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Can Mortgage Lenders Coexist With Green Energy PACE Liens?

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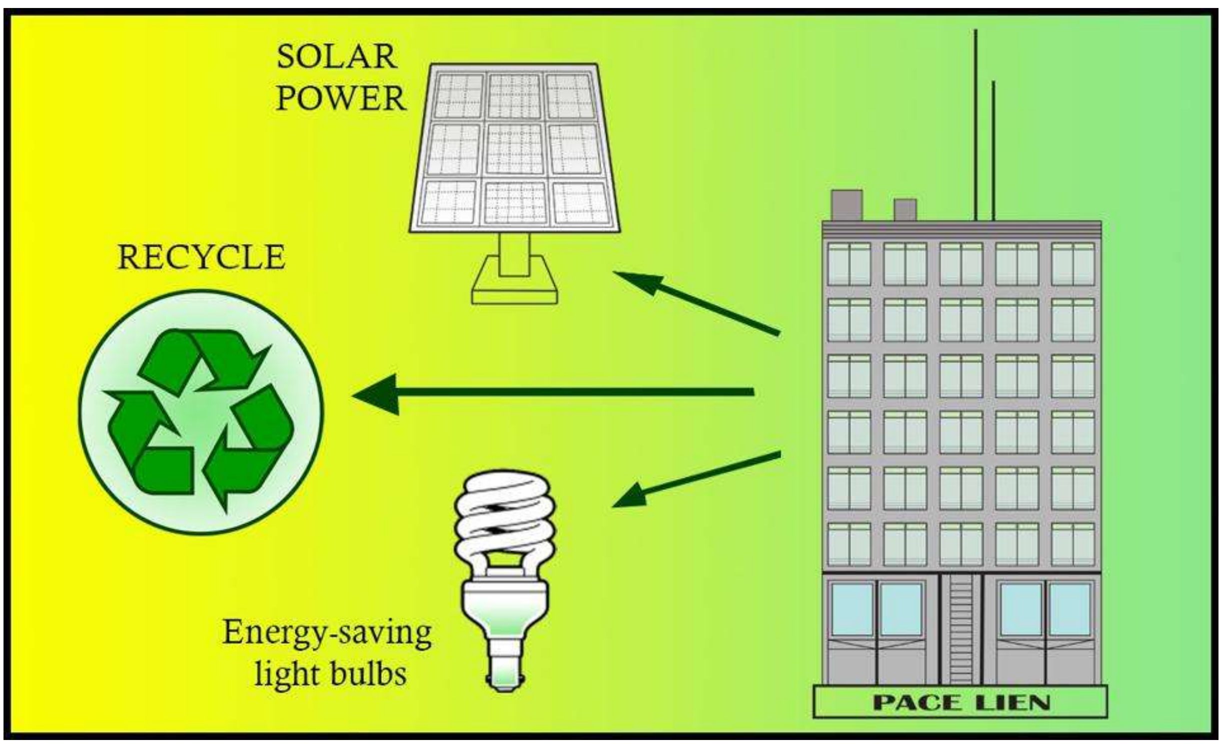
I write about commercial real estate negotiations, deals and legal issues.



A new financing technique for energy-saving improvements terrified mortgage lenders until they learned how to live with it. [-] RANJAN SAMARAKONE

To make commercial buildings more energy-efficient often requires significant capital investment. Environmental advocates have come up with a system to finance capital investment for energy-efficient improvements: Property-Assessed Clean Energy (PACE) liens. A funder advances the necessary capital for energy-efficient improvements. The local taxing authority then establishes a lien, just like a real estate tax or assessment lien, against the benefitted property.

The energy-saving improvements are also supposed to save money, and the savings are supposed to enable the property owner to pay off the PACE lien, with interest, over time, perhaps several decades. PACE liens were first rolled out in Berkeley, California. Today most states have legislation to enable them.

When PACE liens started to appear, they terrified mortgage lenders and securitization rating agencies, because they enabled the borrower to undercut the assumptions on which its existing mortgage financing was based. If the mortgage borrower already had a loan equal to 75% of the value of the property, the introduction of a PACE lien might increase the loan-to-value ratio by an amount significant enough to increase the likelihood of default on the existing mortgage loan. And these liens had the same priority as real estate taxes, i.e., they jumped ahead of existing mortgages, exactly what a lender or a rating agency doesn't want to see happen.

Lenders initially responded by trying to make sure their documents banned PACE liens. To the extent existing standard documents didn't already accomplish that, lenders beefed up their documents to try to assure that the borrower couldn't surprise the lender by adding an unexpected PACE lien to the capital stack, with priority ahead of the lender's mortgage.

After that initial panic, commercial real estate lenders eventually learned they could live with PACE liens, as long as they came into the picture as part of the initial capital stack rather than as a post-closing surprise. If considered as part of the original deal structure, PACE liens could be quantified and taken into account in evaluating the overall financing and financial profile of the building.

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For example, if the lender wanted the loan to value ratio to remain below 75%, a PACE lien could provide part of that financing, with the mortgage amount reduced accordingly. The property ends up with the same amount of debt on it, but the part of the debt intended to finance energy savings comes from a different lender.

If the PACE lien bears interest at a rate higher than the mortgage loan, then the whole exercise may just increase the borrower's cost to borrow the same amount of money, though the PACE lien will have a very slow amortization schedule. On the other hand, if the mortgage lender determines that the borrower's energy-efficient investment funded from the PACE lien will reliably produce cost savings beyond the payments on the PACE lien, then the whole scheme may create additional real estate value to support additional mortgage debt.

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To further comfort mortgage lenders, PACE liens can be structured to limit the rights of the PACE lender if the property owner doesn't pay. Ordinarily, failure to pay a loan eventually allows the lender to accelerate the entire loan and require immediate payment, with failure to pay triggering a foreclosure. Modern PACE liens often don't allow acceleration or foreclosure for nonpayment. So that's one less thing for mortgage lenders to worry about.

When PACE liens consider the agenda of mortgage lenders, finance energy saving improvements that will also reliably save money, and are structured as part of the original capital stack, they can make sense for borrowers and lenders. They do, however, introduce complexity and an additional agenda of potential concerns. And if they come onto the scene by surprise once a mortgage is already in place, they will legitimately worry the mortgage lender.

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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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