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The Past and Future of PACE

By T. Robert Finlay, Founding Partner, Wright, Finlay & Zak and Sonia Edwards, Senior Associate, Wright, Finlay & Zak, California

With global warming and other environmental issues at the forefront of national policy, the creation of programs to finance energy-efficient improvements soon followed. In 35 states and the District of Colombia, the primary means of financing these improvements is through Property Assessed Clean Energy (PACE) programs. While PACE operates in various degrees in the states it is available, it is regulated at the state level only, and currently operates under the state law of the participating states. On a national level, however, PACE programs have been affected by Fannie Mae and Freddie Mac's refusal to back mortgages with PACE liens, and HUD's announcement that PACE liens must be subordinate to any FHA guaranteed mortgages. Thus, it is not surprising that while PACE regulation varies from state to state, common issues will arise.

Like any new program, PACE has not been without issues, many of which did not become apparent until its implementation. California, the state in which PACE originated, is no exception.

Last fall, California implemented a major overhaul of the PACE program in the form of SB 242 and AB 1284, which will take effect on January 1, 2018, and January 1, 2019. These new laws, which supplemented existing law and will be renamed "California Finance Lenders Laws", are intended to establish a uniform, statewide set of regulations with the dual goal of consumer protection and ensuring the future of financing for environmental improvements under an existing financing program. Other states are likely to follow California's lead in regulating PACE loans.

PACE Before the New Laws

In 2007, the State of California first introduced PACE to provide commercial and residential financing for renewable and clean energy improvements for existing and new structures. The programs enabled homeowners and businesses alike to install a wide range of efficiency-increasing upgrades, such as solar windows and panels, LED lighting, insulation, and, in the commercial context, seismic retrofitting, as well as the installation of vehicle-charging stations for electric cars.

The PACE program really took off in 2010, when the California Legislature set up the State's Loan Loss Residential Fund for Residential PACE programs. These programs provide various sources of financing, usually through local governments obtaining financing from private lenders in the form of bonds of various duration, ranging from a few months up to 20 years. Once recorded, the assessment contracts become liens against the property that secured repayments that appeared twice a year on the property tax bills of the affected properties as a line item and were repaid through the localities. Like property taxes, PACE assessments created liens that were superior to any existing lien, including senior mortgages. These liens were not eliminated by foreclosure and could be foreclosed in the same manner as delinquent property taxes. For a senior lender, the consequences were clear: these assessments, if delinquent, had to be advanced by the lender to protect the lender's security interest. The advances could, however, then be added to the balance due on the loan.

It is important to note that, in the *residential context*, there is no notice requirement to the existing senior lienholder at the time of their creation. Thus, the liens are created without any consideration of the impact of the assessment on the existing lienholders. They are in effect, imposed on the lienholders. Thus, PACE assessments created a de facto "super lien."

In addition, the PACE assessments ran with the land, not the borrower. As a result, prior to the enactment of the new law, PACE financing decisions were based entirely on the amount of equity in the property, a cursory review of the borrower's payment history of property taxes, and the absence of a recent bankruptcy. No consideration was given to the borrower's creditworthiness, his/her income, assets, existing liabilities (including the current mortgage), or overall ability to repay. Moreover, because PACE contracts did not require lending disclosures many borrowers did not understand the extent to which they were

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increasing their monthly obligations. In fact, many were lured into the often-false belief that, with tax credits and energy savings, the improvements would virtually "pay for themselves". More often than not, the results were disastrous, because the extra burden of the assessment caused not only default in the payment of the assessment, but potentially in the underlying loan obligation. In addition, the PACE assessments created a new category of essentially mandatory advances for mortgage lenders, on par with delinquent property taxes. In a declining real estate market, these advances could potentially become losses, and make reinstatement less likely for the borrower.

The fact that the PACE liens ran with the land gave rise to another unexpected consequence for borrowers: Namely, most borrowers were not informed that the presence of the negative impact of PACE liens on the sale of the property or the refinance of their loans, primarily due to the fact that the majority of lenders refuse to finance loans on properties with existing PACE liens. This limitation stemmed in part from the fact that, in 2010, Fannie Mae and Freddie Mac refused to back mortgages with PACE liens on them. In 2015, HUD announced that FHA loans on homes with PACE liens would not be made absent a subordination agreement of the PACE lien. These limitations thus affected the marketability of the properties burdened by PACE liens, and in many instances required borrowers to pay off the liens before selling the home; something which was not always feasible.

The New PACE Regulation

The two assembly bills are intended to address what was seen by the Legislature as critical defects in the existing law including, the lack of oversight and regulation in the industry; the lack of proper underwriting requirements, and specifically the lack of concern for the ability to repay; the lack of disclosures and a right of rescission; and fraud prevention, including, false advertising.

The most significant modification to address these concerns is the creation under AB 1284 of a licensing and regulatory framework for the PACE industry, under the supervision of the California Department of Business Oversight (DBO).

Beginning January 1, 2019, AB 1284 will require, among other things, that PACE Program administrators be licensed, new underwritings standards be established based on income verification, and ability to repay consideration, that includes repayment not only of the PACE obligation, but of all debt, including existing mortgage debt; require PACE providers to undergo background investigations and satisfy net worth requirements to obtain a license; require PACE providers to train home improvement contractors and their sales representatives, and will hold PACE administrators responsible for screening and monitoring of contractors and their sales representatives and finally, empower the DBO to take action against noncompliant PACE administrators, by, among other things, prohibiting them from working with certain contractors and their employees who have engaged in activity harmful to consumers.

In addition, SB 242, requires that, beginning on January 1, 2018, prior to the execution of any assessment agreement, PACE providers engage in a recorded telephone call with the borrower(s), which sets forth a "confirmation" of the terms of the assessment contract, and all of the newly-mandated written disclosures concerning the terms of repayment under the contract, including the monthly and annual costs of the assessment, a notification that the cost may not be offset or reduced by the improvements, and a disclosure regarding the inability to guarantee the existence or amount of any taxable deductions. SB 242 also expands the three-day right of rescission on the PACE financing agreement to the separate home improvement contract. Under the new law, a contractor that commences work prematurely will be responsible for restoring the property to its original condition, at no cost to the homeowner. Finally, SB 242 prevents kickbacks from contractors, requires the same price as cash quote for financed improvements, and prevents the disclosure to the contractor by the PACE provider of the amount of financing for which a homeowner qualifies.

SB 242 also includes a foreign language requirement for the confirmation call for five supported languages and beginning on January 1, 2019, will require that confirmation calls in languages other than English, will need to be accompanied by all operative documents in the same language as the call. Currently, the five supported languages include Spanish, Chinese, Korean, Tagalog, and Vietnamese.

The New Laws and Their Impact on Existing Lenders

While receiving the full support of the mortgage and servicing industry, it is clear that the legislation was advanced by consumer groups, many of which continue to claim that the new legislation, while a step in the right direction, is still lacking. Thus the only significant benefits to mortgage lenders would be incidental, at best. One such benefit would likely be that, if applied properly, the new underwriting requirements should reduce the number of overburdened borrowers, and the ensuing defaults. However, this reduction will not eliminate the fact that any financing that increases a borrower's obligation while creating a lien that has priority over a prior existing deed of trust, is going to negatively impact the holder of that deed of trust. The new laws still allow residential borrowers to take on additional debt that could potentially increase the risk of default, and still creates a superior lien, without any type of prior notice to that lender. Even with the most conscientious underwriting techniques, new debt creates an additional risk that was not contemplated at the time of the origination of the mortgage as it not only increases the possibility of default but potentially creates an additional obligation to the mortgage lender since it takes the form of a lien that not only places the mortgage lender's own security at risk, but that survives the mortgage lender's foreclosure and will have to be repaid even if title reverts to the lender.

While overall, these new laws seem like they will a positive impact on mortgage lenders, only time will tell. Increased regulation and a new overseeing entity may create more questions than answers, and possibly a new type of litigation that ties up properties for extended periods of time. As with all new legislation, even the best of intentions can give rise to unanticipated problems. It will also be interesting to see if other states follow California's lead in updating their own programs. Hopefully, states without current programs will be cognizant of the issues that arose in California and other pioneer states, and craft laws that will mitigate them from the onset.

In the meantime, the DBO has invited commentaries and input from the lending industry. Now is the time for the mortgage industry to bring up their concerns, and join forces with the DBO in the hope of finding solutions that are beneficial to lenders and homeowners alike.

T. Robert Finlay is one of the three founding partners of Wright, Finlay & Zak. Since 1994, Finlay has focused his legal career on consumer credit business and real estate litigation and has extensive experience with trials, mediations, arbitrations, and appeals. He is at the forefront of the mortgage banking industry, handling all aspects of the ever-changing default servicing and mortgage banking litigation arena, including compliance issues for servicers, lenders, investors, title companies, and foreclosure trustees. He is a regular speaker on a variety of loan servicing and mortgage banking issues, including key legislative and legal updates, California and Nevada Homeowner Bill of Rights (HOBR), Nevada HOA lien problems and other relevant litigation and compliance issues.

Sonia Plesset Edwards has practiced in the Financial Services industry since 1989, *when she first served as a judicial extern to the Honorable Geraldine Mund, United States Bankruptcy Court, Central District of California. Since being admitted to the California State Bar in December 1991, Edwards has focused her career on representing the interests of lenders, servicers, foreclosure trustees, and private investors on both the plaintiff and defense side. She has a broad range of experience in real estate-related and title matters, foreclosure law, collection law, receiverships, evictions, rent-control, and bankruptcy. Edwards is admitted to practice in all federal and state courts in California, as well as the Ninth Circuit Court of Appeals. She is also a licensed California real estate broker.*

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