MARY JO LANZAFAME
ASSISTANT CITY ATTORNEY
TIMOTHY J. FITZPATRICK
DEPUTY CITY ATTORNEY
FREDERICK M. ORTLIEB
DEUTY CITY ATTORNEY

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

Jan I. Goldsmith
CITY ATTORNEY

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

May 4, 2010

REPORT TO THE HONORABLE MAYOR
AND CITY COUNCIL

SAN DIEGO CLEAN GENERATION PROGRAM

INTRODUCTION

This Report reviews material legal issues relating to the San Diego Clean Generation Program (Program). The Program is based on the concept of a "Property Assessed Clean Energy" (PACE) special tax district financing. The legal concepts upon which PACE programs are based are relatively new and untested legally. As a consequence, a number of sometimes novel legal issues are presented by such programs that are summarized herein.

On April 27, 2010, the City Council voted to approve the Resolution establishing the district, approved the Resolution determining the necessity to incur bonded indebtedness and approved the Ordinance levying special taxes. On May 4, 2010, the City Council will consider the Administrative Services Agreement with Renewable Funding, LLC (Agreement) which describes the compensation paid to Renewable and the services it will provide to the Program. Most importantly, the Program financing documents are tentatively scheduled to be brought before City Council on June 14, 2010.

This Report provides the City Council with an analysis of the legal issues in connection with the Program.

DISCUSSION

I. THE LEGAL FOUNDATION OF THE PROPERTY ASSESSED CLEAN ENERGY (PACE) PROGRAM CONCEPT IS UNTESTED LEGALLY

PACE programs are a very new concept and their legal foundation is generally untested. The essential premises of a PACE program are: (1) the debt for the efficiency or renewable energy improvements attaches to a property and is secured by a special tax lien, and (2) the taxes are presumed to have priority over other debt such as a secured mortgage. This presumption of priority is the *sine qua non* of the PACE programs. Without the benefit of this presumption, the PACE concept lacks a strong and tested legal foundation to support the priority of the special tax lien.

Therefore, as the proposed issuer of bonds, the City may be in a less secure position than it would under a traditional Mello-Roos scenario. These legal risks result from the fact that there

is no legal authority known to this Office that holds that renewable and energy efficiency special taxes incurred voluntarily and individually by a property owner do indeed take priority over secured mortgages.

A number of states have enacted legislation to enable this type of lien priority, but these statutes have not yet been validated by a court. California has enabled PACE through AB 811 (California Streets and Highways Code sections 5890.10 et seq.). However, AB 811 has not been judicially tested. Moreover, and more importantly, the currently proposed Program is not founded upon a specific PACE statute like AB 811.

Instead, the Program is based upon the City's powers under the Charter, to establish special tax districts. San Diego Charter section 76.1. While the Program has been designed to have senior lien status, an equally strong argument exists that a court may not uphold the lien priority. In addition, the proposed PACE special taxes are fundamentally different from traditional public finance districts where lien priority has been firmly established in the law.

Therefore, neither this Office nor Special District Counsel Stradling Yocca Carlson and Rauth can opine that special taxes such as these have priority over prior recorded secured interests such as a first mortgage. Moreover, this Office is not aware of any law firm that has issued such an unqualified opinion in connection with a PACE program.

To reduce its risks, the City could file a validation action to establish the seniority of the liens and the validity of the assessments. Alternatively, or in addition to, the City could require that all participants provide the express written consent of existing lenders to the subordination of their mortgages to the PACE program. Renewable Funding LLC (Renewable) has objected to this provision.

II. OPPOSITION EXISTS IN THE MORTGAGE AND FINANCIAL INDUSTRY ALLEGING THAT PACE PROGRAMS ARE UNCONSTITUTIONAL

PACE Programs appear to be legally controversial based on articles in the press as described herein. Opposition to PACE programs has been expressed by mortgage industry participants, particularly from Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac. This opposition was noted in the attached Wall Street Journal (Journal) article dated March 25, 2010 (Exhibit A). The Journal article quotes a former senior counsel for Federal Finance Housing Authority (which manages Fannie Mae and Freddie Mac) who opined that the PACE program phenomena has " . . . got all the right economics to take off in a huge way and then cause huge losses. When you are able to market to people who can't get financing for an ordinary home equity loan that should set off alarm bells."

Similarly, the attached February 18, 2010 whitepaper legal analysis (Whitepaper) (Exhibit B) by Michael Swartz, whose firm represents institutional investors, alleges that PACE programs violate the U.S. Constitution because they impair contracts (existing mortgages). This analysis also alleges that PACE programs violate California Constitution Article XIII D

(Proposition 218) and predicts that PACE programs will ultimately be held to be unconstitutional.

In conclusion, PACE programs could face legal challenges under the United States and California Constitutions. If the City starts a PACE program and issues bonds, constitutional challenges to the City's right to priority in a foreclosure situation could arise. If the challenges are successful, the City may have exposure on any issued bonds without the legal ability to collect the special taxes.

To reduce its risks, the City could file validation actions and obtain written consent from all the lenders before the improvements are contracted for. Additionally, the City could appropriately qualify, with assumptions and limitations, any representations regarding the lien status in all legal documents and review the risk profile of the Program and the future issuance of the bonds.

III. INDEMNIFICATION PROVISIONS OF THE AGREEMENT GIVE THE CITY ONLY LIMITED PROTECTION AND SHIFT MATERIAL RISKS TO CITY

Under the draft Agreement, Renewable is obligated to defend and indemnify the City against claims arising from the negligence of Renewable only. While the Agreement requires that Renewable's subcontractors include provisions in their respective subcontractor agreements to indemnify and hold the City harmless, there is no guaranty the subcontractors will include the indemnification clauses in their agreements since the City has no control over the subcontractors.

The indemnification from Renewable to the City is only as good as the financial resources of Renewable and the insurance it is to provide. However, to date, City staff has not required Renewable to submit its financial statements or other evidence of its financial condition to assist staff in evaluating their financial ability to perform under the indemnification provisions.

The current indemnification provisions leave the City exposed to paying for the defense and possibly the costs and expenses for any claims and losses that arise from the Program, except from the negligence of Renewable. The list of possible plaintiffs is long and includes contractors, homeowners, mortgage holders, GSEs and bondholders.

The indemnification clauses in the subcontractor agreements and the Program Terms (see Section X below) could be overcome by claimants contending they are unenforceable as contrary to public policy. Additionally, the waiver clauses do not protect the City from claims of third parties who do not execute them. A much higher degree of protection for the City would exist if Renewable had an absolute duty to defend and indemnify the City for *any* claims arising from the Program. However, in light of the dearth of financial information, Renewable may not have the financial resources to make good on the limited indemnification they have provided.

The potential exposure to the City is further evidenced by Renewable's lobbying efforts for a bill that would prohibit GSEs and lenders from taking adverse action on property owners

that use the PACE mechanism or communities that have enabled PACE programs. *See* Whitepaper at page 7.

To reduce its risks, the City could negotiate for more expansive indemnification provisions and insurance requirements from Renewable and its subcontractors and review the financial condition of Renewable to determine their ability to fund indemnification claims. The City also could require that the contractors have minimum levels of insurance to cover potential claims against them. This is because claims from the homeowners against the contractors are the most likely source of complaints and potential litigation.

IV. HOMEOWNERS WILL SIGN CONTRACTS FOR IMPROVEMENTS BASED ON "PRE-APPROVAL" FROM RENEWABLE BEFORE THE FINANCING IS CLOSED

Participants seeking to participate in the Program will be "pre-approved" by Renewable and then enter into an installation contract and have the improvements installed before the financing is closed and *before* any lien is recorded.

This sequence potentially exposes the City to claims from contractors or homeowners if Renewable cannot provide the financing to the homeowner. To date, Renewable has not posted security to protect the City.

Under the draft Agreement, if the financing is not closed by Renewable, the homeowner will have already had the improvements installed pursuant to a signed contract, with an installer, with no confirmed source of funding to pay for the improvements. The risk to the City increases in that Renewable has not posted any security for the up-front reliance by homeowners on the "pre-approval" by Renewable to contract for improvements. Thus, the City could face claims from either the homeowners and/or installation contractors as the lender and deep pocket. See Section V below.

To reduce the City's risks, Renewable should post adequate security to legally secure the obligation of Renewable to provide the financing to the homeowners for their improvements after Renewable has "pre-approved" their application.

V. COMPLIANCE WITH CONSUMER PROTECTION, REAL ESTATE AND RELATED LAWS.

As the Program administrator, Renewable would be responsible for compliance with applicable federal and state consumer protection, real estate, finance and related laws. The applicable federal and state laws may include the following: Truth-In-Lending Act (Act) at 15 U.S.C. §§ 1601 et seq. and its companion Regulation Z at 12 C.F.R. Part 226; Real Estate Settlement Procedures Act (RESPA) at 12 C.F.R. §§ 2601 et seq.; California Consumer Remedies Act at California Civil Code sections 1780 et seq.; and Rosenthal Fair Debt Collection Practices Act at California Civil Code sections 1788 et seq.

The Act may apply to Renewable since Renewable could be considered both the "creditor" and loan originator under the Act. In fact, Renewable intends to require that each homeowner sign Truth-In-Lending Act forms specifically selected by Renewable for the homeowners. Renewable will present these forms to each homeowner for signature and Renewable will describe the meaning and content of the forms as part of the application process. These forms include the Truth-In-Lending Act Disclosure Statement; HUD - 1 Statement; Good Faith Estimates of Closing Costs and Notices of Right of Rescission.

The Act also applies to any individual or business that offers or extends consumer credit if four conditions are met: (1) the credit is offered to consumers; (2) credit is offered on a regular basis; (3) the credit is subject to a finance charge or must be paid in more than four installments according to a written agreement; and (4) the credit is primarily for personal, family or household purposes. Regulation Z at 12 C.F.R. § 226.1(c).

Under section 103(e) and (f) of the Act, the term "creditor" includes a person or entity who regularly extends, in connection with loans, sales of property, services or otherwise, the right to defer payment of a debt in more than four installments, and to whom the debt arising from the consumer credit transaction is payable. The "creditor" is responsible for compliance with the Act regardless of whether the consumer was harmed by the transaction.

In the present case, Renewable intends to offer credit to consumers on a regular basis to finance the cost of their improvements and then advance the money to the homeowner to pay for such improvements. The credit to the homeowner is subject to a finance charge in more than four installments and the credit is primarily for personal, family or household purposes.

Renewable has declined to provide either representations and warranties that it will in fact comply with such laws. In addition, Renewable has suggested the City is responsible for compliance with such laws. Given Renewable's assertion of the City's responsibility, the City is exposed to a wide range of potential legal risks as discussed below. Renewable argues that their lawyers have reviewed the issues with the Act and related laws and have concluded that they are not required to comply with the Act or related consumer protection or real estate laws, but are doing it as a best practice. These facts alone appear to be a compelling reason to require that Renewable provide the appropriate representations and warranties. Even if the Act does not otherwise apply, if homeowners actually sign Truth-In-Lending Act forms there is a reasonable chance that in the event of litigation, a court may hold that the parties have availed themselves of the Act or portions thereof, and therefore its provisions apply.

As such, under the broad definition of "creditor," the homeowners could allege that the City, as the lien holder, is the "creditor" under the Act and therefore responsible for compliance with the Act or related laws.

If Renewable does not comply with the above described laws, the City could incur the following:

1. Criminal liability under section112 of the Act, for failing *to provide information which is required to be disclosed under the Act* or otherwise failing to comply with the requirements of the Act. As discussed above, the City could be liable if the City were deemed to be the "creditor," and therefore responsible for compliance with the Act.

2. As a special purpose limited liability company and since the City has not reviewed Renewable's financial statements and does not know their financial resources, Renewable may not have enough money to pay fines or penalties or to settle litigation in connection with potential alleged violations described above. Similarly, Renewable could declare Bankruptcy if faced with litigation. In these instances, the homeowners could sue the City as the "deep pocket" and assert that the City, as the creditor, is also liable. If litigation were initiated, a court may find the City liable under one or both of two theories. Plaintiffs could recover actual damages, attorney's fees, court costs, and statutory damages.

    a. As the Program sponsor, a court may find that the City had an obligation to act reasonably and impose reasonable requirements including compliance with applicable laws.

    b. A court could impose liability on the City under the theory that as the issuer of the bonds, the City is ultimately responsible for all aspects of the Program, including reasonable measures to implement the Program and bond issuance.

To reduce the City's risks, the Agreement should include maximum representations and warranties.

VI. COMPLIANCE WITH CALIFORNIA CONTRACTORS LICENSING LAWS

All contractors who perform the solar energy or related installation services for the homeowners of the program must be licensed contractors under the appropriate category with the California Contractors State License Board (CCSLB) under California Business & Professions Code (B&P Code) sections 7000 et seq.

However, Renewable will only use contractors approved by them and on its list of qualified contractors. The current language in the Agreement is vague as to who is responsible for ensuring compliance with the CCSLB licensing requirements and when. The Agreement does not have a requirement that Renewable must verify the contractors bonds for each approved contractor.

A failure to comply with the CCSLB license requirements could subject Renewable (and the contractor) to criminal misdemeanor penalties under B&P Code section 7027 if it advertises

for construction work for non-licensed persons through its "qualified contractor" list. If a non-licensed contractor is used, the homeowner can sue to recover all compensation paid to the contractor under B&P Code section 7031.

If non-licensed contractors are used and litigation is filed against Renewable under B&P Code sections 7027 or 7031, Renewable may not have enough money to pay fines or penalties or to settle litigation. Renewable may also declare Bankruptcy. If Renewable had inadequate financial resources, the City may be named as a "deep pocket" by a plaintiff looking for financial recovery. If the City were sued, a court could impose liability on the City as either the Program sponsor or as the issuer of the bonds. *See* Section V above.

To reduce the City's risks, the Agreement should clearly state that Renewable is responsible for ensuring that all contractors have appropriate licenses with the CCSLB before Renewable approves the contractor to participate in the program. The Agreement should also state that Renewable shall verify that each contractor has current and valid contractors bonds before they approve them as qualified contractors.

VII. CALIFORNIA REAL ESTATE BROKER LICENSING COMPLIANCE.

While Renewable has provided a representation and warranty they will obtain all licenses required, they have specifically stated that they will not obtain a real estate broker license. In response to questions by this Office as to the basis for their position, Renewable has declined to explain such basis.

This Office suggests that, pursuant to B&P Code section 10131, Renewable should be required to possess a California real estate broker's license to receive compensation for providing services for borrowers or lenders in connection with loans secured by real property.

Section 10131 of the B&P Code states that a real estate broker is any person who, for compensation, does or negotiates to do, one or more of the following acts for another:

> (d) Solicits borrowers or lenders for or . . . or performs services for borrowers or lenders or . . . in connection with loans secured directly or collaterally by liens on real property . . .

As discussed previously, if the City were sued, a court could impose liability on City as either the Program sponsor or as the issuer of the bonds. *See* Section V above. Therefore, civil and criminal penalties could apply to the City (and Renewable) for violation of the real estate licensing provisions under B&P Code sections 10130 et seq. It is a misdemeanor under B&P Code section10138, punishable by a fine not exceeding $1000, for any person (including Renewable or the City) to pay or deliver to anyone any compensation for performing any acts within the referenced chapter of the B&P Code, who is not known to be and does not present evidence that they are a licensed real estate broker at the time the compensation is earned.

Under B&P Code section10139, any person acting as a real estate broker or salesperson without a license or who advertises without being licensed (this could include Renewable) is

guilty of a public offense punishable by a fine not exceeding $20,000 or by imprisonment in county jail for a term not exceeding six months, or by both fine and imprisonment.

To reduce the risk to the City, Renewable should provide a reasonable response explaining why it believes the real estate broker licensing requirements do not apply so that City staff can further evaluate this issue. Alternatively, the City should require Renewable to obtain a real estate broker license.

VIII. CONTRACTORS NOT REQUIRED TO HAVE INSURANCE

Renewable does not require that the contractors they use will have any insurance. The benefits, however, of requiring such liability insurance could be substantial for the Program, Renewable and the City. To date, Renewable has declined to verify in the Agreement that all participating contractors on its list of qualified contractors have a minimum level of commercial general liability insurance. This is a common and standard industry practice.

If the contractors have insurance, certain homeowner claims related to their improvement work may be covered by insurance without the necessity of litigation. Also, if necessary, the homeowners could proceed against the contractors' insurance policies.

Renewable argues that this insurance requirement would entangle the City and Renewable with the contractors and the homeowners and increase liability for the City and Renewable. In fact, this Office suggests that the opposite is true and that the potential liability could actually decrease for the City (and Renewable) since the insurance may be able to cover the majority of claims from homeowners. Since homeowners may only use contractors approved by Renewable and Renewable (or its principle subcontractor, CCSE) undertakes a quality control review of the contractors work, requiring insurance should not entangle them or the City in liability issues in any material way.

In conclusion, if the improvements fail or the contractor fails to properly perform, the homeowners would not have the option to file claims against the contractors' insurance policies. Therefore, the lack of insurance could expose the City to liability as the only "deep pocket."

To reduce risk to the City, the Agreement should include an obligation that Renewable require a minimum level of commercial liability insurance for each contractor.

IX. RESPONSIBILITIES OF RENEWABLE ARE NOT CLEARLY DEFINED IN THE AGREEMENT AND MAY NOT BE ENFORCEABLE

The Agreement at Section 6 specifies in great detail the compensation of Renewable for providing its services to the Program. However, the Agreement does not clearly describe the precise responsibilities, services, performance requirements and/or milestones that Renewable will provide to earn its compensation. Rather than include the description of the responsibilities of Renewable in the body of the Agreement, the only description of the responsibilities of Renewable in the Agreement are an attachment – Scope of Work for Program Design and Administration, etc.

Unlike other City contracts, the description of the responsibilities of Renewable in the Scope of Work is vague, ambiguous and inadequate to legally enforce performance by Renewable (or its principal subcontractor, CCSE). In addition, the responsibilities of CCSE and any other subcontractors Renewable may choose have the same related issues, ambiguities and inadequacies regarding specific performance.

For example, the services that Renewable provides for a critically important and complex service that involves complicated federal laws and documents, namely "Loan Origination and Closing" are described in one very brief and vague sentence in the Scope of Work. The "Loan Origination and Closing" services involve complex Truth-In-Lending Disclosure Statements, Rights of Rescission and other documents under the federal Truth-In-Lending Act. However, neither the Agreement nor the Scope of Work discuss these documents, why the homeowners must sign them, or what each of them means.

Moreover, the entire description of its responsibilities for another important process, "Application Processing," is described in one brief, vague, and ambiguous sentence. The same is true for a description of the responsibilities of Renewable for "Customer Service" and "Contractor Qualification."

As such, Renewable could successfully argue that it has very little, if any responsibilities in administering the Program, to earn its compensation. Also, the ambiguities of the Agreement give both Renewable and CCSE the ability to avoid a host of responsibilities and argue that any disputed responsibilities are the City's responsibilities. To reduce risk to the City, the responsibilities of Renewal should be explicitly detailed in the Scope of the Work.

X. PROGRAM TERMS ARE NOT PART OF THE AGREEMENT AND MAY NOT BE ENFORCEABLE AGAINST RENEWABLE

Renewable has proposed draft Program Terms and Conditions (Program Terms) that are intended to spell out in more detail the responsibilities of Renewable and summarize how the Program works and is administered.

As proposed, the Program Terms constitute a deliverable under the Agreement rather than provisions of the Agreement itself. The Program Terms contain important features, such as the eligibility requirements for the Program. Eligibility terms, for example, might include a requirement that the participant property owners have a minimum amount of equity in their homes. However, the Program Terms, as currently proposed, contain no minimum equity requirements. This presents legal risks because owners who have zero or even negative equity can qualify for the program. This is reminiscent of the factors that led to the sub-prime mortgage market collapse.

To reduce the City's risks, the Program Terms should be fully negotiated and be part of the Agreement and therefore binding on Renewable. They shall also spell out in detail the roles and responsibilities and performance milestone of Renewable, CCSE and any other subcontractors selected by Renewable in administering the program. Failure to incorporate the

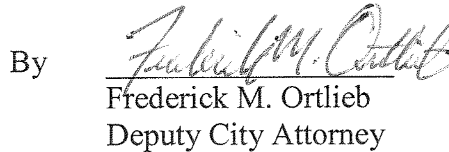
actual Program Terms in the Agreement will leave the City unable to legally impose these obligations on Renewable.

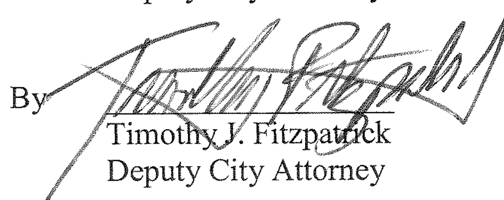
CONCLUSION

Given the untested and evolving legal aspect of the financing mechanism of this Program, this Report provides an evaluation of the risks for the City Council to consider during its deliberation of the various components of the Program.

Sincerely yours,

JAN I. GOLDSMITH, City Attorney

By 
Frederick M. Ortlieb
Deputy City Attorney

By 
Timothy J. Fitzpatrick
Deputy City Attorney

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Exhibits
cc: Andrea Tevlin, Independent Budget Analyst
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EXHIBIT A

EXHIBIT A

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Fannie and Freddie Resist Loans for Energy Efficiency

By NICK TIMIRAOS

The government's mortgage-finance agencies Fannie Mae and Freddie Mac are resisting a White House-backed effort to make it easier for homeowners to get loans to make their houses more energy efficient.

The problem: deciding who gets paid first if the borrower defaults.

Under the program, homeowners would borrow money from their local government to pay for energy improvements—from high-efficiency furnaces that cost a few thousand dollars, to solar-panel systems that can cost more than $30,000. They would then repay the loan over 15 to 20 years through a special assessment added to their property-tax bills. Local governments would get the funding by selling municipal bonds to investors.

This debt would be senior to existing mortgage debt, so if the homeowner defaults or goes into foreclosure, it would be repaid before the mortgage lender gets any money. While property-tax assessments are usually senior to existing property debt, cities have traditionally used their assessment authority for community-wide improvements like sewers and roads—not for upgrades that homeowners elect to make on their own homes.

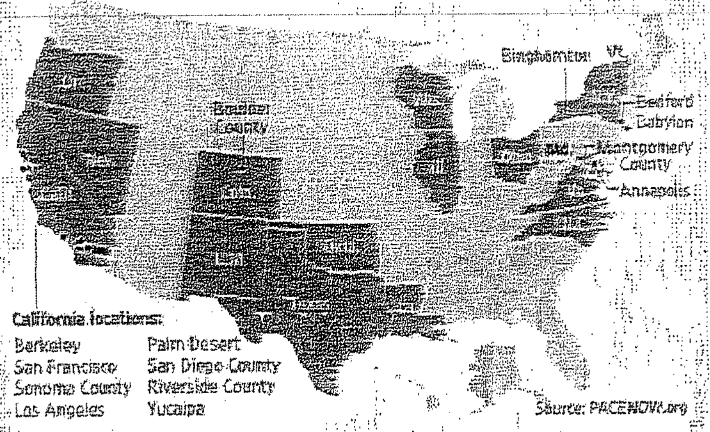
Proponents of the program, called Property Assessed Clean Energy, or PACE, say it is necessary for the loans to be paid before mortgages if local governments are to raise funds for the program from municipal-bond investors.

Backers also say the programs offer a novel financing mechanism to address the high upfront costs that so far have limited the widespread adoption of practical energy-saving improvements.

But the regulator of Fannie Mae and Freddie Mac—which guarantee half of the nation's $11 trillion in mortgages—has raised concerns in meetings about the program with federal and state officials. Alfred Pollard, general counsel for the mortgage companies' regulator, the Federal Housing Finance Agency, said he was worried about the problems that a first-lien, or first-in-line, loan could create. "The goal of enhancing energy efficiency, which we share, should not overcome the need for prudent underwriting," he said.

Fannie and Freddie aren't allowed to speak out on public policy, and the companies declined to comment for this article. PACE advocates have lobbied for a measure barring Fannie and Freddie from taking any adverse action over the next two years on communities participating in PACE.

Critics of the program say that Fannie and Freddie, or mortgage lenders themselves, could raise rates in such communities to cover the risk that a PACE loan will displace payments to the mortgage holder. Cities could



also face legal challenges, they say. The state of Maine is considering making energy loans junior to existing debt in legislation that would establish its PACE program.

"The fundamental problem is that there isn't a free lunch but there often appears to be," said William K. Black, a professor of economics and law at the University of Missouri-Kansas City.

Sixteen states have passed legislation that would allow municipalities to establish PACE programs, including Texas, Virginia, California and Colorado. San Francisco, Los Angeles and San Diego are set to launch pilot programs this year, joining Berkeley, Calif., and Boulder County, Colo., which last year financed $10 million of improvements for 600 homeowners.

Advocates say the programs could fund $1 billion in projects in California.

Local governments establish their own rules for eligibility, although a White House task force has issued guidelines.

PACE critics say homeowners, prodded by contractors, could pile on more debt at a time when home values are falling. They also say cities aren't equipped to underwrite loans.

"It's got all the right economics to take off in a huge way and then cause huge losses," said David Felt, a retired senior FHFA lawyer. "When you're able to market to people who can't get financing for an ordinary home-equity loan, that should set off alarm bells."

PACE supporters say the programs will attract responsible homeowners and those who have equity in their homes or are mortgage-free. Cities are also being instructed by the task force on PACE loans to promote high-yield investments that lower energy costs and offset higher payments.

"The nature of the investment is such that it is typically going to lead to cautious investments, not granite countertops or vacations," said Will Toor, a Boulder County commissioner.

Unlike home-equity loans, which allow homeowners to take money out of the home and spend it on things that don't improve property value, PACE loans are targeted narrowly on improvements that should add value to homes and create energy savings.

Some new PACE programs are limiting their scope to assuage lenders' concerns. In San Francisco, for example, financing can't exceed 10% of the assessed value of the property, and homes that are worth less than the outstanding mortgage debt aren't eligible. Homeowners must be current on all property debt, and the existing mortgage lenders must sign off on any projects of more than $50,000.

Dwight Jaffee, a professor of finance and real estate at the University of California, Berkeley, said PACE programs could be structured to satisfy lenders' concerns by providing lenders with evidence that improvements reduce energy costs and add value, as lower energy bills offset the costs from the higher tax assessment.

"Presented with this evidence, the bank lenders should say in their own interest, 'Bless you, we're happy to sign off on this,' " Mr. Jaffee said.

Write to Nick Timiraos at nick.timiraos@wsj.com

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EXHIBIT B

EXHIBIT B

A White Paper on PACE Loans: Unconstitutional And Damaging To GSE's Such As Fannie Mae And Freddie Mac

By Michael Swartz, Partner

865 S. Figueroa, Suite 2900
Los Angeles, CA 90017
(213) 694-1200
www.hbdlawyers.com

February 18, 2010

Introduction

This White Paper addresses Constitutional and other flaws in the PACE loan programs that have recently begun to gain favor. PACE programs are currently being implemented by municipalities in California, Colorado and elsewhere. Under these programs, property owners borrow money from municipalities to finance home improvements. The owners repay these loans through voluntary "assessments" on their property tax bills.

Ordinary home improvement loans are given lower lien priority than the pre-existing mortgages through which the owners purchased their property. In the PACE statutes, however, various legislatures have tried to give PACE home improvement loans priority over existing mortgages. This White Paper demonstrates that this attempt to move the existing mortgages out of their priority position is unconstitutional. Indeed, courts have often declared similar programs unconstitutional over the past 85 years.

Not only are these programs unconstitutional, they are poor public policy. For property owners whose homes are worth less than the amount of their mortgages, these programs combine with existing federal and state incentives to give a cash rebate to the property owner at the expense of the federal and state governments and of federally-supported lenders such as Fannie Mae and Freddie Mac. If property owners are seriously "underwater" with mortgage loans far in excess of their homes' value (and unfortunately many find themselves in this distressed circumstance), these programs are an irresistible way to pocket large sums before foreclosure. So, while federally-supported lenders are facing the most difficulty in their history, state legislatures are worsening their problems through PACE programs. As discussed below, this inflicting of injury on the GSE's is not inadvertent.

PACE Loans Are Rapidly Expanding To The Harm of GSE's Such As Fannie Mae And Freddie Mac

"PACE" stands for "Property Assessed Clean Energy." While the name reflects a focus on clean energy retrofits, the programs include much more.

As of January 1, 2010, California expanded its statutory scheme so that municipalities can provide PACE loans for water efficiency and broad energy efficiency improvements as well. So Palm Desert, California now expressly

authorizes borrowers to use PACE loans for swimming pool pumps, skylights and air conditioners. http://www.cityofpalmdesert.org/Index.aspx?page=484
In similar fashion, Boulder County, Colorado offers PACE loans for pool covers, shade trees and fireplace improvements.
http://www.bouldercounty.org/bocc/cslp/measures.pdf
There is no limit to the kinds of home improvements that states and municipalities may decide should be given priority over mortgage lenders, such as Fannie Mae and Freddie Mac.

PACE Programs Violate The U.S. And State Constitutions

PACE programs will likely be declared unlawful when challenged in court. They run afoul of the U.S. Constitutional prohibition against state laws that impair contracts. Additionally, in California where PACE lending is perhaps most active, the programs violate the California Constitution's limits on the power of municipalities to impose property assessments.

Violation of the U.S. Constitution

Article I, Section 10 of the U.S. Constitution provides: "No State shall . . . pass any . . . law impairing the obligation of contracts."

The constitutional prohibition is applicable to laws that injure existing mortgagees and has led courts to invalidate laws similar to the PACE programs. For example, in *Jeffreys v. Point Richmond Canal & Land Co.*, 202 Cal. 290 (1927), California's Supreme Court invalidated a statute that sought to improve an assessment's priority over an existing mortgage.

Except for broadly-applied property taxes, states do not often enact statutes designed to allow municipalities to obtain lien priority over a mortgage that existed prior to the statute. When states have done so, the courts have struck down the attempt. *E.g., Central Savings Bank v. City of New York*, 279 N.Y. 266, 275 (1938); *Davis v. County of McLean*, 52 N.D. 857, 871-75 (1925).

For example, to avoid impairment of mortgage contracts, the Illinois Supreme Court in 1995 determined that a new cemetery trust fund statute could not retroactively create a priority lien to the detriment of a pre-statute mortgage holder. *First of America Bank v. Netsch*, 166 Ill. 2d 165, 184-87 (1995). The Court explained that the statute would otherwise "substantially reduce the value of the cemetery property and, in effect, [would] deprive the Bank of the collateral it obtained under the mortgage contracts."

In *Central Savings Bank*, 279 N.Y. at 266, 275, New York's highest court voided a law that allowed a city to impose a priority lien for expenses it incurred in repairing tenement housing. The Court held that this was an unconstitutional impairment of a pre-existing mortgage. In its analysis, the Court rejected as speculative an argument that the repairs would increase the property's value enough to justify the mortgagee's subordination.

In *Davis*, the North Dakota Supreme Court held that a voluntary contractual lien for the cost of obtaining state-provided hail damage indemnity, even though called a "hail tax," cannot take priority over a pre-statute mortgage. The Court explained at length why it is unlawful for a state to supplant a pre-existing lien through a voluntary arrangement with a property owner.

"To postpone a legal existing lien upon real property to a subsequent lien by a statute enacted subsequently to the attaching of such prior lien is to impair the obligation of a contract. … The legislature could not by an act passed after the plaintiff's mortgage had been executed and become a lien upon the property, confer upon any person who should loan or advance money … to the mortgagor a lien upon such property prior to that of the existing mortgage. Nor can the legislature lawfully give to a county or other public corporation or subdivision of the state any such priority in such a case unless the claim be for a tax, as a tax is known to the law. Neither can the state itself secure any such priority under such circumstances."

"<u>When entering into contract relations with individuals, the state, or a municipal corporation thereof, is to be treated the same as an individual. It cannot call or charge up the amount of a loan as a tax, and by that device confer upon the loan all the qualities of a tax. If it could, and in this manner insert a lien for this pseudo tax ahead of existing liens, the holder of security upon real estate would be at the mercy of the state</u>, despite the supreme law of the land preventing the impairing of the obligations of a contract by any state."

"<u>If the state can make this claim a tax, then there is no limit to its power by definition to confiscate the securities of others</u> … . The loan by the public supplanting the first lien upon real property might be so great as to work a destruction of the lien supplanted. But it is sufficient to condemn a law that it works any impairment, however slight, of the obligations of a contract. To affect a dollar of a prior lien by subsequent legislation is as vicious before the law as to destroy the lien altogether."

In giving lien priority to PACE loans, the states impair the rights of pre-existing mortgage lenders. Accordingly, as the cases discussed above indicate, PACE programs violate the U.S. Constitutional provision barring impairment of contract.

Violation of the California Constitution

PACE programs in California also violate that state's Constitution. Article XIII D of the California Constitution constrains local governments' ability to impose fees, assessments and taxes.

Under Section 3 of Article XIII D, a local government entity may not "assess" "any parcel of property" unless it fits one of four categories: the standard value-based property tax; a special tax approved by a two-thirds vote at an election; assessments meeting certain substantive and procedural requirements established by Section 4 of Article XIII D; or fees for property-related services meeting certain substantive and procedural requirements.

A PACE assessment fits none of these four categories. In particular, it does not comply with the substantive and procedural requirements for assessments under Section 4 of Article XIII D.[1] Under Section 4 of Article XIII D, a lawful assessment requires: a "detailed engineer's report" supporting the assessment; written notice to the property owner of a public hearing and vote of the affected property owners regarding the assessment; and a public hearing not less than 45 days after mailing of the notice. None of these requirements are met by the California PACE programs.

Additionally, under Section 4(f) of Article XIII D, in any legal action contesting the validity of an assessment, "the burden shall be on the agency to demonstrate that . . . the amount of the contested assessment is . . . no greater than . . . the benefits conferred on the property or properties in question." Here, the new California programs do nothing to ensure that the property's value is increased by the amount of the assessment. Even if California's municipalities attempted to meet the Section 4(f) requirements, they would likely fail. With respect to its similar program, Boulder County has acknowledged that there is not yet any evidence indicating a consistent increase in fair market value on account of PACE-

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[1] Section 2 of Article XIII D defines an "assessment" as "any levy or charge upon real property by an agency for a special benefit conferred upon the real property." A voluntary contractual assessment is charged on the owner's property tax bill and is an immediate lien on the property. Cal. Streets & Highways Code § 5898.30.

financed renewable energy/energy efficiency improvements.
http://www.bouldercounty.org/bocc/cslp/FAQ/financing.htm#tax

Rather than attempting to comply with Article XIII D's requirements, the County of Sonoma has baldly asserted that Article XIII D does not apply to any voluntary lien. This argument, however, ignores the fact that Article XIII D has to be given the meaning dictated by its plain language, and its plain language establishes the invalidity of PACE assessments and provides no exception for "voluntariness." *See Silicon Valley Taxpayers' Ass'n v. Santa Clara County Open Space Authority*, 44 Cal. 4th 431, 444 (2008).

Additionally, Sonoma's position ignores the fact that recent California authority establishes that "voluntariness" does not allow a municipality to avoid Article XIII D. In *Pajaro Valley Water Management Agency v. Amrhein*, 150 Cal. App. 4th 1364, 1384-88 (2007), the Court of Appeal held that Article XIII D applied to a groundwater augmentation fee to be charged to well operators even though it was incurred through the voluntary act of pumping groundwater and even though it would be impossible to predict who would actually incur the fee. As *Pajaro Valley* stated, the California Supreme Court recently rejected an argument that the "voluntary" nature of a decision to consume an amount of water made Article XIII D inapplicable. *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205, 216 (2006).

As the analysis above demonstrates, PACE loan programs require assessments that violate Article XIII D of the California Constitution.

The Programs Are Disastrous Public Policy—Particularly For GSE's Such As Fannie Mae And Freddie Mac

These programs are harmful to federally-supported lenders such as Fannie Mae and Freddie Mac, and fiscally dangerous for the municipalities that are implementing them.

As briefly noted above, PACE loans are an irresistible temptation for "underwater" homeowners—a temptation that inflicts significant injury on federally-supported lenders. Let us suppose that someone finds themselves in the unfortunately-not-uncommon position of being substantially behind on payments on a Fannie Mae mortgage that is secured by a home that due to recent market declines is worth less than the mortgage. The home owner has little hope of obtaining any value for

many years through the sale of the home, and Fannie Mae stands to recover less than the amount lent to the homeowner.

Along comes a PACE program to dramatically worsen Fannie Mae's position.

Federal and state laws provide subsidies to homeowners to lower the costs of solar installations. In many jurisdictions, PACE loans can be made on the pre-subsidy amount, greatly inflating the loan amount above the true post-subsidy cost of the solar system. For a typical $36,000 solar system, a homeowner can walk away with $15,000 in cash back from the subsidies, while strapping the home (and potential future homeowners) with the full $36,000 loan amount, including interest over a 15-20 year period.[2]

These financial incentives are irresistible. $15,000 is a substantial amount of money to your average "underwater" homeowner facing foreclosure. Every one of them should therefore want to do a PACE solar installation (even if their home is surrounded by sun-obscuring redwoods), and each time this happens on a Fannie Mae property, it suffers a significant injury. The only way that Fannie Mae is not injured in this scenario is if the home's value is increased by at least the amount of the PACE loan—but the PACE programs do nothing to ensure this.

Injuries to lenders from PACE-type loans are not simply logical, they are a matter of historical experience. As discussed above, in 1925 the North Dakota Supreme Court struck down a similar scheme involving a hail tax. When it did so, the state had to pay more than $100,000 (in 1920's dollars) to mortgage lenders that had been injured by the subordination to the new loans. "North Dakota Hail Insurance, 1911-36", 11 *Journal of Business of the University of Chicago* 277, 296 (1938). A municipality counting on priority for its PACE loans is therefore exposed to the likelihood of significant losses when the Constitution invalidates the program.

As for GSE's like Fannie Mae, PACE municipalities know that a typical mortgage lender would likely object to being subordinated. And many PACE municipalities do not want their local lenders to be injured by PACE programs. So, for example, Sonoma County protects its local lenders by requiring mortgage lender consent for PACE loans on commercial properties, but not on residential properties. Why the distinction? As a different California municipality explained, Sonoma drew this distinction because its local lenders tend to keep many commercial mortgages

[2] Sonoma County did not dispute a finding that all but one homeowner who used PACE solely to finance solar energy is experiencing annual property taxes in excess of electricity savings.

while the substantial majority of residential mortgages are transferred into hands outside Sonoma (*e.g.*, Fannie Mae). http://www.placer.ca.gov/upload/bos/cob/documents/sumarchv/091096A/BOSD_091006_02_p3_p62.pdf. In other words, Sonoma gets the consent of its local lenders, but does not worry about the GSE's.

PACE programs raise other problems. For example, the current credit crisis was caused in part by homeowners borrowing excessively against their homes. Most PACE programs do little or nothing to ensure that a homeowner is not incurring excessive debt. After all, unlike a typical home improvement lender, the PACE municipality is grabbing the first lien position, so it does not care terribly much about overall debt levels. In the current credit crisis, bank underwriting was insufficient in large part because mortgages could be sold to third parties. Under PACE, the priming of existing indebtedness results in losses being incurred by truly external third parties (principally the GSEs), posing an ever greater moral hazard.

Worse yet, present economic difficulties encourage municipalities to embark on PACE programs. In going into the business of making home improvement loans, municipalities can attempt to make rates of return above the returns that they can obtain through the kinds of secure debt instruments in which they can generally invest. With money market investments yielding less than 0.5% per year, municipalities are tempted to follow poor (and risky) public policy by making PACE home improvement loans at 7%.

Summary: PACE Programs Are Unconstitutional And Unwise

PACE Programs are unconstitutional and unwise. In violation of the U.S. (and California) Constitutions, they inflict injury on federally-supported lenders including Fannie Mae and Freddie Mac while encouraging excessive borrowing that a typical home improvement lender would avoid. Congress and the Administration should bar these programs or at the very least provide no further support for these programs.[3] For instance, at least four bills are pending in Congress that would provide these programs credit support, tax exemption, and/or authorize the federal government to buy PACE bonds directly.

[3] Renewable Funding, a company that arranges PACE programs, is lobbying Congress to include in a jobs bill a two-year period during which "the Federal Housing Finance Agency, the GSEs and lenders will be prohibited from taking adverse action on property owners that use the PACE mechanism or communities that have enabled PACE programs."