

This document is provided courtesy of Jamie Evans,  
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## Financing Contaminated Real Estate

### The Loan Process

The typical loan approval process at Canadian banks includes the following steps:

1. Origination of Loan
2. Account Manager (accept or decline loan)
3. Risk Management (approve, modify or reject loan application)
4. Environmental Risk Management (approve or reject application)
5. Reject —> Pushback or new information (accept or decline loan)
6. Credit Adjudication (approve or reject application)
7. If Approved – Account Manager and back office (monitor)
8. Special Loans for delinquent clients (asset recovery)

The ability of the bank to offer financing depends on the loan amount and loan to value ratio (LTV). The greater the loan or the higher the LTV, the greater the risk and the more stringent the requirements become. That being said, some banks have approved loans for up to \$10 million on the basis of a two-page questionnaire and required Phase I, II, and III environmental site assessment reports for a \$250,000 loan for a former gas station property.

A good business plan, experienced management, audited financial statements, and plan for the repayment of the loan are absolutely critical. The maximum most banks will lend for commercial properties is 70% of the appraised value (on an income approach). For special use properties such as gas stations or golf course the limit is 50%. For CMHC multi-residential properties, banks can go as high as 95% for a good borrower. A borrower has much more leverage with its bank in terms of financing if the property is clean as it is then much easier to convince risk management to approve the loan.

All lenders look at the following for all property lending, including Brownfields:

### Credit side

- Financial strength of the borrower – this trumps all else. For instance, if the bank has a \$5 million loan out to a borrower and it is sitting on property worth \$10 million in downtown Vancouver, it is not going to be overly concerned about contamination on the site. In the event of realization, the borrower's equity will almost always cover the remediation costs. That being said, however, banks of course are also interested in the strength of the management team, the cash flow, the balance sheet, who the tenants are, how long their leases are, building condition, etc.

- The project has to make sense from a financial perspective regardless of the environmental condition.

## **Environment Side**

- **The Consultant.** Banks have a much greater level of confidence in the consultants that they have pre-screened and are on their list. Before retaining a consultant, the borrower should first see if its bank has any concerns about using them.
- **Extent of Contamination.** Banks want any contamination delineated with a “clean line” if possible. Banks have done transactions with offsite contamination but only those where all affected landowners are aware of it, the borrower is very strong financially, the source has been removed and the contamination has not moved onto a private property. Sites involved in litigation are generally a “no-go” for any bank.
- **Ease of Remediation.** Can it be cleaned up fairly easily or is it under a foundation? This is critical and will determine whether the bank will require that the contamination be cleaned up, they can live with it, or they will decline to finance.
- **Type of contamination.** Chlorinated solvents in groundwater are a lot trickier (and more expensive) to deal with than metals. Most banks are aware of this.
- **Remediation Plans.** Are there any? When will it be done and is it feasible? Generic or SSRA approach? Dig and dump is generally the easiest, although not always the cheapest. Most banks are open to innovation as long as they reach the same end point in a reasonable time frame (generally less than 2 years).
- **Mitigation Techniques.** Does the borrower have other security? Can the bank cross-collateralize on another property? Can secured creditor insurance be obtained?

There are not different lending rates for contaminated versus uncontaminated property. The lending rate for most loans depends primarily on two things: the cost of funds and the borrower risk rating. The cost of funds is the cost the bank pays to acquire the funds (usually through the bond market). The borrower risk rating is a credit rating the bank puts on a borrower and is dependent on the borrower’s ability to service the loan and its past payment history. In terms of rate, there is not a great deal of difference between banks since they all pay the same cost of funds, the borrower risk rating

across the banks is very similar and competition can be stiff for a target client. However, each Canadian bank had a different risk tolerance level and in some larger banks it actually varies between platforms.

Some banks (RBC, CIBC, JP Morgan, Citi, Wells Fargo) have in-house technical expertise in dealing with contaminated properties. It is seldom the environmental issues that kill the deal but they can be the final nail in the coffin. If the lender has not financed a contaminated property in the past 6 months, the borrower should consider switching lenders. Educating and persuading a lender that does not have the knowledge or the tools to understand the environmental issues is seldom successful.

### **Banker Concerns with Contaminated Properties**

The objective of environmental risk management in the credit risk assessment process is to protect the bank from direct and indirect losses associated with environmental problems. Even when no charge is taken over real property, environmental risk must be assessed for the following reasons:

- **Stability of Client Cash Flow:** The number one issue for any bank is the ability of the borrower to repay the loan and they use cash flow to do that. Fines, shutdowns, clean-up orders, or lawsuits can adversely affect the financial position of borrowers with contaminated properties or significant environmental problems.
- **Reputation Risk:** A bank faces negative impacts on its corporate reputation if it does not hold its clients to some reasonable environmental standard and for a bank – reputation is everything.
- **Value of Collateral:** The property may be worth much less than the appraised value, or may be so contaminated that it has no value at all as collateral.
- **Super Priority of Environmental Claims:** In a bankruptcy situation, federal, provincial or state government environmental claims rank above any other claims, rights or charges against a property.
- **Portfolio Liquidity:** Liquidity of the portfolio may be adversely affected by contaminated sites since they are less desirable than clean properties for securitization or redevelopment. Liquidity is the ease in which an asset can be converted to cash – usually within one year. Thus contaminated property is not easy to sell and it may sit vacant for years because no-one wants to buy something with built-in headaches.
- **Avoid Legal Liability:** In some jurisdictions a bank may be held legally liable for remediation of environmental problems in the event it realizes on contaminated

security. This risk is declining with changes in provincial legislation and there are techniques available to realize on properties without incurring liability for activities on the site. However, if banks are not careful or make the situation worse they will be tagged for the clean-up.

Banks can, and do, accept pre-closing undertakings that impose post-closing remediation requirements. They will, however, require that all the investigations are done and the contamination is fully delineated before they will lend anything.

Banks can impose holdbacks and take other actions to ensure that required post-closing environmental work is done. Holdbacks are typically 1.5 to 2 times the environmental consultant's cost estimate to do the remediation. Thus if a consultant indicates the cost to clean up is \$50,000 and the loan is for \$1 million, the bank will lend the borrower \$900,000 up-front and the remainder when the work is complete but the borrower pays the interest on \$1 million from day one. Banks will often take other security in lieu of taking contaminated property, such as accounts receivable, inventory, and personal property.

### **Environmental Consultants**

Banks use environmental consultants to assess the environmental condition of property they finance to ensure that the property valuation is not materially affected by contamination or other environmental issues. Most banks have an approved consultant list based on the consultants' experience, depth, level of education and client service.

Choosing an environmental consultant is very important. If the bank does not like the choice of consultant, the request for financing is in serious jeopardy of being rejected. If the bank tells the client to get a Phase II or get the report re-done and they use a consultant that is not on the approved list, the report will not be accepted.

### **How to Make the Banker Happy**

- Make sure that city hall and the community support your development. Banks will not finance a development that the surrounding community vehemently opposes.
- Attract a quality anchor tenant with good, consistent cash flow. This could include a branded grocery store, a national drug store chain, a bank branch, a government office, etc.
- Review the take-out options prior to construction. Before a bank will loan money to do the construction, it has to know who will be paying them out on the other side. If the client has an existing relationship with another financial institution it can provide the borrower and the lender with more options.

- Explain how you will be able to handle delays and cost over-runs. Where is the money going to come from and how much is available?
- Make sure that you are building something for which there is strong market demand. If the market doesn't want it, the banks don't either.
- Make sure that your clean-up numbers are realistic and make sense. Ensure they contain a contingency for the unexpected.
- Use top-notch environmental and legal help. A risk manager can tell almost immediately whether or not a financing proposition is going to be difficult just by the name of the consultant on the report and the name of the legal firm representing the proponent. Those that skimp on either will not be getting financing from a conventional Canadian bank.
- Obtain cost cap and other insurance products to deal with any surprises. Make sure you understand what the triggers are for the insurance products so that you can explain them to the bank.

## **Risk Assessments**

A risk assessment was once “the kiss of death” for getting a property financed. Some banks will still not accept them because they do not understand them. All banks prefer a full depth clean-up to generic standards versus a risk assessment. It is critical that the risk assessment consultant has clear conclusions and recommendations.

In all provinces (except if you are going through the MOE RSC process in Ontario) ensure that the risk assessment undergoes a peer review by a bank-approved consultant before you submit it to the bank. Ensure that the original consultant is very well qualified to conduct risk assessments. If the report and conclusions are not clear, banks cannot finance.

## **Buying Contaminated Property**

Be careful in your property selection process and know exactly what you are getting into. Ensure that you obtain full disclosure from the vendor. If they will not give you sufficient time to complete an adequate assessment of the property ...walk. Ensure that the purchase price reflects the environmental condition of the property.

How much management time can you afford to put towards managing the contamination issues? A major remediation project requires a lot of management time, often in areas where you have little expertise. Time away from managing your business may not be management time well spent.

If you are planning on remediating a site, can you afford significant cost over-runs? A cost estimate from a remediation consultant is just that – an estimate – and maintaining an appropriate (30% to 50%) contingency is wise.

Can you get financing for this site? It would be wise to take whatever reports you can obtain to the lender before you sign the offer to purchase. You could find yourself high and dry without financing if you sign first.

Could you sell it for what you paid for it if you had to? The market for contaminated properties is very limited until the site is cleaned up.

### **Selling Contaminated Properties**

Your disclosure to a prospective purchaser must be complete although this may sometimes not be enough as court decisions in at least two provinces have shown. If you do have contamination, make the buyer sign an ironclad agreement indicating they are fully aware of the contamination and will accept all responsibility for it and that they will not sue you in the future. It may not protect you from the government, but it will protect you from a future lawsuit by the buyer.

Ensure that you allow and encourage prospective buyers to conduct their own environmental assessments as this negates the misinformed buyer claim. Allow them adequate time to do it; sixty to ninety days is appropriate.

Retain qualified environmental consultants and legal assistance. You should have your consultant do a baseline assessment of the property before you sell so that you will know exactly how contaminated it is and with what. You will need this if the buyer or subsequent buyers ever come back claiming that contamination they caused was your fault. It also gives a good basis for price negotiations. Ensure that you also retain qualified legal assistance with environmental specific expertise. You want to ensure that there is no way the buyer can come back to you for redress or compensation. Make sure you get a lawyer who has experience with contaminated property issues and not just one who dabbles in it.

Your contaminated property is probably worth less than you think unless it is in a major urban centre with high demand.

### **The Deal Breakers**

Banks will walk away from negotiations if you fail to provide the required financial documentation or if the borrower has:

- a poor credit rating or a poorly conceived, overly-optimistic business plan;

- provided a report by a restricted consultant and refuses to get it redone by a bank-approved one;
- hindered, threatened or bribed the environmental consultant; or
- provided false or misleading information.

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