PMP is the ability to define in writing acceptable practices at the site. A common example for a lender would be a site where, if the lender takes title, it will need to take some actions to ensure that the property is in an acceptable and safe condition for marketing. The lender needs to be able to identify in the PMP the actions it will take. So long as the lender follows the PMP it will retain its liability protection, even if contamination is inadvertently mobilized despite precautions taken. A PMP can also be an effective tool if any demolition needs to occur because the party can define the manner in which it will conduct those activities. Moreover, if the site is one where the only ongoing obligations are periodic monitoring, the PMP should be relatively simple in that access would need to be provided to conduct the monitoring or any other act that is part of the remedy. Therefore, the existence of contamination should not pose a significant obstacle to taking title.

Once the application is submitted, the Cabinet, under the proposed regulations, shall issue in writing within 30 days either a Notice of Eligibility, a determination that the application is incomplete or a final determination that the application does not meet the requirements of KRS 224.1-415. Under the proposed regulations, the Notice of Eligibility will be effective for 180 days, which may be extended for an additional period of time. After receiving a Notice of Eligibility, the applicant, upon obtaining legal title to the property, shall submit a deed evidencing its ownership within 60 days of acquisition. The Cabinet then issues a Notice of Concurrence, which states in writing that the property owner is not liable for responding to contamination at the site.

Two additional points are noteworthy. First, if the property owner discovers contamination that was

previously unidentified, it must provide notice to the Cabinet identifying the discovery and stating that the certification in its previous application is also applicable to the newly discovered contamination. By giving this notice, the property owner will not be liable for responding to newly discovered contamination. Second, the Cabinet shall revoke its Notice of Concurrence if the applicant provides a false application. In addition, the Cabinet may, in its discretion, revoke a Notice of Concurrence if the applicant does not follow the PMP. Providing a false application and failing to follow a PMP are the only two acts that allow the Cabinet to revoke a Notice of Concurrence.

A Lender's New Choices In Underwriting, Loan Administration And Enforcement of Mortgages

The process under Kentucky's new Brownfield program offers new possibilities for transactions involving contaminated property. Concerning new transactions, lenders will want to know, during underwriting, whether a borrower has obtained a Notice of Eligibility from the Cabinet with respect to the reviewed transaction. This fact will impact any analysis of the liabilities faced by a borrower. In addition, lenders will want to understand the contents of the PMP to determine whether, and how, the obligations in the PMP affect underwriting.

In transactions where the borrower who obtained a Notice of Concurrence defaults, or even where the borrower is liable for the contamination because the transaction is an existing loan or the borrower could not obtain a Notice of Concurrence, a lender has the new, and perhaps more attractive options, of foreclosure or taking a deed in lieu of foreclosure under the new brownfield statute. The lender can assess the condition of the property and decide whether taking possession under the statute with a PMP is in its interests. A lender can achieve a level of certainty concerning its non-liability through the Notice of Concurrence and the PMP. Moreover, the lender will be able to market the property to prospective purchasers and, assuming they meet the eligibility requirements, the prospective purchasers will be able to receive a Notice of Concurrence. Prospective purchasers will have an

understanding of their potential obligations at the site by way of the lender's already approved PMP. These facts may enhance the ability to sell contaminated property.

If a lender is contemplating taking title, the lender should have a Phase I performed, as the existence of a Phase I is fundamental to obtaining liability protection under the statute. A lender must assess the appropriateness of the timing for a Phase I because the Phase I may not be more than 180 days old at the time of the application. Similarly, a lender must assess the right time during the work out phase of the loan to submit an application to the Cabinet because any Notice of Eligibility issued by the Cabinet is only effective for 180 days.

Other than potential time constraints created by the proposed regulations, the main consideration will be whether taking title and implementing a PMP is the route that will preserve the lender's collateral and maximize a return. One may envision a number of scenarios where the ability to receive assurances from the Cabinet concerning the lender's non-liability; coupled with the ability to define one's obligations at the site, will result in foreclosure or a deed in lieu being a more attractive option.

Time will tell whether the procedures established by the Cabinet will result in an increase in the redevelopment of previously contaminated property. However, the Cabinet has definitely established an innovative approach that should provide more certainty to prospective owners than has previously existed. The Cabinet, namely Tony Hatton, the Director of the Division of Waste Management and, Shawn Cecil, who has spearheaded the new program, should be commended for devising an innovative approach that attempts to serve the needs of owners and lenders in developing Brownfields while, at the same time, complying with the Cabinet's charge to protect human health and the environment. In any transaction involving property with environmental issues, a lender must be well aware of requirements of KRS 224.1-415 and have an understanding of how to utilize the new statute in connection with the transaction.