

May 14, 2009

To: PACE Working Group

From: Chris Lynch

Re: Issues Relating to Existing Mortgage Documents

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650 California Street  
18th Floor  
San Francisco, CA 94108  
t. 415.391.5780  
f. 415.391.5784

Local agencies in California are proposing to finance renewable energy/energy efficiency improvements on private property using special taxes and assessments, i.e., Property Assessed Clean Energy (PACE) Financing. Under existing California law, these special taxes and assessments would have a super-priority lien: the lien securing the obligation to pay special taxes and assessments would be on a parity with the lien securing the obligation to pay *ad valorem* property taxes and senior to private liens, including pre-existing purchase money mortgages.

#### Mortgage-Related Concerns

A number of parties have raised concerns about the relationship between PACE Financing and private liens. Assuming the validity of the super-priority PACE liens, the most significant question is whether existing lenders who will be subordinated to PACE liens have legal rights under their loan documents as a result of the creation of the PACE liens and, if so, whether the exercise by lenders of those rights will adversely impact PACE Financing.

We conclude that lenders may have a right to exercise remedies under existing loan documents as a result of the creation of a senior PACE lien. The lenders' remedies could include acceleration of the private loan or the lender could prepay the PACE special taxes/assessments and increase the amount of their loan. Unless property owners interested in PACE Financing can be assured that PACE Financing will not trigger lenders' rights, municipalities will be hesitant to offer PACE Financing and property owners will be unwilling to undertake PACE Financing. Accordingly, we suggest for discussion some approaches to eliminating the potentially-adverse impact of lender rights on PACE Financing.



As you consider these issues, please be aware of two facts:

1. These issues are limited to existing (pre-PACE) lenders. Private mortgage loans made to property owners after creation of a PACE lien will not raise the same issues as loans made before creation of a PACE lien because a post-PACE lender will make its loan subject to the PACE lien.
2. Lenders do not typically exercise rights under existing loan documents upon the creation of senior tax and assessment liens to finance public improvements. We are most likely concerned about lenders' rights as a result of PACE Financings because PACE Financing is consensual and the renewable energy/energy efficiency improvements are privately-owned. Fundamentally, the concern probably reflects the novelty of public financing of privately-owned improvements to accomplish a public purpose.

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#### Background

It is not possible to speak authoritatively about all existing loans. For example, we are informed that many commercial loans contain due-on-further-encumbrance provisions. See Appendix A ("The Promise and Perils of Assembly Bill 811's Contractual Assessments," California Real Estate Journal, January 26, 2009). However, it is possible to highlight the issues by reference to Fannie Mae/Freddie Mac Single-Family Uniform Instrument Form 3005 (amended 5/91), which provides as follows (emphasis added):

**"4. Charges; Liens. Borrower shall pay all taxes, assessments, charges, fines and impositions attributable to the Property which may attain priority over this Security Instrument, and leasehold payments or ground rents, if any. Borrower shall pay these obligations in the manner provided in paragraph 2 ["2. Funds for Taxes and Insurance. Subject to applicable law or to a written waiver by Lender, Borrower shall pay to Lender on the day monthly payments are due under the Note, until the Note is paid in full, a sum ("Funds") for: (a) **yearly taxes and assessments which may attain priority over this Security Instrument as a lien on the Property**"], or if not paid in that manner, **Borrower shall pay them on time** directly to the person owed payment. Borrower shall promptly furnish to Lender all notices of amounts to be paid under this paragraph. If Borrower makes these payments directly, Borrower shall promptly furnish to Lender receipts evidencing the payments.**



**Borrower shall promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender; (b) contests in good faith the lien by, or defends against enforcement of the lien in, legal proceedings which in the Lender's opinion operate to prevent the enforcement of the lien; or (c) secures from the holder of the lien an agreement satisfactory to Lender subordinating the lien to this Security Instrument. If Lender determines that any part of the Property is subject to a lien which may attain priority over this Security Instrument, Lender may give Borrower a notice identifying the lien. Borrower shall satisfy the lien or take one or more of the actions set forth above within 10 days of the giving of notice.”**

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It is possible to read Section 2 to allow on-time payment of senior PACE special taxes/assessments and Section 4 to give lenders rights only in the event of payment delinquencies. However, because PACE special taxes/assessments are secured by a senior lien upon initial levy (unlike many senior liens that arise only upon delinquency (e.g., mechanics' liens)), the second paragraph of Section 4 is broad enough on its face to cover PACE liens prior to delinquency (“Borrower shall promptly discharge any lien which has priority over this Security Instrument....”).

#### Question Presented

How can we ensure that lender issues don't adversely impact widespread adoption of PACE Financing (with the goal of achieving widespread adoption of renewable energy/energy efficiency improvements on private property)?

#### Proposed Solutions

Lender-Specific Solutions. If Section 4 is applicable to super-priority PACE liens, then two of the options provided for in Section 4 are not applicable: (i) a borrower would not contest the PACE lien and (ii) California law does not contemplate subordination of a PACE lien to existing private liens.

The only possibility that would be applicable to PACE Financing – which is consistent with the spirit of Section 2 and the first paragraph of Section 4 -- is an agreement by the borrower “in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender”. With that in mind, how does a property owner determine whether the payment of PACE special



taxes/assessments when due is acceptable to its lender? We believe it can be done in two ways:

Option #1: The borrower can solicit and receive from the lender an executed acknowledgement/consent that the periodic, on-time payment of PACE special taxes/assessments is acceptable to the lender. However, at least with respect to residential loans, it may be difficult for property owners to engage their lenders in a meaningful discussion of the PACE lien and secure a written acknowledgement/consent because many mortgage loans have been sold and re-sold and because of the outsourced nature of customer service.

Option #2: The borrower can send a letter to the lender in which the borrower (i) describes the financed improvements and anticipated cash flow savings, (ii) agrees to pay the PACE special taxes/assessments when due, (iii) asks for the lender's written acknowledgement within 30 days that it will not exercise remedies as a result of the PACE special taxes/assessments if paid when due, and (iv) declares that the lender will be deemed to have consented to the PACE lien after 30 days if the lender does not protest in writing. This approach is consistent with the language of Section 4, which requires the borrower to agree in writing but does not require the lender to express its acceptance in writing. I have not undertaken an in-depth review of whether this approach is legal under California law, but it does appear that "opt out" agreements of this type are generally upheld under California law. Mitchell v. American Fair Credit Association, Inc. (2002) 99 Cal.App.4th 1345.<sup>1</sup>

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Fannie Mae/Freddie Mac Solutions. In addition to the lender/borrower-specific approaches described above, it may be possible to amend the Fannie Mae/Freddie Mac deed of trust to address concerns about existing lenders.

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<sup>1</sup> "... we agree with defendants that a consumer may be held to have accepted a written modification [of a written agreement] when the consumer receives notification of it, is provided an opportunity to accept or reject it, and accepts the modification according to the instructions provided. Numerous federal cases have found an acceptance of a written modification when, as here, the consumer fails to opt out. (See, e.g., Bank One, N.A. v. Coates (S.D. Miss. 2001) 125 F. Supp. 2d 819, 830-834; Marsh v. First USA Bank, N.A. (N.D. Tex 2000) 103 F.Supp. 2d 909, 919.)"



1. Amendment #1: The deed of trust form could be revised to expressly provide that “property taxes and assessments with a senior lien under applicable state law shall be paid by Borrower when due and the Lender shall have no rights under the Note or this Security Instrument unless the Borrower is delinquent in the payment of such property taxes and assessments.”

2. Amendment #2: The deed of trust form could be revised to incorporate the concept embodied in Option #2 above, i.e., expressly provide for notice by the borrower to the lender of a proposed PACE lien and deemed consent by the lender after 30 days. The problem with this approach is that we believe PACE taxes/assessments should be treated the same as other governmental taxes/assessments, but amending the deed of trust to create a notice/deemed consent carve-out for all senior taxes/assessments would cover other taxes/assessments which, currently, are not a problem for lenders and, in many cases, are imposed upon the property owner without its consent. And, if we define the amendment to apply only to “consensual” taxes/assessments, it could implicate other governmental taxes/assessments to which a property owner might be considered to have consented (for example, a City-wide special tax/assessment for a new public library for which the property owner might have voted).

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Legislative Solutions. Because of constitutional issues, I do not believe it is possible to legislatively address this issue with respect to existing deeds of trust. However, although I have not undertaken an in-depth review of whether this approach would be legal under California law, it may be possible for states to pass legislation requiring deeds of trust securing loans made with respect to property in their state to include the concept embodied in Option #2 above, i.e., expressly provide for notice of a PACE lien by the borrower to the lender and deemed consent by the lender after 30 days.



JONES HALL

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## APPENDIX A

### **The Promise and Perils of Assembly Bill 811's Contractual Assessments**

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f. 415.391.5784



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GUEST COLUMN

## The Promise and Peril of Assembly Bill 811's Contractual Assessments

BY ROBERT C. BARNES

California Assembly Bill 811 was signed into law on July 21, 2008, and was promptly hailed as an important tool for local California governments to fund renewable energy upgrades by property owners. The legislation, codified in California Streets and Highways Code Sections 5898.10 through 5898.14 and 5898.20 through 5898.32, authorizes cities and counties to enter into contracts with owners of any type of improved real property — excluding property to be developed — to fund the installation of permanent improvements for renewable energy and energy efficiency.



BARNES

Hidden in plain sight, though, is a real threat to third-party real estate lenders and tenants: The contractual obligations authorized by AB811 will be secured by governmental assessment liens against the improved real property.

Those assessment liens will take priority over all other private liens and leases, just as any tax or assessment lien would.

Why does that matter? Because unlike most other assessment liens, AB811 contracts and their resulting assessment liens are contractual and consensual. AB811 allows for a wholly voluntary scheme of contracts and resulting assessment liens — a rarity among governmental assessment liens.

Contracts entered into under AB811's authority may have relatively low interest rates and long terms, depending on the terms of the property owner's private contract with the lender city or county. The improvements funded by the contracts must be permanently installed on the real property, such as solar panels, high-efficiency air conditioners and air-source heat pumps. The funds may not be used to install appli-

ances.

Cities and counties have great flexibility in structuring and funding

THE NEXT LEVEL  
DEVELOPMENT

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AS LENDERS PULL  
BACK FINANCING,  
DEVELOPERS FACE  
LITIGATION FROM  
CONTRACTORS

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\$33,000. Among those contracts, though, was at least one for about \$100,000. Since renewable energy improvements can be costly — solar energy systems alone can cost up to \$40,000 per installation — the amount of any given AB811 contract is likely to be tens of thousands of dollars.

The structure, terms and conditions of each contract are set by the contracting city or county. Palm Desert's initial contracts were structured as loans bearing interest rates of seven percent, and the borrower could pick the term of the loan, anywhere from one to 20 years. Not surprisingly, the great majority of Palm Desert borrowers thus far have chosen 20-year terms.

There are no mandatory creditworthiness standards for AB811 contracts, nor are appraisals of the real property security required by the legislation. Upon entering into an AB811 contract, the county clerk must record notice of the new assessment lien and the amount of the contractual assessment.

The foreclosure of an AB811 assessment lien would be like that of any assessment lien foreclosure. The foreclosing governmental entity would be obligated to provide notice to all holders of junior encumbrances, such as otherwise first-priority deeds of trust, giving them the chance to cure the default on behalf of the delinquent landowner and add the cure amount to the holder's outstanding obligations.

There are compelling practical and policy reasons for AB811 contracts. If this funding mechanism becomes popular and widely available, the renewable energy improvements funded by them will help California meet the aggressive greenhouse gas emissions reduction goals set by California's landmark Global Warming Solutions Act, or AB32. These contracts can provide a source of market-rate — or lower — interest capital to owners who want to make renewable energy improvements but otherwise would not be able to obtain private financing for them. And the improvements funded by them will be permanent, meaning that the improved properties will presumably become and then stay more energy efficient — or use renewable energy — for the reasonably foreseeable future.

For private lenders, though, AB811 contracts and their assessment liens may pose a conundrum: On one hand, these contracts are arguably good public policy. It's not likely that many institutional lenders would want to find

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AB811 contracts. Funding can come from a variety of sources, including but not limited to bond proceeds. One early adopter, the city of Palm Desert, has already funded \$2.5 million under AB811 contracts, the source of which was its general fund — to be sure, a fiscal luxury that few cities enjoy today.

The maximum amount of any AB811 contract is determined by the lender city or county. For example, the average amount of Palm Desert's initial AB811 contracts was approximately

themselves arguing against property owners' ability to make environmentally friendly energy improvements.

However, AB811 contracts pose several real risks for private lenders. The mere possibility of AB811 funding may compete with private lenders' equity second loans or other private lenders' products. (Indeed, some may ask why these contracts, whose interest rates may likely be comparable to market rates, are needed in the first place.) Aside from competitive risk, the foreclosure of an AB811 assessment lien — as with the foreclosure of any assessment lien — would wipe out all other private liens and deeds of trust, regardless of whether they otherwise were in first position.

Just as importantly, there is no loan-to-value or other equity test for AB811 contracts. Private landowners can conceivably over-leverage real property without regard for the security of the private lender's position.

Tenants of real property that become subject to AB811 assessment liens are also potentially at risk. Like other non-tax monetary liens, leases would also be eliminated by operation of law if a property subject to an AB811 assessment lien were sold at a tax sale. One possible advantage that tenants may enjoy is that AB811 improvements may lower the tenant's operating costs, assuming that the improvements make economic sense.

Depending on the terms of the lease, the new

payments for an AB811 contract could possibly be passed through to the tenant as an increase in taxes and assessments affecting the premises. And contrary to subordination and non-disturbance agreements with private lenders on leased premises, there is no non-disturbance agreement with the city or county that will protect the tenant's lease and tenancy in the event that a consensual AB811 lien is foreclosed upon.

What can a lender do to protect itself? There are some current safeguards for lenders, such as provisions in non-residential loan documents declaring an event of default if the borrower further encumbers the property with a further loan and mortgage or deed of trust. These kinds of due-on-further-encumbrance provisions should be enforceable to prohibit AB811 loans' assessment liens, assuming they are properly drafted. Before enforcing such a clause for an AB811 loan, though, an institutional lender may want to consider the adverse publicity that could result from a spate of "anti-green" foreclosures.

Residential lenders have long been constrained by both federal and California law from declaring an event of default due to the further encumbering of property with junior mortgages and deeds of trust. Despite that constraint, many residential loan documents still include a due-on-further-encumbrance clause along with their standard due-on-sale clause. If a residential deed of trust or mortgage includes such language, the assertion of an AB811 senior lien conceivably could qualify as an event of default.

Additionally, virtually every deed of trust includes language making the trustor's failure to pay taxes and assessments an event of default, giving lenders another line of defense.

The underlying problem is that AB811 has no third-party protections. Although laws permitting contractual assessments are rare, they do exist. For example, California Streets and Highways Code Section 10100.2 allows cities and counties to make loans to property owners for seismic stability improvements. Like AB811 contracts, those loans are secured by assessments against real property. Unlike AB811, however, Section 10100.2 contains two important lender protections: First, it prohibits loans by public entities that would create a loan-to-value ratio of more than 80 percent, as determined by

an independent appraiser (unless waived by the existing lienholders).

Second, Section 10100.2 requires that written notice be given to all existing lienholders not less than 30 days prior to any vote of a local agency authorizing the financing in the first place.

Both of these safeguards make sense in light of AB811's scheme of consensual assessment liens. All parties in interest should be given written notice of an impending AB811 contract and assessment lien. An equity test also makes sense, although today's declining real estate values means that many properties could not meet such a test now — and might not for a while. This could render AB811 funding hard to obtain until values recover. However, one reason real estate values are suffering in many places is because of just the kind of over-leverage that AB811 as it currently exists would permit.

Practically, the risk of serious over-leveraging due to AB811 improvement contracts may be somewhat low. When property owners analyze the economics of making energy improvements — the cost of the improvements compared to the length of time needed to recoup those costs through energy savings — they are likely to limit expenditures to levels that make economic sense. In fact, an analysis published by the Climate Protection Campaign argues for and against specific kinds of permanent improvements based on their future reductions of energy costs.

For now, lenders and tenants can have existing tax services monitor new AB811 liens along with other taxes and assessments. They can scour loan documents and leases for provisions that may prevent a landowner from encumbering its property or increasing the premises' tax burden. In the future, though, the legislature should take another look at this important — and potentially disruptive — statute and take steps to protect all of the stakeholders while encouraging energy efficiency and renewable energy improvements. 🐾

*Robert C. Barnes is a real estate transactional attorney in the Los Angeles office of the global firm of Fulbright & Jaworski LLP. Donald L. Hunt and Daniel W. Kim contributed to the article.*