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LAW SUMMARY

Keeping PACE: Federal Mortgage Lenders Halt Local Clean Energy Programs

IAN M. LARSON*

I. INTRODUCTION

Due to rapid technological improvements and growing concerns over global warming and per capita energy consumption, low-energy appliances and environmental retrofits\(^1\) have become increasingly available to homeowners in the past few years.\(^2\) During this period, there has been a concomitant rise in the number of programs available for financing such improvements.\(^3\) In the burgeoning market for clean energy, no program has proved as dynamic\(^4\) or controversial\(^5\) as property assessed clean energy (PACE) financ-

* B.A., University of Missouri, 2009; J.D. Candidate, University of Missouri School of Law, 2012; Editor in Chief, Missouri Law Review, 2011-12. I am extremely grateful to Professor R. Wilson Freyermuth for his advice and guidance in writing this Law Summary and to my wife Abby and daughter Haley for their love, patience, and support.

1. An environmental retrofit consists of improving an energy-consuming product by replacing inefficiencies with parts, devices, or equipment not available at the time the product was manufactured. Merriam-Webster, Retrofit, http://www.merriam-webster.com/dictionary/retrofit (last visited Feb. 22, 2011).


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PACE, a local government initiative now established in twenty-two states, expands upon traditional land-secured finance authority for the purpose of improving household and commercial energy efficiency. PACE programs provide bond-financed funding to qualifying property owners for the purpose of financing energy improvements. Under such a program, the cost of qualified energy improvements is added as an assessment tax to the owner’s yearly property tax bill, with the obligation to pay being secured by a lien on the encumbered property.

The controversy surrounding PACE programs stems from the nature of local assessment law and the doctrine of “tax lien seniority”; because the PACE program administers funds to homeowners via assessments against their property, rather than as loans to the homeowners, municipalities are entitled to senior status in the case of default. This controversy culminated in July 2010, when federal mortgage lenders, the Federal National Mortgage Association (Fannie Mac), and the Federal Home Loan Mortgage Corporation (Freddie Mac), acting under the supervision of their regulatory agency, the Federal Housing Finance Authority (FHFA), refused to purchase any mortgages encumbered by a PACE lien.

FHFA is the Federal Housing Finance Authority, overseer of “mortgage giants” the Federal National Mortgage Association and the Federal Home Loan Mortgage Association. See id.


8. RANCHOD ET AL., supra note 6, at 2.

9. DeVries & Lynch, supra note 4, at 2 (“[PACE] repayment is secured as a senior lien against the property, which means that the bonds receive repayment priority should property owners default on tax and/or mortgage payments.”). This means that mortgagors and private lenders become subordinate to PACE liens, regardless of which party is “first in time.” Id.


Missouri citizens have a special interest in the outcome of this dispute, as Missouri was the last of twenty-two states to pass PACE enabling legislation, a product of vociferous support by Missouri environmental interest groups and small businesses that recognized the potential of spending initiatives in a recessed economy.\textsuperscript{14} Unfortunately, federal suspension of PACE occurred almost simultaneously with Missouri’s enactment of PACE legislation.\textsuperscript{15} Missouri lenders, legislators, homeowners, environmentalists, and small businesses have thus been unable to move forward with a PACE program since federal lenders halted the initiative nationwide.

This Law Summary analyzes and comments upon the legal arguments put forth by supporters and critics of PACE liens in the wake of the July 2010 disputes. Part II discusses the origins of PACE in 2008 and its rapid expansion across the United States, paying particular attention to the passage of PACE legislation in Missouri. Part III analyzes the escalating dispute between PACE supporters and the federal mortgage lenders who oppose it, commenting upon the legal arguments articulated by both sides. Part IV proposes a resolution to the conflict that provides a more secure position for federal mortgage groups while still allowing PACE to continue. This Law Summary concludes that while federal mortgage groups overreacted to PACE’s potential dangers by unilaterally halting the programs, their substantive concerns are legitimate and both parties would be well-served by resuming negotiations so that PACE lending can continue providing a benefit to worthy borrowers.

II. LEGAL BACKGROUND

A. The Mechanics of a PACE Lien

The starting point for any PACE program is the enactment of a PACE enabling statute, authorizing municipalities to establish PACE assessment boards.\textsuperscript{16} Once receiving statutory authority, the municipality must develop a source of capital from which the money for homeowner retrofits may be tapped: many local governments have looked to bonds to provide that capital.\textsuperscript{17} These bonds allow local governments to finance new energy improvements with private funds. The municipalities repay those bonds with interest

\textsuperscript{13} See infra notes 73-81; see also Letter from Patricia J. McClung, Vice President, Offerings Mgmt., Freddie Mac, to Freddie Mac Seller/Servicers (May 5, 2010), available at http://www.freddiemac.com/sell/guide/bulletins/pdf/iltr050510.pdf.

\textsuperscript{14} See infra Part II.C.

\textsuperscript{15} See infra Part II.C-D.

\textsuperscript{16} RANCHOD ET AL., supra note 6, at 3.

\textsuperscript{17} Mark Zimring & Merrian Fuller, Accelerating the Payment of PACE Assessments, CLEAN ENERGY FINANCING POLICY BRIEF (Lawrence Berkeley National Laboratory, Berkeley, CA), May 4, 2010, at 2, http://eetd.lbl.gov/ea/emp/reports/ee-policybrief_050410.pdf.
provided from assessment payments made by homeowners as part of their yearly property tax bill.\textsuperscript{18}

In Missouri, a homeowner seeking to take advantage of such a program would first obtain an energy audit to verify his need for energy-efficient improvements and then apply with a local PACE assessment board for consideration.\textsuperscript{19} Having obtained approval, a borrower would receive a payout from the municipal board in the amount of the proposed improvement.\textsuperscript{20} Repayment would consist of a yearly supplement to the homeowner’s property tax bill, typically for up to twenty years.\textsuperscript{21}

The promise to repay is secured by a tax lien filed by the municipal board against the homeowner’s property.\textsuperscript{22} This means that repaying the debt is an obligation on the benefitted property, not the individual taking out the loan.\textsuperscript{23} If the property is foreclosed upon, or the property owner fails to pay his property taxes (resulting in foreclosure), the PACE lien would take seniority over the mortgage, and the amount past due would be paid first to the municipality.\textsuperscript{24} The remaining balance of the lien would stay with the property and be paid by subsequent purchasers of the land.\textsuperscript{25}

B. California Pioneers PACE Financing

The first PACE program was established in Berkeley, California in 2008.\textsuperscript{26} The program was immediately popular,\textsuperscript{27} and Berkeley’s local assessment board granted its first PACE bond in January 2009.\textsuperscript{28} The program

\begin{itemize}
  \item \textsuperscript{18} ld.; see also DeVries & Lynch, supra note 4, at 4.
  \item \textsuperscript{19} Tomich, supra note 5. For more on the approval process, see infra Part IV.A.3.
  \item \textsuperscript{20} See Tomich, supra note 5.
  \item \textsuperscript{21} ld.
  \item \textsuperscript{22} RANCHOD ET AL., supra note 6, at 3.
  \item \textsuperscript{23} ld.
  \item \textsuperscript{24} See, e.g., PACENow, Presentation to the Senate Banking Committee, Property Assessed Clean Energy Districts: States Rights, Benefits & Responses to FHFA/Regulator Overreach, at 16 (July 22, 2010), available at http://pacenow.org/blog/wp-content/uploads/7.22.10-PACE-Banking-Committee-PPT.pdf.
  \item \textsuperscript{25} ld.
  \item \textsuperscript{26} CAL. PUB. RES. CODE § 26100(a)(2) (West 2011); PACENow, Brief History of PACE, http://pacenow.org/blog/2010/07/brief-history-of-pace/ (last visited Feb 22, 2011).
  \item \textsuperscript{27} All available borrower slots in the program were filled within nine minutes. DeVries & Lynch, supra note 4, at 5.
  \item \textsuperscript{28} PACENow, supra note 26. PACENow, a not-for-profit interest group, “work[s] to accelerate the development of the PACE industry through the development of the asset class and nationwide adoption of PACE finance programs.” PACENow, Job Description, Executive Director, http://pacenow.org/documents/CMI%20
raised capital through the issuance of municipal bonds for the purpose of providing low-interest energy efficiency loans to local homeowners, administered by municipal "clean energy" boards. In early 2009, the program was copied in select cities and counties across California, and shortly thereafter the program went statewide. During the following two years, twenty-two states followed suit by enacting some form of PACE legislation.


30. CAL. PUB. RES. CODE § 26100(a)(2) ("[T]he City and County of San Francisco, City of San Diego, City of Palm Desert, Sonoma County, and the California Statewide Communities Development Authority (CSCDA) have already initiated or are working to launch additional programs.").

31. See id.; id. §§ 26100-26141 (outlining California's PACE program). California's PACE program has proven to be one of the most popular in the country; as of June 2010, Sonoma County alone has contracted for $24 million in energy-efficient retrofits. Ethan N. Elkind, Fannie, Freddie Blocking Progress on Clean Energy, SAN JOSE MERCURY NEWS, June 18, 2010, at 14A.

32. See, e.g., PACENow, supra note 24, at 19. Arizona, California, Colorado, Florida, Georgia, Illinois, Maine, Maryland, Minnesota, Missouri, Nevada, New Hampshire, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Texas, Vermont, Virginia, and Wisconsin currently have enacted PACE legislation.

PACE bonds rely upon the municipality’s inherent power to levy special tax assessments against properties that lie within its jurisdiction.33 This power exists in many municipal governments around the country34 and has been recognized for more than one hundred years.35 Traditional special tax assessments have been used to finance public improvements such as sewers, sidewalks, road repaving, seismic retrofitting, and fire safety improvements.36

One of the disconcerting issues for lenders regarding the current status of clean energy bonds is how quickly states moved to pass PACE enabling statutes. The following chart demonstrates the rapidity with which enabling bills were passed in each of PACE’s three operational years.37

<table>
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<th>State (Legislation)</th>
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<td>New Mexico (H.B. 572)</td>
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<td>Wisconsin (A.B. 255)</td>
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<td>Enacted</td>
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<tr>
<td>Nevada (S.B. 358)</td>
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<td>Maine (L.B. 1717)</td>
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33. See Elkind, supra note 31.
34. Estimates suggest that as of 2010, a total of 37,000 municipal organizations have existing assessment powers and would be capable of issuing PACE loans given the appropriate enabling legislation. Editorial, Congress Must Save Clean-Energy Loan Program, SAN JOSE MERCURY NEWS, July 13, 2010, at 7A.
35. RANCHOD ET AL., supra note 6, at 3 (citing Ronald H. Rosenberg, The Changing Culture of American Land Use Regulation: Paying for Growth with Impact Fees, 59 SMU L. REV. 177, 217 n.138 (2006)).
36. Id.
37. See supra note 32 and sources cited therein.
However, while almost half the states have enabled PACE programs, actual active PACE programs are rare: as of May 2010, less than ten active programs were in existence, each located in either California, Colorado, or New York. Rather than indicative of an unwillingness to initiate PACE programs, the small number of operational programs is probably reflective of the rapid enactment of PACE enabling legislation, as well as the slower local processes of establishing boards and issuing bonds, given that one-quarter of all enabling statutes were not passed until the 2010 sessions.

According to PACE supporters, the government’s inherent power to assess taxes not only gave municipalities the capacity to establish PACE boards but also gave board-approved bonds seniority over any outstanding land-secured debts. The seniority of municipal assessments effectively means that the lender’s private mortgage loans are instantly subordinated to the municipality. Seniority is premised on the distinction made by the PACE programs between lending and assessments: any loans would follow the “first-in-time, first-in-right” principle that gives seniority to any antecedent loan.

<table>
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<td>In Senate Committee</td>
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<tr>
<td>New Hampshire (H.B. 1554)</td>
<td>5/12/10</td>
<td>Passed House/Senate</td>
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<td>Enacted</td>
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<tr>
<td>Georgia (H.B. 1388)</td>
<td>5/20/10</td>
<td>Enacted</td>
</tr>
<tr>
<td>Florida (H.B. 7179)</td>
<td>5/28/10</td>
<td>Enacted</td>
</tr>
</tbody>
</table>

38. RANCHOD ET AL., supra note 6, at 4 ("Eight active PACE programs currently are in place: Berkeley, CA; Palm Desert, CA; Placer County, CA; San Francisco, CA; Santa Barbara County, CA; Sonoma County, CA; Yucaipa, CA; Boulder, CO; and Babylon, NY.").

39. All PACE programs currently operating lie in states with enabling statutes passed in either 2008 or 2009. See HOME PERFORMANCE RES. CTR., supra note 32.

40. Id. As discussed infra Part III, unilateral action by federal lending authorities halted any progress towards the establishment of new PACE boards as of May 2010. This further demonstrates that the small number of operational PACE programs is not truly reflective of the program’s popularity. For instance, Missouri’s PACE enabling legislation was signed into law within one week of an effective halt to all PACE lending. See infra Parts II.D, III.

41. RANCHOD ET AL., supra note 6, at 3.

42. Id. An important caveat, noted by supporters of the PACE loan programs and discussed infra at Part IV.A.2, is that private lenders are only subordinated by the amount of the loan in arrears, or the amount defaulted on. The remaining balance of the loan “stays with” the land and is an encumbrance taken by any subsequent purchaser of the property. PACENow, supra note 24, at 20.

43. See U.S. ex rel. IRS v. McDermott, 507 U.S. 447, 449 (1993) ("Absent provision to the contrary, priority . . . is governed by the common-law principle that ‘the
Under the state assessment power, however, the state is entitled to be reimbursed prior to any existing mortgages, regardless of chronology. 44

Municipal bonds rely on private investment as a tool for raising money and are attractive to investors because they ensure regular returns on a relatively safe investment. PACE programs are particularly attractive to investors because they offer the added assurance of senior lien status. 45 Municipal bonds backed by property taxes traditionally have experienced low default rates, 46 and the assurance of being repaid first even when default occurs provides a prime incentive for investors. 47 PACE supporters argue that this seniority ensures the program’s viability and its attractiveness as an investment vehicle; as explained in one lawsuit recently filed against FHFA, first lien priority is critical to the program’s success because “there is currently almost no demand in the secondary market for conventional junior mortgage instruments.” 48 In contrast, there has been great demand for senior mortgage instruments: as of April 2010, $300 million worth of PACE bonds had been sold in the State of California, and that number has been predicted (by its supporters) to reach several billion dollars within the next few years. 49

By the fall of 2009, commentators had begun to spread the word about PACE’s potential. 50 Environmentalists and interest groups began to advocate for the establishment of PACE programs as both an opportunity to reduce energy consumption and to spur economic growth through increased retrofitting projects. 51 Sensing the mood, Vice President Joe Biden, as head of the

44. See, e.g., Dunlap v. County of Gallatin, 15 Ill. 7, 9 (1853) (“A tax is not an ordinary debt. It is levied for the support of government, and takes precedence of all other demands against the owner.”).

45. See Rep. Israel Speaks About Property Assessed Clean Energy Bonds at Forum on Financing for Clean Energy Building Retrofits, supra note 3. Investor groups, especially real estate investment trusts (REITs), have expressed interest in the program. Id. The National Association of Real Estate Investment Trusts officially endorsed the PACE lending program. Id.


49. Green Consultant Touts Energy Bonds, supra note 47.

50. See, e.g., Coppa, supra note 2.

51. Id.

[M]ore attractive finance offers are necessary . . . [and will] provide[] a plethora of long-term benefits for homeowners and the economy as a whole . . . [I]t is possible that this [PACE] program . . . will be instrumen-
Middle Class Task Force’s Council on Environmental Quality, released the “Recovery Through Retrofit” announcement on October 19, 2009, propelling the federal government into the clean energy financing discussion.\textsuperscript{52} The task force announced that the federal goal would be “[t]o lay the groundwork for a self-sustaining home energy efficiency retrofit industry” by “do[ing] for homes what ENERGY STAR\textsuperscript{R} has done for appliances.”\textsuperscript{53}

Following release of Vice President Biden’s report, the White House allocated $80 billion of American Recovery and Reinvestment Act (ARRA) funds to assist local governments in implementing clean energy municipal board programs.\textsuperscript{54} However, with federal funds came federal conditions, expressed in a White House Policy Framework that contained preferred underwriting standards for emerging PACE programs.\textsuperscript{55} The White House Policy Framework included three guidelines intended to protect individual homeowners\textsuperscript{56} and eight guidelines intended to protect lenders;\textsuperscript{57} it is these guide-

\begin{quote}
tal in aiding in the recovery of the U.S. economy. Also, it will allow homeowners to build equity faster in their homes, which will ultimately improve consumer spending, which fuels the overall economy.
\end{quote}

\textit{Id.}

\textsuperscript{52} \textbf{MIDDLE CLASS TASK FORCE COUNCIL ON ENVTL. QUALITY, RECOVERY THROUGH RETROFIT 5} (2009), available at http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf [hereinafter \textit{RECOVERY THROUGH RETROFIT}]. The report stated that “[h]ome retrofits can potentially help people earn money, as home retrofit workers, while also helping them save money, by lowering their utility bills. By encouraging nationwide weatherization of homes, workers . . . will participate in ramping up a national home retrofit market.” \textit{Id.} at 1.


\textsuperscript{54} \textit{RECOVERY THROUGH RETROFIT, supra} note 52, at 2.

\textsuperscript{55} Policy Framework for PACE Financing Programs (Oct. 18, 2009), http://pacenow.org/documents/PACE_Principles.pdf. The White House described the role of federal funds as one that would “facilitate the collection of data, objectively measure and evaluate the performance of PACE programs, and speed the adoption of more uniform and universal best practices that include robust and effective homeowner and lender protections.” \textit{Id.} at 3.

\textsuperscript{56} \textit{Id.} at 4-5. The three guidelines advocated for homeowner protection are (1) borrowing only in the cases of savings-to-investment ratios greater than one, thus maintaining “pay for itself” status and increasing homeowner cash flow; (2) limiting borrowing to situations in which homeowners would be assured “high return[s] in terms of energy efficiency gains”; and (3) assuring that the loans are performed in accord with the manner in which they are requested through three measures: (i) pre-determining the appropriateness of the project by a list of “presumptively-efficient projects,” or, alternatively, an energy audit; (ii) ensuring that only “validly licensed contractors or installers” do the work; and (iii) conducting an “after-the-fact quality assurance program.” \textit{Id.}
lines that supporters would come to rely on as proof of PACE’s inherent safety to lenders.\textsuperscript{58}

D. PACE Legislation Comes to Missouri

On February 17, 2010, PACE enabling legislation was introduced in the Missouri House of Representatives.\textsuperscript{59} The bill spent five months in legislative committee before being sent to Governor Jay Nixon, who signed it into law on July 12, 2010.\textsuperscript{60} Like other PACE programs, the final version of the bill allows municipalities to establish clean energy development boards that would fund energy efficiency and renewable energy improvements; these loans would be financed through the issuance of bonds and repaid by special assessment revenues.\textsuperscript{61}

Missouri’s PACE legislation generally operates in the same manner as previously enacted PACE programs. As such, a property owner may be required to first obtain an energy audit of his or her property performed by a

\textsuperscript{57} Id. at 7-8. The eight guidelines directed at protecting lenders are (1) the establishment of assessment reserve funds to protect investors against late and non-payments; (2) limiting the bond term to the life expectancy of the energy benefit; (3) limiting the size of the loan to ten percent of the property’s fair-market value; (4) ensuring that applicants hold clear title to the assessed property; (5) ensuring that all borrowers are (i) current on property taxes, (ii) have no outstanding or unsatisfied tax liens on the property, (iii) have no defaults in the past three years, and (iv) have no outstanding mortgage debts; (6) avoiding granting bonds to homeowners who lack equity in their properties; (7) avoiding lending in areas with high rates of default or “underwater” homes; and (8) providing for the escrowing of PACE assessments in the same manner that the homeowner escrows his or her property taxes. \textit{Id.}

\textsuperscript{58} See infra Part IV.A.2


\textsuperscript{60} See S. 1037, 95th Gen. Assem., 2d Sess. (Mo. 2010). The relevant portion of the bill was entitled “The Property Assessed Clean Energy Act.” \textit{Id.}

\textsuperscript{61} \textit{Id.} Missouri’s bill describes the applicable energy efficiency improvement as including, but not limited to: wall, roof, attic, foundation or floor insulation; heating and cooling distribution systems; storm windows and doors “and other window and door improvements designed to reduce energy consumption; [a]utomatic energy control systems; heating, ventilating or air conditioning distribution system modifications and replacements; [c]aulking and weather-stripping; [r]eplacement or modification of lighting fixtures . . . ; [e]nergy recovery systems; [and] [d]aylighting systems.” \textit{Id.} (subsections omitted).
qualified home energy auditor.\textsuperscript{62} In order to be approved for a loan, this audit must show that the benefit obtained by the energy improvement would meet or exceed the total assessments that would be due under the assessment contract.\textsuperscript{63} Additional requirements include that (1) the prospective property owner have good creditworthiness, (2) the property owner voluntarily agree (i) to pay assessments for a period not to exceed twenty years and (ii) that obligations “are a covenant that shall run with the land and be obligations upon future owners of such property,” and (3) the property subject to assessment not be subdivided unless the contract or amendment “divides the total annual special assessment due between the newly subdivided parcels pro rata” based upon the benefit received by each parcel.\textsuperscript{64} If approved, the assessment contract would be filed and recorded with the county recorder of deeds.\textsuperscript{65} Any such assessment constitutes a lien on the property and is collected “in the same manner and with the same priority as ad valorem real property taxes.”\textsuperscript{66} Missouri’s PACE enabling legislation goes further than most states in that it limits the duration of a PACE assessment, mandates cash-positivity, and requires borrower “creditworthiness”;\textsuperscript{67} however, significant gaps remain in the state’s underwriting standards as compared to those advised by the federal government.\textsuperscript{68}

Despite their general lack of stringent underwriting requirements, PACE programs around the country enjoyed a relatively calm existence until May 2010. By the time Missouri’s PACE bill had been signed, however, the turmoil over lien seniority had come to a head. In a St. Louis Post-Dispatch article published on July 18, 2010 – a mere six days after Missouri’s bill was signed – journalist Jeffrey Tomich posed the question of whether Missouri’s “newest and boldest initiative to encourage energy savings” was “doomed before it [took] root?”\textsuperscript{69} Tomich had seen the writing on the wall: during May and June, lending agencies had begun a movement to discourage PACE


\textsuperscript{63} Mo. Rev. Stat. § 67.2815.1. This is referred to as “cash flow positive”; that is, the benefit conveyed by the energy improvement, evaluated by a dollar-for-dollar reduction in monthly energy bills to the homeowner, exceeds on a yearly basis the annual amount of the assessment. See PACENow, supra note 24, at 9, 20. Cash flow positive transactions thus improve the net worth of the borrower, improving his financial position vis-à-vis other lienholders and creditors. See id. Whether a PACE lien creates a “cash flow positive” transaction becomes crucial when local underwriting standards fail to mandate cash flow positivity. See infra Part IV.A.3.

\textsuperscript{64} Mo. Rev. Stat. § 67.2815.

\textsuperscript{65} Id. § 67.2815.4.

\textsuperscript{66} Id. § 67.2815.5.

\textsuperscript{67} Compare id. § 67.2815, with sources cited supra note 32.

\textsuperscript{68} See supra notes 56-57.

\textsuperscript{69} Tomich, supra note 5.
Beginning with a Freddie Mac mortgage lender memorandum issued on May 5, these developments effectively halted Missouri’s PACE program before it began.

III. RECENT DEVELOPMENTS

On May 5, 2010, Freddie Mac issued an industry-wide memorandum entitled “First Lien Mortgages and Energy Efficient Loans.” The letter instructed all Freddie Mac lenders that energy efficiency PACE liens should not be senior to mortgages delivered to Freddie Mac. This position was restated in Bulletin 2010-20, issued by Freddie Mac on August 31, 2010:

Freddie Mac supports the goal of encouraging responsible financing of energy efficient and renewable energy home improvements, [but] we believe this goal may be achieved without altering the lien priority status of first Mortgages or other underwriting requirements. To the extent necessary to mitigate greater risks associated with PACE and PACE-like programs, Freddie Mac will take additional actions.

The bulletin went on to reiterate that Freddie Mac would refuse to purchase mortgages secured by properties subject to any PACE obligations so long as those obligations allowed for lien seniority.

On July 6, 2010, FHFA followed Freddie Mac with a statement expressing concern over the lending priority of PACE liens. Specifically, FHFA stated that PACE “liens” are inherently dissimilar from routine tax assessments and that they “pose unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors.” FHFA directed Fannie Mae and Freddie Mac, as well as the Federal Home Loan Banks, to

70. See id.
71. McClung, supra note 13.
72. See Tomich, supra note 5.
73. McClung, supra note 13.
74. Id.
76. Id.
78. Id.
79. "Created by Congress, the Federal Home Loan Banks have been the largest source of funding for mortgage lending for nearly eight decades. The Federal Home Loan Banks are twelve regional cooperative banks that lending institutions use to finance housing and economic development in local communities.” Federal Home
take three actions with regard to their local PACE loan programs: (1) in existing PACE-encumbered mortgages, waive their prohibitions against senior municipal liens; (2) take specific steps to protect themselves in PACE jurisdictions; and (3) ensure that any pledged collateral is free of PACE liens. On the same day, the United States Comptroller of the Currency (OCC), which “charter[s], regulate[s], and supervise[s] all national banks,” issued a guidance memorandum to warn national banks and lending institutions of the potential effects of PACE lien priority and to advise lenders of their options when seeking to mitigate a PACE lien’s effects. The OCC warned that the lien priority raised significant concerns for mortgage lenders and investors.


The specific actions recommended by FHFA to protect themselves in such jurisdictions were:

1. Adjusting loan-to-value ratios to reflect the maximum permissible PACE loan amount available to borrowers in PACE jurisdictions;
2. Ensuring that loan covenants require approval/consent for any PACE loan;
3. Tightening borrower debt-to-income ratios to account for additional obligations associated with possible future PACE loans; and
4. Ensuring that mortgages on properties in a jurisdiction offering PACE-like programs satisfy all applicable federal and state lending regulations and guidance.

FHFA Statement, supra note 77.


Government agencies were not the only concerned group raising the alarm. On July 23, 2010, the American Land Title Association (ALTA) wrote an open letter to FHFA on behalf of ALTA’s 3700 members. Letter from Kurt Pfotenhauer, Chief Exec. Officer, Am. Land Title Ass’n, to Alfred M. Pollard, Gen. Counsel, Fed. Hous. Fin. Agency (July 23, 2010), available at http://www.alta.org/advocacy/advocacyupdate/attachments/10-0723_Alfred_Pollard.pdf. ALTA is the national trade association for real estate settlement service and abstract and title insurance companies. The letter asked for “guidance in resolving uncertainty surrounding these programs.” Specifically, the letter was concerned with whether PACE financing would be considered loans (or federally related mortgages) for the purpose of compliance with the Real Estate Settlement and Procedures Act (RESPA).

The letter pointed out to FHFA that noncompliance with established lien recording regulations and procedures could result in an inability to adequately weigh risks, delays, and cancellations of real estate transactions due to an inability to adequately insure properties without knowledge of existing liens, as well as “significant losses due to fraud.” Id.
The OCC suggested four measures to national banks to mitigate their exposure and protect the positions of investors: "[1] [p]rocuring loss guarantees from the respective states or municipalities; [2] [e]scrow[ing] tax assessment-related debt . . . ; [3] [r]e-evaluating and adjusting home equity line[s] of credit . . . ; and [4] [i]n the case of commercial properties, securing additional collateral."\(^8\)

According to the interest group PACENow, the impact of these announcements was an effective halt to all active and potential PACE programs across the United States.\(^8\) Given the recommendations of Fannie Mae and Freddie Mac, lenders immediately refused any and all mortgages associated with PACE liens.\(^8\) As a result, no state has enacted PACE enabling legislation since May 2010.\(^8\) The unilateral refusal of federal lending agencies to purchase the mortgages of any PACE-encumbered properties, regardless of the strength of their underwriting or likelihood of default, represents the most aggressive action then available to those agencies.

PACENow responded with a comprehensive presentation to the Senate Banking Committee entitled “Property Assessed Clean Energy Districts: States Rights, Benefits & Responses to FHFA/Regulator Overreach,” in which it presented seven arguments in response to the federal regulators’ criticism.\(^8\) Stated concisely, PACENow made three key responses: (1) in ignoring state assessment rights, FHFA mischaracterized PACE programs as granting loans; (2) because only the portions of PACE liens in arrears\(^9\) are accelerated into senior positions, PACE lien seniority does not significantly harm creditors; and (3) collateral-based programs, the type of borrowing

85. OCC Statement, supra note 83, at *1. Reiterating the position previously stated by FHFA, the OCC also made clear that it “supports commercial and residential energy lending when such lending programs observe existing lien preference, ensure prudent underwriting, and comply with appropriate consumer protections.” Id. at *2.

86. PACENow, supra note 24, at 3; see also Tomich, supra note 5 (“The position [articulated in the July 6 FHFA Statement] in effect shut down PACE programs across the country.”).


88. See sources cited supra note 32; see also supra Part II.C, chart.

89. See PACENow, supra note 24, at 19-26.

90. An account in arrears is overdue in the amount accrued from the date on which the first payment was due. See BLACK’S LAW DICTIONARY 763 (7th ed. 1999). In other words, the amount of the lien due would only be past unpaid amounts, not any accelerated future amounts. See id.
PACE relies upon, do not pose significantly higher risks than ability-to-pay lending.91

By the time PACENow made its presentation, the House of Representatives had already responded to the uproar, introducing the subtly titled “PACE Assessment Protection Act of 2010” in an effort to force Fannie Mae and Freddie Mac to continue facilitating PACE programs.92 According to the resolution, Fannie Mae and Freddie Mac would be barred from making special requirements for properties affected by PACE liens.93

91. PACENow, supra note 24, at 19-26. Specifically, PACENow responded to seven concerns raised by FHFA and the OCC. Id. First, PACENow addressed concerns regarding safety and soundness protections by pointing out that the Department of Energy “guidelines were developed in concert with HUD, NEC, Treasury, CEQ, OMB and the White House.” Id. at 19. Second, PACENow argued that since only past-due PACE payments earned seniority, with the remaining balance assumed by new home purchasers, mortgage lenders were protected. Id. at 20. Third, it argued that collateral-based financing (as opposed to ability-to-pay lending) “pose[d] no more risk” than traditional financing methods, and its traditionally low default rates meant the maximum potential liability to mortgage lenders was less than $200 per PACE-affected property. Id. at 21-22. Fourth, it responded to the lenders’ concern over “unusual and difficult risk management challenges” by pointing out that land-secured financing had been “used for more than a century to levy special tax assessments through special taxing districts to fund . . . projects that serve a public purpose.” Id. at 22. Fifth, it argued that the size and duration of PACE liens are well within the scope of traditional assessments and that by reducing energy bills, PACE liens operate exclusively to “improve[] cash flow to the property owner.” Id. at 23. Sixth, it reiterated that PACE loans do not “represent a key alteration of traditional mortgage lending practice” because tax/assessment liens are well established and because only “assessments in arrears” earn seniority. Id. at 25. Seventh and finally, PACENow argued that “robust and prudent underwriting and consumer protection standards” were in place to protect lenders and that assessments “have not historically disrupted housing markets.” Id. at 26.


93. Id. Senators Boxer, Gillibrand, Merkley, and Begich introduced the Senate version of the bill on July 22, the very day PACENow made its presentation. U.S. SENATE, 111TH CONG., BOXER, COLLEAGUES INTRODUCE LEGISLATION TO PROTECT CLEAN-ENERGY INITIATIVES (2010), 2010 WLNR 14660880 [hereinafter CONG. DOC.]. The language of the bill stated that

[i]lens or other property obligations that secure property taxes or assessments under a PACE program and are consistent with such [underwriting] standards [containing within the May 7, 2010 Department of Energy guidelines] shall be considered to comply . . . and shall not constitute a default on an existing mortgage or trigger the exercise of lender’s remedies for a property with such a lien. With respect to a property that meets the underwriting criteria . . . [Fannie Mae and Freddie Mac] shall not require re-payment of a PACE program tax or assessment in order for a property owner to finance, refinance or transfer the property.

H.R. 5766. In her statement following introduction of the bill, Senator Barbara Boxer, the bill’s sponsor, explained that “[t]he current uncertainty surrounding PACE
Congress was not the only interested party to respond to the lenders. On July 29, 2010, the Sierra Club filed a complaint for declaratory and equitable relief against the FHFA, asking the court to enjoin the agency from further disrupting the PACE process.\textsuperscript{94} The Sierra Club argued three counts against the FHFA: (1) the FHFA violated the Federal Housing Finance Act of 2008\textsuperscript{95} by operating outside the scope of its authority,\textsuperscript{96} in that PACE did not represent a threat to federal mortgage lenders and the FHFA’s actions were therefore either “arbitrary, capricious, an abuse of discretion, or not otherwise in accordance with law”;\textsuperscript{97} (2) the FHFA violated the Administrative Procedure Act (APA) requirement for a notice and comment period\textsuperscript{98} prior to unilateral agency action, in that it failed to follow proper notice and comment procedures prior to enacting the rules contained in its “Statement on Certain Energy Retrofit Loan Programs”;\textsuperscript{99} and (3) the FHFA violated the National Environmental Policy Act (NEPA), in that it issued guidance directly affecting the availability of an energy efficiency program and its “attendant environmental benefits” without a prior evaluation of the guidance’s impact through either an environmental impact statement (EIS) or an environmental assessment (EA).\textsuperscript{100} In the following months, parties filed additional lawsuits, each of which articulated claims similar to those alleged in \textit{Sierra Club v. Federal Housing Finance Agency}.\textsuperscript{101}


\textsuperscript{96} According to FHFA’s enabling legislation, FHFA exists for the purpose of ensuring that Fannie Mae and Freddie Mac “operate[] in a safe and sound manner, including maintenance of adequate capital and internal controls” and “foster liquid, efficient, competitive, and resilient national housing finance markets.” \textit{Id.} § 4513(a)(1)(B)(i)-(ii).

\textsuperscript{97} Complaint for Declaratory and Equitable Relief, \textit{supra} note 94, at 11.

\textsuperscript{98} 5 U.S.C. § 553(b)-(c).

\textsuperscript{99} Complaint for Declaratory and Equitable Relief, \textit{supra} note 94, at 12.

\textsuperscript{100} \textit{Id.} at 13.

The statutory violations alleged in Sierra Club and other suits align closely with the larger dispute between supporters and critics of PACE financing: what is the nature of PACE bonds, and what effect do these bonds have upon mortgage markets? These questions, along with the important question of whether PACE lien seniority violates the Contracts Clause, form the basis of this Law Summary's Discussion.102

IV. DISCUSSION

A. Major Disagreements Between PACE Supporters and Lenders

As negotiations between PACE supporters and federal lending agencies broke down in May and June 2010, it became apparent that three fundamental issues had become intractable. The first of these issues involved the appropriate characterization of PACE financing: whether local governments were appropriately financing PACE borrowing through their land-secured financing authority.

1. Is PACE Funding Appropriately Characterized As an Assessment?

In its May 5 directive, Freddie Mac addressed “energy efficient loan programs” and directed mortgagors that any liens created by such loans could not be senior to a federally backed mortgage.103 The characterization of the PACE program by Fannie Mae and Freddie Mac as a “loan” was not accidental, but rather indicative of the basic disagreement between supporters and critics of the program. In its complaint against the federal lenders, the Sierra Club asserted that “[t]he May 5, 2010 advice letters wrongfully mischaracterized the PACE program as issuing ‘loans.’”104 The Sierra Club asserted that the advice letters were wrong because the program was an assessment against real property and operated under “well settled principles of California [assessment] law.”105 Proper characterization of PACE financing is crucial because under assessment law government liens enjoy priority over mortgages and private lenders; conversely, loans taken against the land are subordinate to any preexisting mortgages.106 If critics succeed in characterizing PACE as a loan program, then there is no justification for granting seniority to such liens, and mortgagors should be entitled to be repaid before investors.

102. This Law Summary avoids the more narrow statutory questions of the FHFA’s actions in light of the Administrative Procedure Act and the National Environmental Policy Act. This avoidance is due to this author’s hope that effective negotiation between the parties would be a more effective resolution of each side’s concerns than litigation over the manner in which the FHFA suspended PACE financing.
103. McClung, supra note 13 (emphasis added); McClung, supra note 75.
104. Complaint for Declaratory and Equitable Relief, supra note 94, at 3.
105. Id.
To PACE supporters, the right to be repaid first is primarily important as a tool to encourage private investment:

[F]irst lien status is critical to the success of PACE programs. . . . In the case of a foreclosure, the property value has often decreased, resulting in . . . no money to pay off any secondary liens. Where this occurs . . . the junior lienholder suffers a loss. Because of the risks associated with subordinated liens, there is currently almost no demand in the secondary market for conventional junior mortgage instruments. Eliminating priority lien status for PACE assessments would render them effectively impossible to finance through the capital markets.107

Regardless of whether this statement is true, the purpose for granting seniority to PACE liens is immaterial if the authority to do so is not contained within the state power to levy assessments for public improvements.108 The question then turns upon whether PACE programs legitimately fall within the state assessment authority, rather than upon whether a certain program is viable as a non-assessment.

PACE supporters have defended the PACE program as an assessment based on the fact that the money is given not to individual homeowners, but to properties; thus, the assessment “runs with the land” and binds subsequent homeowners who purchase the property.109 Conversely, the FHFA defended its decision on the basis that PACE loans are not an appropriate use of state authority because they (1) exceed the normal size and duration of typical tax assessment programs and (2) do not offer the same community benefits typically associated with tax assessment programs.110

107. First Amended Complaint for Declaratory and Injunctive Relief, supra note 48, at 12.

108. Alternative arguments put forth by PACE supporters may suggest that first lien priority is not as crucial as they insist. PACE supporters point to a default rate of less than two percent nationally in support of the low-risk nature of municipal bond investing; thus, municipal bond investing should still be attractive as a low-risk way to ensure regular long-term returns. See, e.g., PACENow, supra note 24, at 21. Additionally, the Department of Energy has recommended to states that they establish “[d]ebt service reserve fund[s]” to provide pools of cash for investors in case of late payments or nonpayment. See DEP’T OF ENERGY, GUIDELINES FOR PILOT PACE FINANCING PROGRAMS 5 (2010), available at http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf [hereinafter DOE Guidelines]. In other words, in rare cases (less than two percent) of defaults, investors will frequently see no interruption of returns. California’s statute explicitly called for the establishment of such “reserve funds.” CAL. PUB. RES. CODE § 26124 (West 2011).

109. PACENow, supra note 24, at 7; see also Rep. Israel Speaks About Property Assessed Clean Energy Bonds at Forum on Financing for Clean Energy Building Retrofits, supra note 3.

110. FHFA Statement, supra note 77.
Most state PACE initiatives, including Missouri’s, explicitly set a twenty-year maximum term for any PACE assessment. However, most PACE enabling legislation does not expressly dictate the maximum permitted lien-to-value ratio. The Department of Energy (DOE), in a May 7, 2010 issuance describing what it considered to be “Best Practice Guidelines,” stated that PACE loans should not exceed ten percent of any given property’s value, with a minimum threshold cost of $2500. DOE presented ten “Program Design Best Practice Guidelines” that sought to “increase the reliability of energy and economic performance for the benefit of program participants, mortgage holders, and investors,” as well as three “Assessment Underwriting Best Practice Guidelines” intended to reduce the risk of default. Thus, the question is whether a maximum loan term of twenty years with a maximum lien-to-value ratio of one-to-ten exceeds more traditional assessments that the local municipality has generally issued.

A survey of Sonoma County municipal financing programs found that the typical PACE lien in that county falls well within the boundaries of tradi-

111. PACENow, supra note 24, at 23; see also Mo. Rev. Stat. § 67.2800.2(1) (West 2011). The Department of Energy and the White House have recommended that the length of the loan not exceed the period of time during which the energy improvement would provide cash-positive returns to the homeowner (i.e. the period of time during which the homeowner realizes a benefit on the investment). DOE Guidelines, supra note 108, at 3; Policy Framework for PACE Financing Programs, supra note 55, at 5.

112. See sources cited supra note 32.

113. DOE Guidelines, supra note 108, at 1, 3. PACE supporters rely upon the ten percent limitation in contending that a PACE loan’s small size and cash flow positivity make such loans immaterial to mortgage holders, discussed infra at IV.A.2; see also PACENow, supra note 24, at 22. In addition, DOE stated that its guidelines are “significantly more rigorous than the underwriting standards currently applied to land-secured financing districts.” DOE Guidelines, supra note 108, at 1. Because so many PACE programs have relied upon federal funds to provide for start-up costs, the DOE guidelines carry great authority with most, if not all, local PACE programs. See RANCHOD ET AL., supra note 6, at 4. These guidelines are crucial to PACE supporters’ argument that a PACE loan creates no more, and potentially less, risk to all parties. See id. It does not follow, however, that these guidelines will prove binding to state PACE programs going forward. For more on this point, see infra Part IV.A.3, B.

114. DOE Guidelines, supra note 108, at 2-7. The Department of Energy guidelines, developed in concert with the U.S. Department of Housing and Urban Development (HUD), National Economic Council (NEC), Council on Environmental Quality (CEQ), Office of Management and Budget (OMB), and the Department of the Treasury, were issued around the same time as guidelines issued by the White House; both guidelines ensured that municipal programs were being conducted in as low-risk and most effective a manner as possible. See PACENow, supra note 24, at 26; see also DOE Guidelines, supra note 108; Policy Framework for PACE Financing Programs, supra note 55.
tional land-secured financing.\textsuperscript{115} For non-PACE assessment programs, the survey determined that the duration of assessment programs ranges from ten to forty years, and the annual assessment amount ranges from $4000 to $100,000.\textsuperscript{116} In addition, these programs are voluntary in nature and involve property-specific lending for infrastructure-based improvements like PACE programs.\textsuperscript{117} In other words, the survey suggests that a PACE assessment of twenty years at ten percent of a property’s value falls well within the boundaries of a state’s historically recognized assessment authority and thus should not be mischaracterized as a “loan” simply by virtue of its size and scope.

FHFA’s statement that PACE programs do not offer similar community benefits as traditional assessments\textsuperscript{118} also implicitly rejects the idea that the improved energy efficiency of residential properties improves the community in a manner similar to improved roadways, sidewalks, sewers, or infrastructure. PACENow points out in response that “cleaner air, local economic development [in the form of opportunities for local businesses to retrofit more properties] and cost savings” all provide legitimate community benefits.\textsuperscript{119} In fact, PACE is the only form of land-based financing that improves homeowner cash flow in the form of reduced monthly payments for energy bills.\textsuperscript{120} While these community benefits may differ in kind from the benefits attributable to a new sidewalk or safer infrastructure, it is implausible to suggest that the community benefits of an improved environment, increased business opportunities, and homeowners with increased gross monthly income are not legitimate communal improvements of the type a municipality should be financing.

Simply put, a properly structured PACE program operates within the parameters of the state’s traditional assessment authority, both in terms of size and scope and the legitimate, tangible community benefits it provides. PACE programs thus are properly characterized as assessments, entitling them to senior status. The question arises, then, whether that senior status actually harms lenders when the property enters default or foreclosure.

2. Do PACE-Encumbered Properties Substantially Harm Lenders Upon Default?

In a typical PACE assessment scenario, a parcel of property is burdened by a tax levy of a specified amount, typically ten percent or less of the home’s

\textsuperscript{115} PACENow, supra note 24, at 26.
\textsuperscript{116} Id.
\textsuperscript{117} Id.
\textsuperscript{118} FHFA Statement, supra note 77.
\textsuperscript{119} PACENow, supra note 24, at 23.
\textsuperscript{120} Id.
value. Thus, if an assessment is granted against a certain property and the homeowner subsequently sells the property to a new owner (or defaults on the property), that homeowner’s burden to repay the assessment is relieved (less the amount in arrears), with the new purchaser becoming responsible for the assessment (less the amount already paid or in arrears). Unlike a mortgage or traditional loan instrument, default upon an assessment does not “accelerate” the amount due, which would make the full outstanding debt immediately payable. Instead, only the portion of the debt in arrears becomes due, which would amount to one year’s worth of assessments. PACE supporters argue that this factor should alleviate mortgagees’ concerns that they would be subordinate to PACE liens; while the lender’s right to repayment would be subordinate to the PACE lien, the PACE repayment would amount to a statistical average of two hundred dollars, not the tens of thousands of dollars potentially outstanding.

Despite the arguments of PACE supporters, the fact that the lien is forwarded to any subsequent purchaser does not necessarily alleviate the mortgage industry’s concerns. Because of their size and duration, PACE assessments do present a potential barrier to a given property’s marketability. Coupled with the current foreclosure crisis, reduced lending options for prospective homeowners, and a generally stagnant real estate market, lenders

121. See, e.g., RANCHOD ET AL., supra note 6, at 2; PACENow, supra note 24, at 25.
122. This result is justified, as the subsequent owner of the property would inherit the benefit accrued by the debt, while the departing homeowner loses the benefit he or she enjoyed while at the property. See DOE Guidelines, supra note 108, at 3.
123. PACENow, supra note 24, at 16.
124. Id. at 25. Only one year’s worth of assessments would be due because the clean energy assessment would be due upon receipt of the homeowner’s annual property tax bill. See id. A failure to pay the full amount of the bill would trigger a default for that year’s assessments. See id.
125. PACENow, supra note 24, at 16. For a detailed explanation of PACE defaults and the subsequent harm to subordinated lenders, see Posting of Todd Woody to Green: A Blog about Energy and the Environment, http://green.blogs.nytimes.com (July 2, 2010, 12:11 EST). The article explains that for an assessment of $15,000, if foreclosure occurs with one year of assessments being unpaid, the amount in arrears would be $1500. Id. “[A]ssuming a high foreclosure rate of [ten] percent,” average PACE seniority would be $150 per encumbered property. Id. That number is reduced as more realistic default rates are used. In Sonoma County, studies have shown that PACE-encumbered properties default at a rate sixty percent below the average default rate for that county. See PACENow, supra note 24, at 20.
126. See, e.g., Eisen, supra note 32, at 85-86 (explaining that “states would require homeowners to disclose the higher property tax obligation at the time of resale, which might give some prospective buyers second thoughts”).
127. Id.
could reasonably feel that any additional encumbrance on a property represents too great a risk to warrant the investment.\textsuperscript{128}

In reality, any increased burden on a given property reduces its marketability once sold or foreclosed: no amount of safeguards can eliminate that concern for lenders. However, this concern has never prevented municipalities from enforcing senior assessments.\textsuperscript{129} Thus, the scope of PACE is unlikely to have a substantial impact on lenders’ ability to market their properties, and the nature of the program is such that it should reasonably improve a property’s attractiveness, rather than impede it. Lenders should not be concerned about PACE assessments, but rather should embrace them as a low-cost way for homeowners to improve the value of their property, assuming the presence of underwriting safeguards to ensure lender protection.

3. How Serious are the Potential Effects of Collateral-Based Lending?

Lenders have expressed concern that absent strict loan underwriting standards, the risk of default on PACE homes is too great, and collateral-based lending practices incentivize a homeowner to default on his or her property.\textsuperscript{130} Because PACE loans operate by virtue of an interest in the benefitted property rather than an assurance of the borrower’s ability to repay the balance of the debt, lenders are concerned that high-risk borrowers will not be prevented from taking on PACE loans that exceed their ability to pay and will ultimately choose foreclosure.\textsuperscript{131} This result is based on the allegedly loose underwriting standards employed by PACE programs around the country.\textsuperscript{132} Thus, lending authorities have advocated a debt-to-income test to help potential lenders better establish a borrower’s ability to pay.\textsuperscript{133}

In response, PACE advocates point to the historically low default rates on property tax payments (typically below two percent)\textsuperscript{134} and the Department of Energy’s guidelines that direct PACE programs to establish “[d]ebt

\textsuperscript{128} See, e.g., FHFA Statement, supra note 77.
\textsuperscript{129} See, e.g., Dunlap v. County of Gallatin, 15 Ill. 7 (1853).
\textsuperscript{130} FHFA Statement, supra note 77. The threat of default is especially concerning to lenders in PACE situations, given that a homeowner with a PACE loan is not responsible for the balance of the loan upon default. See id.
\textsuperscript{131} Id. In a March 25, 2010 article published in The Wall Street Journal, former FHFA attorney David Felt articulated the FHFA’s fear that PACE programs have “all the right economics to take off in a huge way and then cause huge losses” and that “[w]hen you’re able to market to people who can’t get financing for an ordinary home-equity loan, that should set off alarm bells.” Nick Timiraos, \textit{Fannie and Freddie Resist Loans for Energy Efficiency}, WALL ST. J., Mar. 25, 2010, at A4, available at http://online.wsj.com/article/SB10001424052748704534904575132123115802584.html.
\textsuperscript{132} FHFA Statement, supra note 77.
\textsuperscript{133} Id.
\textsuperscript{134} PACENow, supra note 24, at 21.
service relief fund[s],” which would protect investors by providing a pool of capital in case of late payment or default. The DOE’s guidelines also “recommend” that PACE programs (1) do not loan to homeowners without home equity, (2) avoid lending to homeowners without a history of mortgage and property tax payments for the current affected property, and (3) limit lending to situations where the effect of the assessment is a guaranteed “positive return” (i.e. where the benefit to be derived from the improvement, in terms of reduced yearly energy bill payments, exceeds the annual cost to the homeowner of the assessment, resulting in a “cash positive” transaction for the homeowner). Creating a positive return to the homeowner ensures that PACE funding will not decrease the ability of the homeowner to meet all of his or her other financial obligations, but rather will put the homeowner in a better position to do so than if he or she had not participated in the PACE program.

There is no reason to suspect that the ratio of assessments to defaults will increase substantially from the current level of less than two percent. For example, in Sonoma County, California, the site of the country’s largest PACE program, there has not been a single default on a PACE-encumbered home during its two-year existence; during that same period, however, the default rate for Sonoma County mortgages was seven percent. In other words, in a county with over 100,000 homes, there were over 7000 defaults in two years, but not one with a PACE lien assessed against it. Thus, the traditionally small amount of PACE-encumbered defaults, coupled with increased underwriting requirements, means that even a massive expansion of PACE lending would be unlikely to result in material harm to mortgagors. In fact, none of the literature or argumentation by PACE critics has articulated an actualized harm to the industry: the entirety of the criticism has been based on what could occur, assuming that PACE boards fail to adopt or adhere to any of the recommended underwriting requirements. For this reason, PACE programs are unlikely to significantly impact lenders as long as federally approved underwriting standards are employed.

135. DOE Guidelines, supra note 108, at 5.
136. Id. at 6. It is this last guideline – that PACEdoing be limited to “positive return” situations – that PACE supporters credit with keeping default rates significantly below average, the theory being that homeowners who engage in cash-positive transactions are less likely to default on mortgage and property tax payments, given their increased financial positions. See PACENow, supra note 24, at 25.
137. PACENow, supra note 24, at 11.
139. A concession that PACE lending could be massively expanded seems unlikely. Even in Sonoma County, where PACE lending has been in place for two years and has been widely implemented, the number of PACE-encumbered homes (1010) is less than one percent of the total amount of homes and condominiums (110,511) in the county. See PACENow, supra note 24, at 11; Sonoma County, supra note 138.
However, PACE supporters' reliance upon DOE guidelines is insufficient because guidelines are simply that: guidelines. PACE programs that do not accept federal funds are under no obligation to employ any underwriting standards. Further, once a PACE program satisfies its initial period and begins operating exclusively on private investment, the underwriting guidelines published by federal agencies carry no weight, and thus no disincentive exists to impede municipalities from broadening their programs beyond low-risk borrowers. While the underwriting guidelines provide a move towards better protecting lenders, the guidelines need to carry meaningful weight before lenders will cede their current position.

4. Does PACE Lien Seniority Implicate the U.S. Constitution's Contracts Clause?

A question not comprehensively addressed during the initial period of conflict between PACE's supporters and lenders is whether PACE programs violate the U.S. Constitution, which forbids states from creating any law "impairing the Obligation of Contracts."140 The issue is important because if PACE is found to violate the Contracts Clause, then PACE would be invalid in its entirety, rendering the debate over its merits moot.

As an initial matter, it is important to note that the Contracts Clause provides only a weak form of judicial review under modern Supreme Court jurisprudence.141 While the clause provided a powerful means of judicial review of state economic legislation throughout the nineteenth century and into the

140. U.S. CONST. art. 1, § 10, cl. 1. For a comprehensive analysis of PACE and its interaction with the U.S. and California Constitution's Contracts clauses, see RANCHOD ET AL., supra note 6, at 7-16.

Although it was perhaps the strongest single constitutional check on state legislation during our early years as a Nation, the Contract Clause receded into comparative desuetude with the adoption of the Fourteenth Amendment, and particularly with the development of the large body of jurisprudence under the Due Process Clause of that Amendment in modern constitutional history.

Id.; see also RANCHOD ET AL., supra note 6, at 7 ("Since the 1930s, the U.S. Supreme Court consistently has held that this provision is necessarily qualified by states' inherent 'authority to safeguard the vital interests of [their] people' through statutes and regulations." (alteration in original) (quoting Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 434 (1934)); Leo Clarke, The Contracts Clause: A Basis for Limited Judicial Review of State Economic Regulation, 39 U. MIAMI L. REV. 183, 184 (1985) ("It appeared that the [Contracts] clause would stand alongside the taking clause as a rear guard protecting against certain types of retroactive economic legislation... The [Supreme] Court's enchantment appears, however, to have been short-lived.").
1930s Lochner-era,\textsuperscript{142} only one modern Supreme Court decision has struck down a law on the basis of its impairment of private contracts.\textsuperscript{143} In \textit{Allied Structural Steel Co. v. Spannaus}, the Court laid out its modern approach to analyzing challenges brought under the Contracts Clause.\textsuperscript{144} Under this approach, a court’s initial inquiry is whether the state law or other action substantially impairs the private contract.\textsuperscript{145} Impairment is substantial when the regulatory change creates serious consequences for the private parties and when the law unforeseeably intrudes “into an area not previously subject to regulation by the state.”\textsuperscript{146} If the impairment is substantial, the court then analyzes whether the impairment can be excepted as a legitimate public purpose carried out by reasonable and necessary means.\textsuperscript{147}

PACE programs do not create serious consequences for private preexisting lenders, nor do they represent an unforeseeable intrusion into land-secured finance law. PACE liens do not impair the ability of secured lenders to exercise any of their contractual or statutory rights against PACE-

\textsuperscript{142} Clarke, supra note 141, at 188-93.

The contract clause was the primary constitutional restraint on state and local regulation of business until the late 19th century . . . . The vitality of the traditional contract clause doctrine thus waned in the early years of this [20th] century, and in 1934 [with the \textit{Home Building & Loan Association v. Blaisdell} decision] its death knell sounded. Id. at 187, 192. In \textit{City of El Paso v. Simmons}, 379 U.S. 497, 507-09 (1965), the Court “signified to virtually every commentator that whatever viability was left in the contract clause after \textit{Blaisdell} was gone.” Clarke, supra note 141, at 194. Subsequent decisions by the Court in \textit{United States Trust Co. v. New Jersey}, 431 U.S. 1, 32 (1977), and \textit{Allied Structural Steel Co. v. Spannaus}, 438 U.S. 234, 250 (1978), indicate that the Contracts Clause is still effectual, but neither decision restored the clause to its pre-1934 eminence. See RANCHOD ET AL., supra note 6, at 7-8.

\textsuperscript{143} RANCHOD ET AL., supra note 6, at 7 (citing \textit{Allied Structural Steel}, 438 U.S. 234). In this context, “modern” refers to Court decisions made following the post-Lochner “switch in time,” when the Court ceased wholesale review of economic legislation through the Contracts Clause. See id. at 8 (pointing out that “opponents of PACE programs rely on a handful of dated state court decisions . . . several of [which] date back to the so-called ‘Lochner Era’”).

\textsuperscript{144} 438 U.S. at 244-45.

\textsuperscript{145} Id. (“[T]he first inquiry must be whether the state law has, in fact, operated as a substantial impairment of a contractual relationship. . . . Minimal alteration of contractual obligations may end the inquiry at its first stage. Severe impairment, on the other hand, will push the inquiry to a careful examination of the nature and purpose of the state legislation.”) (footnotes omitted). If the impairment at issue does not constitute a substantial impairment, then the judicial inquiry need not proceed any further. Id. at 245, 250 (finding that a state law that retroactively modified private pension plan agreements did constitute a substantial impairment of contracts).


\textsuperscript{147} Energy Reserves Group, 459 U.S. at 411-12.
encumbered property. 148 In the event that the lender does foreclose, PACE liens are not entitled to acceleration: following foreclosure, the municipality is only entitled to a small portion of its lien because the rest remains attached to the land. 149 While this does constitute impairment of the preexisting contract, a possible loss of several hundred dollars 150 on a $200,000 mortgage contract cannot reasonably be characterized as “substantial.” 151 Moreover, land-based assessment financing and municipal seniority have existed for more than one hundred years, and this authority has been consistently upheld when designed for the public welfare. 152 Furthermore, as has been discussed, PACE programs do not exceed the size and scope of traditional assessments. 153 Therefore, state enactment of PACE legislation is appropriately characterized as “foreseeable” action in an area previously subject to regulation.

Because PACE assessments do not substantially impair preexisting contracts, a court should not need to go further in its analysis and should uphold PACE liens as constitutional uses of state authority. If a court were to rule otherwise, however, it would continue to the second step of modern contract impairment analysis – the “public purpose doctrine.” 154 If the state action operates in the pursuit of “significant and legitimate state interests,” the action should be upheld as within the state’s qualified authority “to protect the lives, health, morals, comfort, and general welfare of the people . . . .” 155

PACE programs create cash-positive transactions that reduce U.S. energy consumption and homeowner energy bills but do not (at least if limited to high-equity properties) force homeowners into situations where the debtor’s liabilities exceed home equity. 156 PACE assessments promote the public welfare by increasing community energy efficiency and the financial security

148. RANCHOD ET AL., supra note 6, at 11.
149. See PACENow, supra note 24, at 16.
150. The assumption that foreclosure in addition to a PACE lien would actually result in a loss to the lender is one that PACE supporters are unwilling to make. PACE supporters argue vehemently that because PACE bonds are cash-positive and designed to improve a home’s energy efficiency and value, lenders will be better off with a PACE-encumbered property than without it. See supra Part IV.A.2.
151. See RANCHOD ET AL., supra note 6, at 11 (“[T]he attachment of a PACE lien to a previously mortgaged property does not substantially impair prior arrangements between landowners and mortgage lenders, regardless of their priority.”).
152. ld. at 11, 13.
153. See supra Part IV.A.1.
155. RANCHOD ET AL., supra note 6, at 13 (quoting Manigault v. Springs, 199 U.S. 473, 480 (1905)).
156. ld. at 11. This situation is commonly referred to as a property that has gone “underwater”; that is, the amount of debt held by the homeowner exceeds the amount of equity he or she holds in the property.
of homeowners. Thus, PACE programs operate within the state power to act in the public good.

The last step in the impairment of contracts analysis is whether the legislation is a necessary and reasonable means to achieve the stated public purpose. While courts typically defer to legislative rationale and findings when analyzing the purpose of a law, PACE presents a novel situation. As originally enacted, PACE enabling statutes contained little, if any, underwriting requirements, and few states have subsequently amended their statutes to reflect the DOE’s advised underwriting requirements. This is reflected in the fact that PACE supporters continue to rely upon DOE and White House guidelines, rather than specific statutes, as evidence of lender protection.

As a result, a court could reasonably conclude that absent express statutory underwriting requirements on the types of borrowers and properties eligible for PACE liens, clean energy legislation is not reasonably tailored to achieve its public purpose. For instance, improperly administered PACE programs fail to operate for the public good by exacerbating the problems inherent in an already fragile housing market – increased underwater properties, increased foreclosures, and decreased satisfaction of private liens. Furthermore, such programs are not necessary means for achieving their purpose: legislation with legitimate underwriting standards would more effectively target those properties inclined to improve the public good. As a result, PACE programs that fail to include strict underwriting requirements do not provide the kinds of communal and individual benefits relied upon by PACE supporters for their assertions that PACE liens improve the public welfare; this failure ultimately undermines all arguments made in support of PACE programs, including their constitutionality under the modern three-part Contracts Clause test. For this reason, analysis of whether a PACE program impairs the right to contract rests on the same question ultimately at issue:

157. See supra Part IV.A.1.
159. Id. ("Unless the state itself is a contracting party, '[a]s is customary in reviewing economic and social regulation, . . . courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.") (alteration in original) (citation omitted) (footnote omitted).
160. See sources cited supra note 32. In The Constitutionality of Property Assessed Clean Energy (PACE) Programs Under Federal and California Law, Ranchod argues that since "the imposition of PACE assessments is subject to reasonable conditions imposed under PACE programs," courts would find the legislation reasonable and appropriate. RANCHOD ET AL., supra note 6, at 14. While California (whose PACE legislation Ranchod addresses directly) does impose such requirements, many states do not. Id.; see also sources cited supra note 32.
161. See sources cited supra note 32.
162. See, e.g., PACENow, supra note 24, at 19.
163. For more on this point, see infra Part IV.B.
How do PACE supporters ensure that the underwriting guidelines they rely on become law?

B. Effectively Resolving the Parties' Differences

While the DOE guidelines ensure the underwriting standards of PACE programs at their inception, they provide no effective guarantee thereafter. Lenders have no assurances that municipal programs will not begin to provide financing to less worthy borrowers and properties. Therefore, additional safeguards must be put in place to secure the positions of mortgage lenders and borrowers alike.

For the DOE guidelines to effectively limit the scope of lending to worthy borrowers, two possibilities are available: secondary implementation by Fannie Mae and Freddie Mac, or original implementation at the municipal level. For the reasons articulated below, this Law Summary advocates the latter approach, under which state legislators would amend PACE legislation to expressly codify the DOE-recommended underwriting standards.

1. Federal Control of Underwriting Standards
   Via Mortgage Acceptance Protocols

One way to resolve the current dispute is for Fannie Mae and Freddie Mac to resume accepting PACE-encumbered mortgages, but only those mortgages complying with the specified underwriting standards. Fannie Mae and Freddie Mac should purchase only those mortgages that (1) have savings-to-investment ratios greater than one, (2) have assessment terms limited to the length of the life of the improvement (or, in the alternative, twenty years), (3) provide notification to mortgage holders of all placed PACE liens, (4) do not permit PACE lien acceleration, and (5) limit assessments to ten percent of the property's value.165 Such a limit on approved PACE loans would sufficiently protect lenders while allowing PACE lending to go forward.

While allowing Fannie Mae and Freddie Mac to control PACE programs via acceptance of specified mortgages would ensure federal lending protection, such a solution would fail to resolve the deeper issues of PACE programs. Under such a solution, local private lenders would still be subject to an interim period of potential high-risk loans without underwriting protections, and homeowners would still be able to assume non-essential PACE debts that place them underwater on their mortgages or result in cash-negativity. Furthermore, federal implementation would allow Fannie Mae and Freddie Mac to continue to control local assessment law. Lawsuits filed on behalf of PACE programs dispute the authority of Fannie Mae and Freddie Mac to control the PACE markets.166 This challenge is unlikely to go away if

165. See supra notes 56-57.
166. See supra notes 94-101 and accompanying text.
those lenders begin accepting mortgages of some, but not all, PACE-encumbered properties. For these reasons, local-level underwriting more effectively protects the parties involved, as well as settles the current disputes regarding federal lending agency authority.

2. The Benefits of State-Level Underwriting Implementation

California has already taken steps to more effectively control the market for PACE bonds by amending its PACE statutes. State-level implementation thus codifies the recommendations PACE supporters have championed: that strict underwriting standards are the basis for the appropriateness and constitutionality of PACE liens.

Furthermore, requiring states to codify stringent underwriting standards would allow Fannie Mae and Freddie Mac to withdraw from the current debate and abstain from effectively regulating local-government assessment law. Doing so would resolve the ongoing litigation regarding the publication of their memoranda and would allow well-deserving homeowners to resume PACE-backed borrowing.

For these reasons, the best way to ensure the resumption of PACE financing and also provide adequate protection to lenders is for states to enact amendments to their existing PACE statutes. As many states have already begun amending their programs to facilitate lenders, this solution provides the quickest and safest means of resolving the current conflict over PACE financing.

V. CONCLUSION

While supporters and critics of PACE programs currently appear to be far from resolving their conflicts, recent actions by the executive branch and some concessions from PACE supporters indicate that a compromise may be possible in the future. In addition, recently amended established PACE programs include express statutory underwriting requirements that mitigate the concerns many lenders had with previous PACE programs.

Assuming that the underwriting standards currently existing as guidelines are enforced as law in the future, PACE liens would be properly characterized as assessments, and PACE programs would not operate outside of the scope of traditional assessment programs. Furthermore, if municipal clean energy boards adhere to underwriting requirements, defaults by homeowners with PACE-encumbered properties are unlikely to dramatically impact mort-
gagors because the underwriting requirements would make high-level defaults unlikely and because states would possess a bulwark of reserve funds to pay investors in cases of default.

However, lending authorities are left with many questions regarding the interaction of PACE liens with preexisting mortgages, registration of title laws, and land-secured lending. This uncertainty arises from the broad application of a California-based program to other states, each of which has its own unique laws and regulations regarding matters such as issuing mortgages and real estate loans, filing property tax assessments, and approving borrowers. As a result, a PACE program designed for a single state was stretched to its limit when broadly adopted by the twenty-two states in which PACE programs have currently been enacted. Hyper-individualization may account for some part of the lending authority’s overreaction: as PACE legislation swept the nation, federal lending agencies faced conflicting state-law issues of priority, registration, and constitutional law, but lacked an effective mechanism for resolving these issues.

For this reason, the response by the White House and the Department of Energy, as well as the appropriation of federal funds to initiate PACE programs, is an important first step towards creating workable PACE underwriting standards. The guidance of carefully crafted underwriting requirements and safeguards can ensure that PACE assessments are limited to well-qualified, well-intentioned borrowers, thereby increasing both community and private benefits. However, the assurance that PACE assessments will be limited to well-qualified borrowers relies upon the assumption that clean energy boards will actually employ the advised underwriting guidelines in the future.

Given the undeniable national interest in reducing energy consumption, rather than unilaterally halting the program’s accessibility for deserving and undeserving borrowers alike, Fannie Mae, Freddie Mac, and FHFA would do best to work with PACE supporters to ensure that all municipalities carry out the advised underwriting requirements, preferably through state amendments codifying the recommended underwriting standards. To do otherwise is to dismiss the concessions and improvements made by PACE proponents and to ignore the thousands of legitimate outstanding PACE liens. Given that PACE programs constitute an evolving and workable tool for financing clean energy improvements and improving the energy efficiency of the world’s largest per capita consumer of energy, permitting all the potential benefits of PACE financing to go unrealized is a consequence that is simply too serious to bear.

171. See supra note 32 and accompanying text.