So Bright You Have to Wear Shades: PACE Financing for Solar Panels and Other Alternative Energy Facilities

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Mark Palmer

Introduction: As competition for tenants continues to heat up in the marketing of commercial, retail, office, multi-family, and other property types, borrowers are exploring new ways of reducing operating costs, including through the use of solar panels and other energy-generating or energy-saving facilities. Property Assessed Clean Energy (PACE) financing is becoming an increasingly popular and preferred means of financing such facilities, and the requirements and terms of such PACE financing present both opportunities and challenges for CMBS loan lenders and servicers.

Although significant savings and better property operating performance may be achieved by installing such facilities, any use of PACE financing involves potential risks that must be carefully considered, especially with respect to the requirement that mortgage liens be subordinated to PACE financing liens. As a result of such required mortgage lien subordination and other risks, loan servicers and rating agencies have been reluctant to consent to and provide no-downgrade confirmations for PACE financing, however, there is, at least on a limited basis, an ongoing re-evaluation of the manner in which PACE financing requests and the risks are being considered and how such risks may be mitigated.

This article focuses on those risks, potential mitigants and credit enhancements, and required consents, including the subordination of the mortgage lien, due on encumbrance and alterations terms, potential reductions in operating costs, and considerations related to foreclosures and REO sales.

PACE Financing: What is it? PACE financing has been established by statute in a majority of the states as a tool to provide access to capital for clean energy and energy-generating and energy-efficiency projects, such as solar panels, tankless water heaters, insulation improvements, electric vehicle charging stations, and upgrading heating and air conditioning systems with more efficient systems. The financing is typically funded by bonds secured by a voluntary assessment lien on the related real property, which is billed and collected as part of the property tax assessment and, like a property tax lien, a PACE financing lien is superior in priority to mortgage liens and other liens. The lien is "voluntary" because the property owner must request and agree to the PACE financing and the related assessment lien.

The term of PACE financing is customarily twenty years, with annual (or semi-annual, depending on the jurisdiction's method of collecting property taxes) fully amortizing payments. PACE financing interest rates are typically less than market rates offered by banks and other conventional lenders for similar projects, in part as a result of such financing being secured by a superior lien on the entire real property on which the facilities are installed. PACE financing cannot be accelerated upon a default, and any collection action or foreclosure of the lien is limited to the amount of the periodic payment or payments that are past due.

PACE financing requires an audit and a projection of savings in energy costs as a result of the energy generation or improved efficiency of the facilities to be installed and a demonstration of a net savings to the property owner after taking into account the cost and repayment of the financing. Annual savings are typically greater with PACE financing than any savings that could be achieved by installing the facilities using conventional financing because of the lower interest rates and extended terms available through PACE financing programs. The net-savings calculations are, however, determined based on assumptions related to the long-term future cost of traditional energy sources, and, especially in the current energy market with changes in pricing resulting from the discovery and use of new energy resources, the validity of such assumptions must be considered.

Additionally, because PACE financing is established at the state level, enabling legislation varies from state to state, and a loan servicer and its legal counsel should review the applicable statute.

Mortgage Subordination, Due on Encumbrance, and Alterations: As discussed above, assessment liens securing PACE financing projects are given the same priority as property tax liens and are, therefore, superior in priority to the liens securing mortgage loans. PACE financing liens and the related facilities to be installed require consent under customary loan document provisions relating to additional encumbrances and indebtedness. PACE financing also typically requires rating agency no-downgrade confirmations under pooling and servicing agreements, whether pursuant to specific terms related to PACE financing under more recent pooling and servicing agreements or, even if PACE financing is not specifically referenced, under the due on encumbrance provisions, as a superior lien, and under the consent and modification terms.

Borrowers sometimes encourage servicers to accept a PACE financing lien as an additional permitted encumbrance under loan documents in which permitted encumbrances include property tax liens. Such a position, however, should be rejected. Although PACE financing liens are similar to property tax liens and are billed and collected by the tax assessor as an additional assessment, they are different than property tax liens. Such liens are assessed and created only at the voluntary request of property owners and can be distinguished from property tax assessment liens even under vague permitted encumbrance terms of loan documents. Recent forms of CMBS mortgage loan documents typically expressly define and prohibit PACE financing without the prior written consent of the mortgage lender.

Additionally, PACE financing customarily requires the consent of mortgage lenders under the applicable statutory framework and PACE documentation (note, however, that the enabling legislation in Florida, among other jurisdictions, suggests that mortgage lender consent may not be required for certain PACE financing projects relating to single family residences, which is a topic of ongoing discussions in the applicable jurisdictions).

Because PACE financing is used to alter the collateral property, noteholder consent is also required under the alterations provisions of loan documents, subject to any permitted alterations and cost threshold terms that may be included as an exception to such consent requirements.

Underwriting, Mitigants, and Credit Enhancements: In addition to the usual underwriting performed in connection with requests to consent to an additional encumbrance, new indebtedness, and alterations projects, additional information relating to PACE financing includes the following, each of which must be reviewed by loan servicers and legal counsel: the state enabling legislation; the audit and projection of savings in energy costs; the company that will coordinate and administer funding and the bonding arrangements; and the requested mortgage lender consent form and other proposed PACE financing documentation. With respect to the audit and projection of savings in energy costs, in particular, the loan servicer must consider the reputation of the firm that prepared such audit and projection and the assumption statements included as part of the projected savings, and, in most situations, such firm must be acceptable to the applicable state or in compliance with any applicable requirements of the enabling legislation.

In discussions concerning underwriting and consideration of PACE financing requests, borrowers (at the urging of the private companies that administer and collect fees from PACE financing) often emphasize that PACE financing loans cannot be accelerated such that collection efforts and foreclosures are limited to the periodic payment or payments that are past due. While that is correct and does have some mitigating effect on the risks of PACE financing, be aware that such inability of a PACE financing lender to accelerate the debt does not mean that a foreclosing mortgage lender will only be liable for the periodic payments that may be past due under the PACE financing. Upon any mortgage loan foreclosure, the remaining balance of any PACE financing loan will remain due and payable and secured by an assessment lien on the collateral property, such that periodic payments must continue to be made by the property owner following any such foreclosure. The manner in which the non-acceleration aspect of PACE financing is described by consultants and others involved in PACE financing, while technically correct, can sometimes be interpreted by those not involved with PACE financing on a regular basis as suggesting that, upon a mortgage loan foreclosure, only the past due PACE financing payments are due and payable, which is incorrect.

As mentioned above, although special servicers and rating agencies have historically been reluctant to consent to and provide no-downgrade confirmations for PACE financing, there has been limited movement toward re-evaluating the manner in which PACE financing requests and the related risks are being considered and how such risks may be mitigated with credit enhancements and other conditions. In our practice, we have recommended and seen such credit enhancements and conditions include the following:

- New or adjusted reserves for deposit of PACE financing payments, often including an advance deposit and retention in the reserve of an amount equal to an annual payment due in connection with the PACE financing;
- A reserve in the full amount of the PACE financing loan though borrowers would typically elect not to undertake the PACE financing project if such a large reserve were required; and
- More recently, a guaranty from a borrower affiliate to cover any gap between the projected net savings to be achieved by the PACE financing project and the actual savings realized.

With such credit enhancement requirements to mitigate the PACE financing risks, special servicers and rating agencies have consented to and provided (or waived) no-downgrade confirmations to allow certain PACE financing projects to proceed. As a result of these more encouraging recent developments the future for PACE financing may indeed be bright.

Considerations Related to Foreclosure and REO: In considering borrower requests for PACE financing, also be aware that the effects of PACE financing on foreclosure and the eventual sale of the property as REO remain largely unknown. Proponents of PACE financing generally take the position that the related improvements financed on favorable terms with an interest rate of less than conventional financing market rates will be perceived as a benefit and add value because of the net savings in energy costs. The counter argument, however, is that potential buyers of REO may not accept the projections of continued savings as being reliable in a rapidly changing and fluctuating energy market and will focus instead on higher assessments relative to competing properties. As more PACE financing projects proceed, such effects will become more certain, but at this stage it remains an open matter.

Conclusion: As the use of on-site facilities for energy-generation and energy-savings increases, property owners are likely to explore PACE financing as a favorable means of financing the costs of such facilities. Although there are potential benefits in the nature of anticipated reductions in operating costs, the required mortgage lien subordination and other risks must be considered by loan servicers. Among other issues, the reliability of the projected savings in energy costs must also be evaluated in light of the instability of energy markets and prices and the difficulty of making accurate projections as to future energy costs.

Nonetheless, with suitable mitigants and credit enhancements, PACE financing and the related improvements may be appropriate for certain projects, and, with special servicers and rating agencies being willing to at least review borrower requests, each project and request should be considered rather than being dismissed or denied without further discussion and evaluation.

For more information, contact:

Mark A. Palmer
Kilpatrick Townsend & Stockton LLP
1100 Peachtree Street NE
Atlanta, GA 30309
t 404 815-6105
MPalmer@KilpatrickTownsend.com