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Emerging Issues: Residential PACE Loans and Bankruptcy

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As the drumbeat to improve energy efficiency grows louder by the day, “green” improvements like solar panels and more-efficient HVAC systems are more desired and prevalent than ever. Starting with California in 2008, 33 states and the District of Columbia have enacted laws authorizing Property Assessed Clean Energy (PACE) loans to finance these improvements.[1]

PACE loan programs nationwide [2] attest to the desirability of energy efficiency improvements as a matter of public policy because the loans require municipal participation through a real estate assessment process. However, the programs are not without issues, and a recent Wall Street Journal article analyzed the growing number of defaulted residential PACE loans in California, where the program is most prevalent.[3] As the number of PACE loans grows nationwide, so too does the likelihood that bankruptcy courts will be presented with novel issues relating to the enforcement and treatment of these loans. This article explains how PACE loans are structured, analyzes the scant federal case law concerning PACE loans and addresses PACEspecific issues that may soon confront bankruptcy judges and practitioners.

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What is a PACE Loan?

PACE financing “allow[s] participants to finance energy efficiency and renewable energy projects through property assessments that last the functional life of a project, typically five to 20 years.”[4] A PACE loan typically involves a three-party financing agreement among the property owner, municipality (where the state legislature has authorized the program) and PACE lender. The property owner can borrow up to 100 percent of the project’s cost to fund the approved energy-saving improvements, but the total loan amount is generally determined by the “tax capacity” of a property and not by traditional loan underwriting.[5] The U.S. Department of Energy recommends that PACE lenders confirm that the estimated value of the real estate be “in excess of [the] property owner’s public and private debt on the property, including the addition of the new PACE assessment.”[6]

PACE debt results in a special assessment on the real estate and is repaid annually in conjunction with the owner’s payment of real estate taxes. The yearly tax bill contains the annual PACE loan repayment amount as a special assessment, and the municipality then remits funds collected to the PACE lender. If a PACE borrower fails to pay the special assessment, the lender can foreclose the assessment much like a municipality would for unpaid real estate taxes. The PACE loan is typically non-recourse to the borrower.[7]

The use of special assessments as the mechanism for repaying PACE loans bestows a senior priority lien status on the PACE loan over existing mortgages. Depending on the enabling statute in the borrower’s home state, lender consent can be a hurdle to PACE financing; residential PACE loan programs typically require lender consent before the loan is made.

Another hurdle is the U.S. Department of Housing and Urban Development’s (HUD) recent issuance of Mortgage Letter 2017-18 (dated Dec. 7, 2017), reversing HUD’s policy under the prior administration of insuring mortgages secured by single-family 1-4 unit properties encumbered with PACE obligations.[8] Now, properties encumbered with PACE liens "will no longer be eligible for [Federal Housing Administration]-insured forward mortgages."[9] This might negatively impact residential mortgage lender consent to priming PACE liens.

Recent Court Rulings Related to PACE Loans

As of December 2017, there are no reported bankruptcy court decisions dealing with PACE loans. Most reported decisions relating to PACE primarily involve actions by municipalities against the federal government regarding investment by Fannie Mae and Freddie Mac in mortgage loans as to properties subject to PACE.[10]

One of the few cases to address the super-priority lien status of PACE loans is Florida Bankers Ass'n v. Florida Development Finance Corp.[11] The Florida Bankers Association (FBA) and a local homeowner (Robert Reynolds) appealed the circuit court's judgment validating bonds to be issued by the Florida Development Finance Corp. (FDFC).[12] The bonds "finance[d] the retrofitting of existing improved properties with qualifying improvements for energy conservation, renewable energy and hurricane protection."[13] Consistent with PACE programs nationwide, the Florida program requires property owners to "enter into voluntary financing agreements to provide for repayment of the cost of the improvements by way of voluntary non-ad valorem assessments imposed upon the [benefited] property."[14]

The appellant, the FBA, did not appear in circuit court but appealed on the grounds that the Florida PACE Act was an "unconstitutional impairment of contracts."[15] The appellate court accepted the FDFC's, as appellee, argument that the FBA lacked standing to bring the appeal and therefore did not address the substantive issue of assessment priority that was raised by the FBA.[16]

However, the concurrence took up the FBA's cause and questioned the priority over existing mortgages that was afforded to "essentially home improvement loans" by the use of special assessments.[17] Noting that the priming priority of PACE loans presented "significant ramifications," the concurrence concluded that the program was "troublesome" and posed "significant constitutional concerns."[18]

In a consolidated action pending in the Central District of California, Hon. Andre Birotte, Jr. confirmed the nonrecourse nature of PACE loans under California law because "PACE assessments are obligations imposed on the property" and a PACE loan therefore "does not constitute a personal debt owed by a consumer."[19] In addition, Judge Birotte held that PACE loans are not subject to the Truth In Lending Act (TILA) or Home Ownership and Equity Protection Act (HOEPA) because the Consumer Financial Protection Bureau's "official staff interpretations of TILA expressly exclude 'tax liens' and 'tax assessments' from the definition of consumer 'credit.'"[20]

PACE Debt Will Give Rise to a "Claim" in Bankruptcy, but § 505 May Limit the Court's Authority

Notwithstanding the non-recourse characteristic of a PACE loan, PACE lenders have a claim in a borrower's bankruptcy under 11 U.S.C. §§ 101(5) and 102(2) because a non-recourse obligation is a "claim" for purposes of § 101(5).[21] A non-recourse tax lien constitutes a "claim" because it is "a right to payment, or alternatively, a right to an equitable remedy" against property of the estate.[22] PACE liens are akin to tax liens because the installments are added to the tax roll as "non-ad valorem assessments imposed upon the [benefited] property."[23] The mortgage lender with a prepetition arrearage claim being paid through a chapter 13 plan would likely object to a debtor's proposal to pay anything more to the PACE lender than the amount of the delinquent pre-petition assessment.

The distinction between a special assessment and a real estate tax is of particular relevance in bankruptcy. A bankruptcy court has the jurisdiction to "determine the amount or legality of any tax" under 11 U.S.C. § 505(a)(1), but special assessments are not taxes. Section 505 limits the bankruptcy court's authority to determine non-tax governmental obligations in some contexts, so a dispute over a PACE assessment might test the court's authority under § 505.24 However, a proceeding to determine the "validity, extent, or priority" of a PACE lien is a "core proceeding" under 28 U.S.C. § 157(2)(K) and is therefore subject to the bankruptcy court's jurisdiction.[25] In such cases, the bankruptcy court will look to the authorizing PACE statute in the state where the real estate is located in order to adjudicate any disputes.[26]

Can a Debtor Strip a PACE Lien Under § 1322(b)(2)?

Residential PACE loans implicate the anti-modification provision of § 1322(b)(2), which prohibits the modification of a claim "secured only by a security interest in real property that is the debtor's principal residence."[27] The typical

PACE loan involves an agreement among the borrower, PACE lender and municipality (as the taxing authority), which will likely have the characteristics of a "security agreement"[28] creating a "security interest"[29] in favor of the PACE lender. Although the characteristics of PACE loan agreements will vary from state to state, the PACE lender should be entitled to the anti-modification protections of § 1322(b)(2).

LaMont elucidates the importance of creating a security interest in the debtor's residence through a security agreement for a PACE lender to avoid modification under § 1322(b)(2). In LaMont, a non-recourse tax lien certificate against the debtor's homestead issued under Illinois law was not created by a security agreement and therefore did not give rise to a security interest in favor of the creditor holding the certificate.[30] As a result, § 1322(b)(2) did not curtail the debtor's ability to modify the obligation.[31]

As the PACE lien gives rise to a special assessment, it should have priority over other lien interests such as mortgages. This should preclude the debtor's use of the valuation mechanism under § 506(a) to modify the PACE lender's claim.[32]

Conclusion

Since 2010, residential PACE programs have resulted in $4.3 billion in financing, 170,000 home upgrades and 35,000 jobs created.33 Proponents of residential PACE financing rightfully tout the energy savings, positive environmental impact and unique loan structure to homeowners.

Outcomes for PACE lenders and homeowners are uncertain if the homeowner files for bankruptcy with unpaid special PACE assessments owed at the time of the filing, and courts and practitioners will likely see novel issues as PACE loans begin to surface in bankruptcy cases. These could include the constitutionality of PACE assessment priority where the lender's consent was not required or obtained, the extent of the lien priority over preexisting mortgage debt, and the modification of PACE loans under § 1322(b)(2). Stay tuned.

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[1] See "PACE Programs Near You," PACENation, available at pacenation.us/pace-programs (unless otherwise specified, all links in this article were last visited on Dec. 28, 2017).

[2] The scope of this article is limited to residential PACE loans, sometimes referred to as "R-PACE."

[3] Kirsten Grind, "More Borrowers Are Defaulting on Their 'Green' PACE Loans," Wall St. J. (Aug. 15, 2017), available at wsj.com/articles/more-borrowers-are-defaulting-on-theirgreen-pace-loans-1502789401.

[4] Sijia Qui and Jocelyn Durkay, "PACE Financing," Nat'l Conference of State Legislatures (Jan. 26, 2016), available at ncsl.org/research/energy/pace-financing.aspx.

[5]. Id.

[6] U.S. Dep't of Energy, "Best Practice Guidelines for Residential PACE Financing Programs" 7 (Nov. 18, 2016).

[7] See In re Hero Loan Litig., No. CV 16-08943-AB), 2017 WL 3038250, at *3 (C.D. Cal. July 17, 2017).

[8] 8 U.S. Dep't of Hous. and Urban Dev., Mortgage Letter 2017-18: Subject Property Assessed Clean Energy (PACE), 2017 WL 6325751 (Dec. 7, 2017).

[9] Id at *2.

[10] In the Northern District of California, Magistrate Judge Laurel Beeler issued two orders that discuss PACE, but those orders memorialize the court's procedural rulings on motions to dismiss and do not get to issues of enforceability that could be relevant in a bankruptcy context. See Smith v. Ygrene Energy Fund Inc., No. 17-CV-01258-LB, 2017 WL 3168519 (N.D. Cal. July 26, 2017); Wooley v. Ygrene Energy Fund Inc., No. 17-CV-01258-LB, 2017 WL 5068573 (N.D. Cal. Nov. 4, 2017).

[11] Fla. Bankers Ass'n v. Fla. Dev. Finance Corp., 176 So. 3d 1258 (Fla. 2015).

[12] Id at 1261.

[13] Id.

[14] Id.

[15] Id.

[16] Id. at 1261-62 ("FBA has never shown that it is a citizen, taxpayer or property owner in any jurisdiction where the FDFC bonds will support PACE improvements.").

[17] Id at 1271.

[18] Id 1t 1271-72.

[19] In re Hero Loan Litig., No. CV 16-08943-AB), 2017 WL 3038250, at *3 (C.D. Cal. July 17, 2017)

[20] Id.

[21] See Johnson v. Home State Bank, 501 U.S. 78, 86-87 (1981) ("However, insofar as Congress did not expressly limit § 102(2) to nonrecourse loans but rather chose general language broad enough to encompass such obligations, we understand Congress's intent to be that § 102(2) extend to all interests having the relevant attributes of non-recourse obligations regardless of how these interests come into existence.").

[22] See, e.g., In re LaMont, 740 F.3d 397, 409 (7th Cir. 2014).

[23] 3 Fla. Bankers Ass'n, 176 So. 3d at 1261.

[24] See In re Olde Fla. Invs. Ltd., 293 B.R. 531, 542 (Bankr. M.D. Fla. 2003)

[25] See Id at 543.

[26] Property interests are "created and defined by state law." Butner v. U.S., 440 U.S. 48, 55 (1979).

[27] 11 U.S.C. § 1322(b)(2).

[28] "The term 'security agreement' means agreement that creates or provides for a security interest." 11 U.S.C. § 101(50)

[29] "The term 'security interest' means [a] lien created by an agreement." 11 U.S.C. § 101(51)

[30] See In re LaMont, 740 F.3d 397, 409 (7th Cir. 2014). There was no question in the case as to whether the claim was secured.

[31] Id.

[32] See, e.g., In re McDonald, 205 F.3d 606 (3d Cir. 2000)

[33] "PACE Market Data: Residential PACE," PACENation, available at pacenation.us/pace-marketdata#residential.