THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: January 27, 2014 REPORT NO: 14-011

ATTENTION: The Committee on the Environment

SUBJECT: Proposed City Residential PACE (Property Assessed Clean Energy) Programs; Status of Commercial PACE

REFERENCE: The Committee on Natural Resources and Culture (NR&C) Committee of the City Council, City of the City of San Diego - October 10, 2012

REQUESTED ACTIONS:

1. Direct staff to prepare all necessary Council authorizations for the City to enter into an agreement with Ygrene Energy Fund to form and administer a special tax district pursuant to the Mello Roos Act, as amended by SB 555.
2. Direct staff to prepare all necessary Council authorizations to allow the City to participate in the California HERO program as administered by the Western Riverside Council of Governments (WRCOG) joint powers authority.
3. Direct staff to prepare a resolution to allow the California Enterprise Development Authority, as the administrator of the Figtree PACE program, to offer the program to the owners of residential property in the City who have non-conforming loans.

STAFF RECOMMENDATIONS: Approve Requested Actions

SUMMARY:

This report responds to previous Council and NR&C Committee requests to proceed with development of PACE options for the City of San Diego. This section begins with a general description of PACE, followed by a summary of Council and Committee directions provided and the actions taken in response to those directives.

Property Assessed Clean Energy or "PACE" programs allow property owners to finance energy efficiency, water conservation, and renewable energy projects on existing residential and commercial structures through a special tax assessment on the property. PACE financing programs can be set up and administered under either of two different statutory frameworks:

1. The Improvement Act of 1911 (Improvement Act) as amended by AB 811 or
2. The Mello-Roos Act as amended by SB 555.

While both SB 555 and AB 811 PACE programs accomplish the same purpose, several important statutory and structural differences exist between programs that operate under these statutes.

1. The Improvement Act of 1911, as amended by AB 811, allows for the formation of assessment districts to provide for the financing of clean energy improvements on private property. Under AB 811:

   a. Property owners enter into a contractual assessment to finance the cost of energy efficiency, renewable energy and water efficiency improvements to their property. Funds are loaned to the property owner to pay for the improvements.

   b. The loan is secured by a lien on the property and is repaid by an assessment. The assessment is paid at the same time and in the same manner as other property taxes. Assessment liens are superior to most other existing liens on the property, including mortgages.

   c. There is generally little to no cost or administrative burden for cities where the assessment district is formed by a joint powers authority ("JPA") Joining or associating with a JPA also reduces the legal exposure of the city.

   The CaliforniaFIRST, Figtree and HERO programs are all assessment districts formed pursuant to AB 811. CaliforniaFIRST was approved by the City Council in September 2012 for commercial properties and Figtree was approved by the City Council for commercial properties and for residential properties with no mortgage liens in October 2012. The HERO program is not currently authorized to operate in the City.

2. The Mello-Roos Act of 1982, as amended by SB 555, authorizes the formation of Community Facilities Districts ("CFDs") to finance the acquisition, installation and improvement of energy efficiency, water conservation and renewable energy systems on real property. Under SB 555:

   d. The city forms a city-wide CFD consisting entirely of property proposed for annexation into the district. Property owners would then voluntarily annex their property into the CFD under provisions specified in SB 555.

   e. Once a property is annexed into the CFD it becomes subject to a special tax, which is collected in the same manner as other property taxes.

   f. Funds are loaned to the property owner to install energy efficiency and water conservation improvements on the property

   g. The loans are repaid with the special taxes collected and are secured by a special tax lien placed on the property.

   Ygrene Energy Fund, a California based company, is the only known provider of SB 555 PACE programs.

Council/Committee Direction

A. In October 2012, the City Council authorized the City Attorney to retain outside legal counsel to:

1. Prepare the necessary memoranda/opinions to City Council on all legal issues and risks related to the City's proposed SB 555 PACE program.
2. Prepare the legal documents to form a Community Facilities District (CFD).
3. File/prosecute a judicial validation.

Ygrene Energy Fund California ("Ygrene"), the proposed administrator of the CFD, was expected to reimburse the City for all costs associated with forming the CFD and having the CFD validated, however, the City and Ygrene were unable to reach mutually agreeable terms to allow the formation of the CFD to move forward at that time. Ygrene has since implemented the formation of CFDs under SB 555 in other jurisdictions, including the City of Chula Vista, and staff is now recommending that Ygrene be awarded a sole source agreement with the City as the program administrator for the formation of a CFD under SB 555. Under this agreement, Ygrene would still pay for all of the upfront legal costs associated with forming and validating the CFD and would cooperate with City staff and the City Attorney's office throughout this process.

B. At the October 10, 2012 NR&C meeting, the Committee requested a legal analysis of the HERO residential PACE program. Upon completion of the analysis, staff would report back to Council with the actions necessary to join the HERO program.

Both the City Attorney's office and Debt Management Department prepared analyses of the HERO residential PACE program (Attachments 1 & 2). At the time the reports were prepared there was significant concern regarding the implications and outstanding issues with FHFA restrictions on mortgages encumbered by PACE liens and the potential negative impact to homeowners.

While these concerns remain, the HERO program has been successfully implemented in many jurisdictions throughout the state and the program's administrator has indicated that there have been no significant negative impacts to homeowners who have participated in the program. Additionally, Governor Brown has taken action to establish a state-backed PACE loan reserve fund. Under the Governor's proposal, the state-backed fund would repay any PACE loan in the event of a mortgage default. Funding for the reserve would come from either California Alternative Energy & Advanced Transportation Financing or State Proposition 39 funds. The City is not aware of any formal response by FHFA to the proposed state fund.

C. On October 23, 2012, the City Council authorized:

1. The City to join the California/PACE program (now known as Figtree).
2. The California Enterprise Development Authority (CEDA) to accept applications from eligible commercial property owners including multi-family properties, and single family residential property with no mortgage liens.
3. Conduct contractual assessment proceedings, levy contractual assessments and other related actions to PACE applications.

On June 7, 2013, the City entered into an agreement with Figtree and CEDA to establish and administer a PACE program within the boundaries of the City of San Diego. Currently, the Figtree PACE program is limited to commercial properties and to residential properties with no mortgage lien attached. Staff's recommendation would allow the program to be offered to residential property owners where the property has a non-conforming loan, i.e., loans that are not subject to FHFA supervision.

D. At the October 10, 2012 NR&C Committee meeting, staff was directed to provide on an annual basis metrics for CaliforniaFirst and all future PACE programs the City makes available. The metrics will include process, outcome and inclusionary data.

PACE Programs:

Ygrene

Ygrene was selected to administer the first SB 555 district, which was formed by the City of Sacramento. Most recently, both the City of Chula Vista and the Coachella Valley Association of Governments (CVAG) selected Ygrene, through competitive-bid processes, to administer their SB 555 PACE programs.

Staff is recommending that the City enter into a sole source agreement to allow Ygrene to form, validate and administer a citywide SB 555 district in the City of San Diego. If authorized by the City Council, staff would work with Ygrene to prepare all necessary resolutions. Under the formation process established by SB 555, at least two public hearings before the City Council are required. Once formed, no properties would be annexed into the district until it is successfully validated. The City Attorney's office has reviewed the formation documents use to establish the SB 555 district in Chula Vista and believes the procedure is legally sound, subject to judicial validation.

HERO Program (AB 811)

The Western Riverside Council of Governments (WRCOG) launched a residential PACE program in January 2012 known as the "Home Energy Renovation Opportunity" (HERO) program. WRCOG is a Joint Powers Authority (JPA) with 18 member jurisdictions in western Riverside County. HERO is operated by the San Diego based company, Renovate America.

As with all AB 811 programs the California HERO program uses "land-secured" financing, wherein a contractual assessment lien is placed on the property to secure a loan, the proceeds of which are used to pay for the installation of authorized improvements on the property. The loan is repaid over a 5 to 20 year term, depending on the expected useful life of the improvements financed. The assessments also pay for the costs of issuing bonds and administering the program. The contractual assessment installments are collected on the county property tax bill. If the owner sells the property, the contractual assessment obligation may remain an obligation of the property. Additionally, because FHFA has instructed Fannie Mae and Freddie Mac not to not to purchase loans with PACE assessments such as those offered by the HERO program, property owners who sell or refinance their property may be required to prepay such assessments at the time they close sale or refinancing. Also, under the California HERO program, if a property owner fails to pay the annual contractual assessment installments, the Authority is

obligated to remove the delinquent installments from the property tax bill and commence foreclosure proceedings to collect the delinquent installments.

Several San Diego jurisdictions including the cities of Carlsbad, San Marco, Vista, Lemon Grove, Oceanside, and Solana Beach have recently adopted the HERO program. There are 76 jurisdictions in the State of California that have approved resolutions to participate in HERO.

The HERO program is available in 13 counties statewide, and has created over 1,000 new jobs and has generated more than $208,000,000 in economic stimulus for the state.

CaliforniaFIRST (AB 811)

The CaliforniaFIRST program only offers PACE financing to commercial property owners at this time. CaliforniaFIRST's PACE program allows owners to receive financing for energy efficiency, water conservation and renewable energy improvements and repay the cost of improvements through a line item on their property taxes. The program is offered by the California Statewide Communities Development Authority, a statewide joint powers authority sponsored by the California State Association of Counties and the League of California Cities. The minimum amount required to be financed is $50,000. Interest rates range from 6-8% and the maximum term is 20 years but cannot exceed the life of the improvements. Lender consent is required.

As of this date, CaliforniaFIRST has not completed any projects in San Diego. However, they have 15 applications for projects pending with 9 in the "preliminary approval" stage. The first project is anticipated to begin in the first quarter of 2014.

FigTree Commercial PACE (AB 811, formerly California PACE)

FigTree is a San Diego-based clean energy finance company providing PACE financing for energy efficiency, renewable energy and water conservation upgrades. FigTree's PACE program allows owners to finance improvements and pay for them over a defined period of time through an assessment collected on their property tax bill. FigTree recently completed its judicial validation so that it can now begin financing PACE projects in the City of San Diego. The minimum amount required to be financed is $5,000. Interest rates range from 6-8% and the maximum term is 20 years but cannot exceed the useful life of the improvements. Lender consent is required.

Now that the judicial validation is complete, FigTree has initiated its full marketing efforts in San Diego and currently has two projects going through the financing process.

DISCUSSION:

In addition to the legal analysis prepared by the City Attorney's Office (Attachment 1) Debt Management was also asked to provide a summary of potential risks to homeowners from a financial perspective in relation to the HERO program.

City Attorney's Legal Analysis

Per the City Attorney's analysis, the proposed HERO program's legal structure and associated lien priority issues raised by FHFA have not been resolved and present potential risks to homeowners who participate in the program. More details are provided in the attached memo from the City Attorney's office.

Debt Management Review

Per Debt Management's review (Attachment 2), it will be important for an interested residential property owner to also consider other available financing programs before opting into the HERO Program to ensure the best financing terms possible for the respective property owner's individual situation. Also, residential property owners should be made aware of the potential risks due to the FHFA restrictions such as:

- Reduced ability to refinance
- Potential default of mortgage
- Reduced ability to sell property
- Mandatory early lien pay-off

In summary, while there are risks associated with the program, particularly to property owners, HERO has been successful in providing financing for residential clean energy and water conservation improvements in other jurisdictions. Based on this, staff believe that providing a HERO residential program would be a valuable service for property owners in San Diego.

METRICS

A proposed list of metrics will be measured on an annual basis and reported to the Committee on the Environment. These metrics will apply to all PACE programs that the City makes available and will include data compiled from the following sources:

- Project summaries provided by the program administrator.
- Work Force Reports completed by participating contractors and financial institutions.
- Disadvantaged Business Enterprise (DBE) certifications for participating contractors and financial institutions.
- A supplemental contractor and lender questionnaire on the places of residence for employees.

To date no PACE projects have been completed by either of the two authorized San Diego PACE providers, although they do have projects in the pipeline worth a combined $12.9 million. The following are the preliminary metrics for those projects:

# of Projects	Location	Type of Project
9	San Diego	Energy Efficiency
3	San Diego	Water Conservation
11	San Diego	Renewable Generation

FISCAL CONSIDERATIONS:

Some minimal staff time, which will be absorbed by existing staff, will be required for all work related to joining and monitoring these programs.

All costs related to energy efficiency, water conservation, and/or renewable energy projects will be borne by the property owner.

PREVIOUS COUNCIL AND/OR COMMITTEE ACTION:

- City Council Meeting – October 23, 2012
  - Council adopted R-307792, retention of outside council (Stradling, Yocca, Carlson & Rauth) in connection with the City's SB555 PACE program, not to exceed $130,000, for such legal services.
  - Council adopted R-307793, authorizing execution of Associate Membership Agreement for membership in the California Enterprise Development Authority.
  - Council adopted R-307794, authorizing participation in the FigTree PACE program; authorizing the California Enterprise Development Authority to accept applications from eligible property owners, conduct contractual assessment proceedings and levy contractual assessments within the territory of the City of San Diego.
- The Committee on Natural Resources and Culture – October 10, 2012:
  - City Attorney's Office was directed to proceed with legal analysis for joining the HERO residential PACE program. Upon completion of the legal analysis, staff would report back to NR&C with the actions necessary to opt into the HERO residential PACE program.
  - Staff was authorized to work with the City Attorney's Office to draft the documents and proceed to City Council with the necessary actions to opt-in to the FigTree Commercial PACE (formerly California PACE) program
  - City Attorney's Office was directed to proceed with Council Action seeking approval to retain outside legal counsel for analysis and preparation of documents to form an SB555 district. Upon completion of the legal analysis and document preparation, staff would report back to NR&C with the actions necessary to establish an SB555 program.
- City Council Meeting – September 18, 2012:
  - Council adopted R-2013-117, opting into CaliforniaFIRST PACE financing program and reaffirming direction to develop additional PACE options.
- The Committee on Natural Resources and Culture (NR&C) – July 25, 2012
  - Approved action entering City into CaliforniaFIRST PACE financing program and directed staff to develop additional PACE financing options.
  - Directed staff to hold an informational stakeholder meeting, and return October 10, 2012 with report on California PACE and SB555 options as well as proposed program performance metrics and present to NR&C in one year on those metrics.
- City Council Meeting – December 6, 2011
  - Adopted R-2012-164, retention of outside counsel to form an assessment program/district under Assembly Bill 811 (AB811) and provide related services.

COMMUNITY PARTICIPATION AND OUTREACH EFFORTS:
From November 2010 through September 2012 interested property owners, contractors, lenders, community groups, energy non-profits and industry groups were engaged in stakeholder and community outreach efforts.

KEY STAKEHOLDERS AND PROJECTED IMPACTS:
While PACE providers will derive direct financial benefit from program adoption, successful program implementation will also provide significant benefit to the City of San Diego through clean energy, energy efficiency, and water conservation improvements, jobs creation, and reductions in greenhouse gas emissions.

Chris Gonaver
Director
Environmental Services Department

Scott Chadwick
Chief Operating Officer

Attachment 1: Office of the City Attorney Memorandum of June 5, 2013
Attachment 2: Department of Finance, Debt Management Division Analysis "HERO Program – Homeowner Considerations."

Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 533-5800

DATE: June 5, 2013

TO: Linda Gianelli Pratt, Chief Program Manager, Energy, Sustainability and Environmental Protection Division

FROM: City Attorney

SUBJECT: Proposed City Participation in HERO Residential Property Assessed Clean Energy (PACE) Program

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INTRODUCTION

On October 10, 2012, the Natural Resources and Culture Committee (Committee) directed the City Attorney's Office to proceed with the legal analysis for joining the California HERO PACE program (HERO Program) and if necessary request authorization from the City Council to retain outside legal counsel. Upon completion of the legal analysis, staff would report back to the Committee with the actions necessary to opt into the HERO residential PACE program.

The City Attorney did not recommend outside counsel for additional legal analysis because the HERO Program is structured through a joint powers authority, similar to the California First and Figtree programs, previously approved by City Council. However the proposed HERO Program includes a residential component, which has not previously been approved by City Council and which is not currently approved by the Federal Housing Finance Agency (FHFA). This memorandum discusses both the legal position of the City in approving a residential PACE program and the practical implications of the FHFA issue.

BACKGROUND

The HERO Program was launched by the Western Riverside Council of Governments (WRCOG) in January 2012. The basic elements of the program are addressed in staff's October 10, 2012 report to the Committee. At the October 10 Committee meeting, representatives for the program administrator and contractors involved in installing energy improvements under the HERO Program spoke regarding the success of the Program to date.

The HERO Program, like the two other PACE programs approved by City Council in the last year, CaliforniaFIRST and Figtree PACE, is established through a joint powers authority (JPA), thus limiting City legal exposure. However, unlike those two programs which were approved with specific limitations on their ability to proceed with residential components, the HERO Program is proposed to include residential properties with existing mortgages. The outstanding issues with the FHFA that resulted in the limits on the other Programs, discussed in more detail in this memorandum, have not been resolved.

ANALYSIS

I. RESIDENTIAL PACE PROGRAMS

In 2010, the City adopted regulations to launch its own PACE program, the "San Diego Clean Generation Program." This Office provided a May 4, 2010 Report addressing legal issues related to the City's proposed program, a copy of which is attached for reference. A significant issue is the implication of the priority of the PACE lien, as provided under California law, and the effect on the rights of existing mortgage holders. Though there have been differing viewpoints voiced on behalf of both those in support of PACE programs (e.g., clean energy) and those opposed to the PACE lien priority (e.g., banks and real estate associations), there has not been any definitive court decision addressing the legal issue of giving PACE liens priority over existing mortgages.[1] The issues raised in 2010 Report regarding priority of PACE liens have not changed.

In 2010, the FHFA issued directives that resulted in the tightening of loan requirements and in the directive that Fannie Mae and Freddie Mac not purchase mortgages on properties encumbered by PACE liens.[2] The City program was stopped, in part due to the position taken by the FHFA, barring Freddie Mac and Fannie Mae from purchasing mortgages with PACE liens. Jurisdictions with residential PACE programs, including the County of Sonoma, sued the FHFA to require that it first go through a federal rulemaking process before taking this action.

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[1] HERO Program representatives rely upon the case of *Rust v. Johnson,* 597 F.2d 174 (9th Cir. 1979) for the proposition that PACE liens do not impair lien rights of Fannie Mae and Freddie Mac. However, the case did not directly address PACE program liens.

[2] See attached May 19, 2010 City Attorney Report RC-2010-18, including the May 5, 2010 Fannie Mae and Freddie Mac lender letters.

In March, the federal Ninth Circuit Court of Appeals ruled that the FHFA has the authority to direct Fannie and Freddie on this issue without going through the rulemaking process.

The City's recent approvals of the CaliforniaFIRST and Figtree PACE programs contain specific language limiting these programs' residential use until the FHFA issues are resolved. At present, FHFA continues to take the position that PACE liens are problematic for a variety of reasons and the prohibition still stands.[3]

A. FHFA Proposed Rulemaking

The FHFA's most recent specific guidance to Fannie, Freddie and Federal Home Loan Banks dated July 6, 2010, shortly after its prohibition on PACE liens and to address the liens already in place, provided as follows:

> Today, FHFA is directing Fannie Mae, Freddie Mac and the Federal Home Loan Banks to undertake the following prudential actions:
>
> 1. For any homeowner who obtained a PACE or PACE-like loan with a priority first lien prior to this date [July 6, 2010], FHFA is directing Fannie Mae and Freddie Mac to waive their Uniform Security Instrument prohibitions against such senior liens.
>
> 2. In addressing PACE programs with first liens, Fannie Mae and Freddie Mac should undertake actions that protect their safe and sound operations. These include, but are not limited to:
>
> - Adjusting loan-to-value ratios to reflect the maximum permissible PACE loan amount available to borrowers in PACE jurisdictions;
> - Ensuring that loan covenants require approval/consent for any PACE loan;
> - Tightening borrower debt-to-income ratios to account for additional obligations associated with possible future PACE loans; and
> - Ensuring that mortgages on properties in a jurisdiction offering PACE-like programs satisfy all applicable federal and state lending regulations and guidance.

[3] See http://www.fhfa.gov/webfiles/24014/77_FR_36086_6-15-12.pdf, FHFA proposed rulemaking, which was not made final and no longer required as a result of the Ninth Circuit decision in *County of Sonoma v. FHFA,* 710 F.3d 987 (9th Circuit 2013). *(County of Sonoma).* The Notice of Proposed Rulemaking (NPR) states, "FHFA will withdraw this NPR should FHFA prevail on its appeal and will, in that situation, continue to address the financial risks FHFA believes PACE programs pose to safety and soundness as it deems appropriate." (p. 36087).

Fannie Mae and Freddie Mac should issue additional guidance as needed.

3. The Federal Home Loan Banks are directed to review their collateral policies in order to assure that pledged collateral is not adversely affected by energy retrofit programs that include first liens.[4]

The FHFA's directive, specifically prohibiting Fannie and Freddie from purchasing any mortgages with first-lien PACE obligations was challenged by the County of Sonoma. During the litigation, the FHFA issued a Notice of Proposed Rulemaking. The FHFA maintained its position that giving PACE liens priority over existing mortgages on residential property represents undue financial risks for mortgage holders. The FHFA's proposed rule provided as follows:

1. The Enterprises [Freddie Mac and Fannie Mae] shall immediately take such actions as are necessary to secure and/or preserve their right to make immediately due the full amount of any obligation secured by a mortgage that becomes, without the consent of the mortgage holder, subject to a first-lien PACE obligation. . . ;

2. The Enterprises shall not purchase any mortgage that is subject to a first-lien PACE obligation; and

3. The Enterprises shall not consent to the imposition of a first-lien PACE obligation on any mortgage.

Prior to the favorable ruling in the *County of Sonoma* case, the FHFA was considering alternatives to the proposed rule that would permit PACE liens. Each of the alternatives under consideration would have required lender consent to the PACE lien and would have required additional measures to protect the mortgage holders from potential financial risks of concern to the FHFA.

With the Ninth Circuit's recent ruling in favor of FHFA on the issue, there has been no change in its position.[5] As of 2010 Fannie and Freddie purchased or guaranteed approximately 65% of new mortgage obligations.[6]

B. HERO Program Residential Provisions

One of the protections built into the CaliforniaFIRST and Figtree PACE programs, and recommended by FHFA, is the requirement of some form of lender consent to the PACE lien. This directly addresses the issue of lien priority. However, it can also mean that it is more

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[4] http://www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf *(County of Sonoma)*
[5] *City of Sonoma v. FHFA,* 710 F. 3d 987(9th Circuit 2013).
[6] http://www.fhfa.gov/default.aspx?Page=4

difficult to get program participants because lenders may say no to the priority of the PACE lien.

Both of the PACE programs recently approved by the City included specific provision for affirmative acknowledgement of lenders of the PACE lien. This acknowledgement provides an opportunity to address potential issues before the property owner takes the loan and encumbers the property. If a lender is going to object to the priority of the PACE lien and the objection could have negative consequences for the property owner, for example a default on their existing mortgage, the property owner would still have the opportunity to decide not to go forward. Without the acknowledgement provision, there is risk that an unwitting property owner could default on an existing mortgage or otherwise affect their ability to sell or refinance their property. We note that HERO program representatives have provided information on program performance to date that indicates very few actual adverse impacts. We recommend staff review this information as part of its evaluation for purposes of recommendation to the City Council on whether to move forward with a residential program.

The HERO Program is not proposing to require lender acknowledgement or consent. Rather, the Program's residential application, a copy of which is attached, includes a disclosure to the homeowner, that puts the responsibility on the homeowner to determine whether the PACE assessment contract may cause a default or other adverse consequences. Applicants could fail to review the application in detail or to confirm the status of their mortgage loans. While this can ease the loan process and thus increase Program participation, it can also leave homeowners unaware of the potentially significant adverse consequences of the PACE lien.

II. HERO PROGRAM LEGAL STRUCTRURE

Like the two programs previously approved, the HERO Program is established through a JPA, WRCOG. WRCOG is responsible for the Program and will conduct assessment proceedings under Chapter 29 of Division 7 of the California Streets and Highways Code, and issue Bonds under the Improvement Bond Act of 1915 (Cal. Sts. & High. Code §§ 8500-8887) to finance energy related Improvements.

As with the recently approved programs, the City will not be responsible for the conduct of any assessment proceedings; the levy or collection of assessments or any required remedial action in the case of delinquencies in assessment payments; or the offer, issuance, sale, or administration of the Bonds or any other bonds issued in connection with the HERO Program. In addition, WRCOG will initiate a validation action for the Program to validate the bonds and related assessment contracts establishing PACE liens on the property. Finally, as with the previously approved programs, the City can require that the City be defended and indemnified with respect to any claims that may arise due to the HERO Program. This structure insulates the City from legal liability associated with the establishment and conduct of the HERO Program.

CONCLUSION

The proposed HERO Program legal structure is the same as previously approved programs and limits legal exposure of the City as a result. However, the HERO Program includes a residential component which has not been approved by the City for other PACE programs pending resolution of the FHFA issues. The lien priority issues raised by the FHFA remain unresolved and present risks to unwitting homeowners who participate in the program. Except for the disclosure language, the HERO Program does not include any specific protections for a participating homeowner to address or avoid lien priority issues. If there is a recommendation to move forward with residential PACE through HERO, the CaliforniaFirst and Figtree program providers will in all likelihood request similar treatment to allow residential as well.

JAN I. GOLDSMITH, CITY ATTORNEY

By Prescilla Dugard
Prescilla Dugard
Chief Deputy City Attorney

PMD:jls

Attachments: A – Report RC-2010-17
B – Report RC-2010-18
C – HERO Residential Application

cc: Mario Sierra
Anita Pyle

Doc. No. 564779

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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

Attach. A

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
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Deputy City Attorney

By
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FMO:TJF:MJLjdf:jab
Exhibits
cc: Andrea Tevlin, Independent Budget Analyst
RC-2010-17

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.

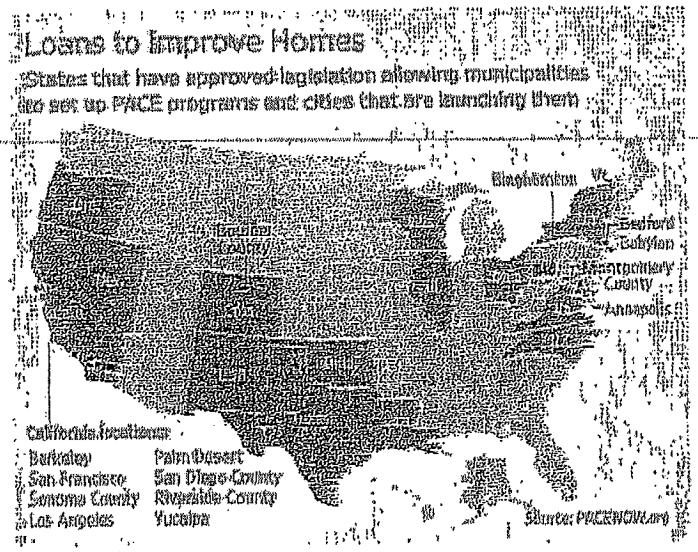
Proponents of the program, called Property Assessed Clean Energy, or PACE, say it is necessary for the loans to be paid before mortgages if local governments are to raise funds for the program from municipal-bond investors.

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.

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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

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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-

[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."

MARY JO LANZAFAME
ASSISTANT CITY ATTORNEY

TIMOTHY J. FITZPATRICK
DEPUTY 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 19, 2010

REPORT TO THE HONORABLE
MAYOR AND CITY COUNCIL

SAN DIEGO CLEAN GENERATION PROGRAM (PROGRAM)

On May 4, 2010 the Council considered the Administrative Services Agreement with Renewable Funding, LLC. The meeting was continued to May 25, 2010 to address additional issues raised at the meeting. This Report provides an update on material events that have occurred since our Report to Council dated May 4, 2010, regarding the San Diego Clean Generation Program (Report).

I. FANNIE MAE AND FREDDIE MAC ISSUED NEW LENDER LETTERS THAT MAY EFFECTIVELY TERMINATE PACE PROGRAMS.

In our Report, we advised that Property Assessed Clean Energy (PACE) programs are untested legally, may violate the US and the California Constitutions and may also violate Fannie Mae legal documents. On May 5, 2010, Fannie Mae and Freddie Mac issued lender letters (Lender Letters) that may effectively terminate PACE programs until the issues they raised are favorably resolved. A copy of the letters are attached as Exhibits A-1 and A-2.

In summary, the Lender Letters argue that the senior lien status of the tax liens for PACE programs violates the security instruments of Fannie and Freddie. Therefore, Fannie and Freddie believe that participation in a PACE program violates the terms of their mortgage documents. Moreover, a homeowner could be interpreted to be in immediate default of their Fannie and Freddie mortgage loan documents just by participating in a PACE program such as the one proposed by the City. Under this interpretation, Fannie and Freddie could accelerate all of the principal and interest owed by the homeowners on the mortgages they hold because of this default and then demand immediate payment in full of the mortgages. The Lender Letters may also be interpreted to allow Fannie and Freddie to prevent homeowners with PACE encumbrances from refinancing or selling homes with Fannie and Freddie mortgages unless the PACE encumbrances were removed. Finally, Fannie and Freddie may not buy or sell mortgages which contain PACE liens as a result of the Lender Letters. *See* Wall Street Journal article of May 17, 2010 attached as Exhibit B.

Attach. B

Since Fannie and Freddie control about two-thirds of all mortgage lending in the U.S., this could effectively terminate the PACE programs. Fannie and Freddie, as well as the participating homeowners, could take legal action against the City if the City proceeds with its Program absent a favorable resolution of the Lender Letters. Also, the City may not be able to collect existing or future tax assessments under the Program without such a favorable resolution. Finally, even if there is a favorable resolution of the issues raised in the Lender Letters, the same constitutional issues identified in our Report would remain unresolved.

On May 7, 2010, Pace Now, Renewable Funding and a number of other interested PACE participants and interested parties sent a letter to Vice President Biden requesting a withdrawal or modification of the Lender Letters and stating that unless changed, it "will effectively eliminate PACE programs." The letter is attached as Exhibit C. We believe this letter speaks for itself in terms of the risks of proceeding with a PACE program until the Lender Letters are favorably resolved.

II. OTHER CITIES AND COUNTIES ARE SUSPENDING OR CONSIDERING SUSPENDING THEIR PACE PROGRAMS IN VIEW OF LENDER LETTERS.

On May 7, 2010 Sonoma County sent a letter to Fannie Mae which is attached as Exhibit D. The letter states, among other things, that Sonoma County may consider suspending all activity under their PACE program until the Lender Letter is favorably resolved. The Sonoma County letter also expresses concern for more than 800 homeowners who may face problems selling their homes due to the Fannie Lender Letter.

On May 14, 2010, the Boulder County Business Report states that Boulder, Colorado has suspended its PACE program pending a favorable resolution of the Lender Letters. Please see the article attached as Exhibit E.

Moreover, we believe it is likely that many if not most municipalities will suspend their PACE programs just like Boulder, Colorado did until the Lender Letters issues are resolved. In support of this view, the Wall Street Journal article of May 17, 2010 attached as Exhibit B quotes the Boulder County Commissioner, Will Toor, as saying that his discussions with other local governments indicate that "pretty much every residential PACE financing program in the country will be on hold until the Fannie Mae issue is resolved."

Likewise, we believe it is reasonable to assume that San Francisco will review its options and may make changes to its program such as, for example, requiring the written consent of the mortgage lenders (which we recommended in our Report to limit the liability to lenders) or follow other municipalities and suspend the future operation of its PACE program pending a favorable resolution of the Lender Letters. We also understand that the Administrative Services Agreement, the Terms and Conditions and the financing documents for San Francisco's PACE program have not yet been finally approved by all parties or signed.

III. U.S. DEPARTMENT OF ENERGY ISSUES NEW GUIDELINES FOR PILOT PACE FINANCING PROGRAMS.

On May 7, 2010, the U.S. Department of Energy issued best practice guidelines for PACE programs (U.S. DOE Guidelines) which are attached as Exhibit F. For example, the U.S. DOE Guidelines at page 6 states:

> Estimated property value should be in excess of property owner's public and private debt on the property, including mortgages, home equity lines of credit (HELOCS), and the addition of the PACE assessment, to ensure the property owners have sufficient equity to support the PACE assessment. Local governments should be cautious about piloting the PACE model in areas with large numbers of "underwater" mortgages.

The City's Program as currently structured does not appear to meet this requirement. This is because a property could be valued at up to 10% less than the value of its outstanding debt (i.e. 10% underwater), even before the PACE assessment, and still qualify for the City's Program. Even if the Fannie and Freddie issues are resolved, we recommend that the City consider requiring that each homeowner have a reasonable and minimum amount of equity in their home to qualify for the Program. This change will materially decrease the risks to the City as previously discussed in our May 4, 2010 Report. It would also help avoid the appearance that the Program includes some of the features that led to the sub-prime mortgage collapse.

Respectfully submitted,

JAN I. GOLDSMITH, City Attorney

By _____
Timothy J. Fitzpatrick
Deputy City Attorney

TJF:jdf
RC-2010-18

EXHIBIT A1

Lender Letter LL-2010-06 **May 5, 2010**

TO: All Fannie Mae Single-Family Sellers and Servicers

Property Assessed Clean Energy Loans

Fannie Mae has received a number of questions from seller-servicers regarding government-sponsored energy loans, sometimes referred to as Property Assessed Clean Energy (PACE) loans. PACE loans generally have automatic first lien priority over previously recorded mortgages. The terms of the Fannie Mae/Freddie Mac Uniform Security Instruments prohibit loans that have senior lien status to a mortgage. As PACE programs progress through the experimental phase and beyond, Fannie Mae will issue additional guidance to lenders as may be needed from time to time.

Fannie Mae supports energy-efficiency initiatives, and is willing to engage with federal and state agencies as they consider sustainable programs to facilitate lending for energy-efficiency home retrofits, while preserving the status of mortgage loans originated as first liens.

Questions should be directed to Resource Center@fanniemae.com with the subject line "PACE." Lenders may also wish to consult with their federal regulators, who share concerns about PACE programs.

*****

Marianne E. Sullivan
Senior Vice President
Single-Family Chief Risk Officer

EXHIBIT A2

Freddie Mac
We make home possible®

Industry Letter

TO: Freddie Mac Seller/Servicers May 5, 2010

SUBJECT: First Lien Mortgages and Energy Efficient Loans

Several states have recently enacted laws that authorize localities to create new energy efficient loan programs that generally rely on the placement of a first priority lien to secure energy efficient home improvements. Programs under these laws are sometimes referred to as Energy Loan Tax Assessment Programs or Property Assessed Clean Energy programs. Freddie Mac has begun to receive questions about these new energy loan programs.

The purpose of this Industry Letter is to remind Seller/Servicers that an energy-related lien may not be senior to any Mortgage delivered to Freddie Mac. Seller/Servicers should determine whether a state or locality in which they originate mortgages has an energy loan program, and whether a first priority lien is permitted. Freddie Mac will provide additional guidance in the event that these energy loan programs move beyond the experimental stage.

Freddie Mac supports the goal of encouraging responsible financing of energy efficient and renewable energy home improvements. We continue to work with federal and state agencies and with Seller/Servicers on initiatives for developing workable energy retrofit programs.

CONCLUSION

Please contact your Freddie Mac representative or call (800) FREDDIE if you have any questions. Seller/Servicers may also wish to contact their federal regulators, who share concerns about energy liens.

Sincerely,

Patricia J. McClung
Vice President
Offerings Management

EXHIBIT B

NEW
Get stocks, mutual funds, asset allocation, and overall market timing picks.
MarketWatch
HULBERT ON MARKETS
WHAT'S WORKING NOW
FREE 4-WEEK TRIAL

THE WALL STREET JOURNAL.
WSJ.com

MAY 17, 2010, 10:25 AM ET

Fannie, Freddie Freeze Out Energy-Efficiency Loan Initiative

Fannie Mae and Freddie Mac are giving the cold shoulder to a White House-backed effort to encourage Americans to make their homes more energy efficient.

The initiative, called Property Assessed Clean Energy, or PACE, aims to eliminate the high upfront costs that have kept homeowners from making cost-saving energy retrofits on their homes. Under the program, property owners borrow money from their local government to pay for the retrofits, repaying cities over 15 to 20 years through a special assessment that is added to their property-tax bills. Local governments fund the programs by selling municipal bonds to investors.

But the programs are raising the blood pressure of mortgage investors, including Fannie Mae, Freddie Mac, and their regulator, because PACE liens become senior to existing mortgage debt. That allows PACE lenders to be paid before mortgage lenders if the homeowner defaults and goes into foreclosure.

In somewhat-cryptic letters that Fannie and Freddie sent to lenders earlier this month, the companies reminded banks that their agreements don't allow them to purchase loans that have a senior lien. "An energy-related lien may not be senior to any Mortgage delivered to Freddie Mac," the company said. Both firms said they would provide "additional guidance" if the PACE programs move beyond the "experimental stage."

The letters suggest that Fannie and Freddie won't allow borrowers with a PACE lien to refinance or sell their properties unless the liens are paid off. Proponents say the liens need to be senior or they won't attract sufficient interest from bond investors. The Department of Energy, meanwhile, issued revised guidelines for municipalities that use the program.

Fannie and Freddie control around two-thirds of all mortgage lending in the country right now, with the remainder largely shouldered by government agencies such as the Federal Housing Administration. That means that their rules have a particularly wide reach.

Officials in Aspen, Colo., told the Aspen Times that their PACE program would be "effectively shut down" if Fannie and Freddie continue to take such a view.

Colorado's Boulder County has suspended its energy-loan program in order to insure compliance with the new Energy Department guidelines and to clarify what Fannie and Freddie's guidance means for their programs. In an email, Boulder County Commissioner Will Toor said that his discussions with other local governments indicate that "pretty much every residential PACE financing program in the country will be on hold until the Fannie Mae issue is resolved," said Mr. Toor in an email.

A spokeswoman for Sonoma County, which has one of the country's largest programs, says that they haven't had to suspend their programs for now because they fund their own loans through the county before selling them to bond investors. They also don't use federal stimulus funds, which means they won't have to follow federal guidelines.

"There are a heck of a lot of people who really need that new furnace but have no equity. Thank God we have a program like this," said Amy Bolten, the county spokeswoman.

It's a delicate dance for Fannie and Freddie because the companies are owned by the government, and the current

administration has supported the fledgling PACE lien initiative. Fannie and Freddie aren't allowed to lobby or take positions on public policy matters, but have raised concerns with other government agencies and with their regulator, the Federal Housing Finance Agency, which also opposes the senior-lien structure of PACE programs.

Proponents have hailed the programs as novel ways to bring market mechanisms to bear on energy retrofitting. But critics say that the programs don't do enough to ensure that borrowers can repay their loans because municipalities don't do any underwriting. They also worry that homeowners with little or no equity could ply more debt to their properties.

Energy Department rules released last week urged municipalities to conduct energy audits to ensure that homeowners will see reduced costs as a result of upgrades and said that assessments should be limited to 10% of the property value.

Follow me for more housing and mortages news on Twitter: @NickTimiraos

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EXHIBIT C

PACENOW

May 7, 2010

The Honorable Joseph R. Biden, Jr.
Vice President of the United States
The White House
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Vice President Biden,

On May 5th, Fannie Mae and Freddie Mac published Lender Letters containing guidance that will effectively eliminate Property Assessed Clean Energy (PACE) programs. The national PACE effort that was successfully championed by your office is at risk. This is especially shocking given that your task force designed thoughtful guidelines that virtually eliminate the risk to the GSEs. Those guidelines are now being incorporated into PACE programs across the country. The following actions must be taken immediately to prevent the elimination of PACE programs:

- **The Administration must act immediately to have the Lender Letters rescinded or revised to protect homeowners in PACE communities**
- **Final underwriting criteria for PACE programs must be approved by all parties (including GSEs and FHFA)**
- **Conforming PACE programs must be exempted from GSE adverse action**

If this situation is not addressed immediately, the Fannie Mae and Freddie Mac Lender Letters will have the following catastrophic consequences:

- The Lender Letters may impact the relationship of homeowners and their lenders to the detriment of the homeowner
- Federally authorized and supported PACE programs across America will shut down, employees will be laid off, and our nation will lose the ability to tap an innovative new means to retrofit homes and buildings
- A significant and troubling precedent will be set by allowing a GSE to curtail the authority of local governments to levy taxes in pursuit of a public purpose. PACE programs utilize tax assessments, not loans. By law, tax assessments have senior lien status to mortgages.

Last year, your office and the White House Middle Class Task Force endorsed PACE financing as a means to create jobs, reduce energy bills and cut greenhouse gas emissions. The White House Policy Framework for PACE programs was released concurrently to guide the development of programs that protect homeowners and lenders. Spurred in part by your announcement, 19 states and the District of Columbia have now passed PACE enabling legislation. **PACE best practices were designed with the clear knowledge of the challenging times for homeowners, mortgage lenders, and the GSEs. The net result is that programs following White House best practices are designed to increase borrower strength while creating no significant risk for mortgage holders.**

The Fannie Mae and Freddie Mac letters appear to assert that homeowners are in default of their mortgages if they finance energy improvements with PACE. These Lender Letters were extraordinarily surprising since Federal, state, and local governments have engaged in a dialogue with lenders and other stakeholders over the past year to eliminate undue risk. Most programs are using federal ARRA funds and incorporating the White House Policy Framework – which help ensure that the borrower's cash flow increases so that mortgage default risk is reduced. Analysis of these programs has found that PACE financing creates less than $200 of seniority risk per home for the GSE's.

We stand ready to work with you to help fulfill the promise of PACE financing and to do so in a manner that helps our nation, homeowners and that provides the proper safeguards for mortgage lenders. We have attached a list of existing and pending PACE programs as well as a partial list of those that are supporting PACE. **Please feel free to contact us through Jeffrey Tannenbaum (jtannenbaum@firtree.com or 212-659-4917).**

Sincerely,

Jeffrey Tannenbaum
Founder, PACE NOW

Greg Hale
Senior Financial Policy Specialist
National Resources Defense Council

Clay G. Nesler
Vice President, Global Energy and Sustainability
Johnson Controls, Inc

Adam Browning
Executive Director
Vote Solar

The Honorable Rod Dole
Treasurer-Tax Collector
Sonoma County, CA

Cisco DeVries
President
Renewable Funding, LLC

Bob Epstein
Co-Founder, E2

David Modi
Vice President, Government Affairs
Trane

The Honorable Cindy Domenico
Chair, Board of County Commissioners
Boulder County, CO

cc: Secretary Steven Chu, U.S. Department of Energy
Secretary Shaun Donovan, U.S. Department of Housing and Urban Development
Secretary Timothy Geithner, U.S. Department of the Treasury
Carol Browner, Director of the White House Office of Energy and Climate Change

Programs Impacted by Lender Letters

Municipality	State	Program Launch Date
Palm Desert	CA	October 2008
Babylon, NY	NY	August 2008
Sonoma County, CA	CA	March 2009
Boulder County, CO	CO	April 2009
Placer County, CA	CA	April 2010
Yucaipa, CA	CA	Q1 2010
San Francisco, CA	CA	April 2010
Santa Barbara County, CA	CA	May 2010
Annapolis, MD	MD	Q3 2010
Santa Fe, NM	NM	Q3 2010
Los Angeles County, CA	CA	Q3 2010
San Diego City, CA	CA	Q3 2010
Alameda County, CA	CA	Q4 2010
Fresno County, CA	CA	Q4 2010
Kern County, CA	CA	Q4 2010
Monterey County, CA	CA	Q4 2010
Sacramento County, CA	CA	Q4 2010
San Benito County, CA	CA	Q4 2010
San Diego County, CA	CA	Q4 2010
San Luis Obispo County, CA	CA	Q4 2010
San Mateo County, CA	CA	Q4 2010
Santa Clara County, CA	CA	Q4 2010
Santa Cruz County, CA	CA	Q4 2010
Solano County, CA	CA	Q4 2010
Ventura County, CA	CA	Q4 2010
Yolo County, CA	CA	Q4 2010
New Orleans	LA	Q4 2010
San Antonio, TX	TX	Q4 2010
Albuquerque, NM	TX	2010
Montgomery County, MD	MD	Q3 2010
Madison, Wisconsin	WI	Q4 2010
Milwaukee, Wisconsin	WI	2010
Cincinnati, OH	OH	2010
New York City, NY	NY	2010
Westchester County, NY	NY	2010
Binghamton, NY	NY	2010
Austin, TX	TX	Q1 2011
Pitkin County, CO	CO	Q3 2010
Eagle County, CO	CO	Q2 2010
Gunnison County, CO	CO	Q3 2010
Ann Arbor, MI	MI	Q1 2010
Orange County, CA	CA	Q4 2010
Riverside County	CA	Q4 2010

Partial List of PACE Supporters

Organized Labor:

International Association of Heat and Frost Insulators and Allied Workers

International Brotherhood of Teamsters

International Union of Painters and Allied Trades (IUPAT)

Laborers International Union of North America (LIUNA)

International Association of Heat and Frost Insulators and Allied Workers

NGO's:

Alliance to Save Energy

American Institute of Architects (AIA)

Americans for Clean Energy

Apollo Alliance

Bipartisan Policy Center

Center for American Progress

Carbon War Room

California Energy Commission

Center for Sustainable Energy

Climate Communities

Clinton Global Initiative

Environmental Defense Fund

Jack D. Hidary Foundation

Living Cities

Milken Institute

National Association of Real Estate Investment Trusts (NAREIT)

Natural Resources Defense Council (NRDC)

Polyiso Insulation Manufacturers Association (PIMA)

Real Estate Roundtable

Renewable and Appropriate Energy Laboratory, University of California, Berkeley

Vermont Energy Investment Corp.

The Vote Solar Initiative

Sierra Club

Solar Energy Industries Association (SEIA)

Stewards for Affordable Housing for the Future (SAHF)

Sustainable Buildings Industry Council

Corporate:

Barclays Capital

Citicorp

Hannon Armstrong

Johnson Controls Inc.

Jonathan Rose Companies

Jones Lang LaSalle Inc.

Lime/Energy

Masco Home Services

ProLogis

Renewable Funding LLC

Royal Bank of Canada

Serrafix Corp

Siemens Corp

Simon Properties Group

Tishman Speyer

Trane

Wells Fargo

Government:

County of Alameda, CA

Association of Bay Area Governments

City of Berkeley, CA

County of Boulder, CO

City of Palm Dessert, CA

City of San Diego, CA

City of San Francisco, CA

City of San Jose, CA

County of Sonoma, CA –

Office of the Attorney General, State of California

Governor Arnold Schwarzenegger, State of California

Governor's Energy Office, State of Colorado

Governor Bill Richardson, State of New Mexico

United States Senator Bernard Sanders

United States Senator Jeff Merkley

United States Senator Michael Bennet

United States Senator Jeff Bingaman

United States Senator Mark Begich

United States Representative Steve Israel

EXHIBIT D

RODNEY A. DOLE
AUDITOR-CONTROLLER
TREASURER-TAX COLLECTOR
COUNTY OF SONOMA
585 FISCAL DRIVE, SUITE 101F
SANTA ROSA, CALIFORNIA 95403-2819
(707) 565-2631

DONNA M. DUNK
ASSISTANT
AUDITOR-CONTROLLER

ROBERT BOITANO
ASSISTANT
TREASURER

PAM JOHNSTON
ASSISTANT
TAX COLLECTOR/AUDITOR

Fannie Mae
3900 Wisconsin Ave. N.W.
Washington, D.C. 20016

ATTN: Marianne E. Sullivan
Senior Vice President, Single-Family Chief Risk Officer

May 7, 2010

Dear Ms. Sullivan

Your lender letter no. LL-2010-06 dated May 5, 2010 has been brought to our attention. We are writing to request your immediate withdrawal of this letter, and reinstatement of your previous advice that PACE assessments be treated as special assessments, set forth in your lender letter no. LL-07-2009 dated September 18, 2009.

We need to make you aware of the immediate, severe consequences your new position may have in our community, and in all communities with existing PACE programs. In Sonoma County, we have funded over 800 energy improvement projects through our PACE programs. In addition to creating significant energy savings, this program has created or saved over hundreds of jobs in our otherwise depressed contractor community, with no negative effect on the mortgage market.

We may not be able continue to operate our program under your current lender letter. Although we verify that all mortgages are current before we accept a participant into the program, based on your Lending Letter a property owner could be interpreted to be in immediate default just by participating in the program. Our 800 existing participants, who entered our program relying on your previous interpretation, may not be able refinance or sell their property without clearing the PACE lien, which they may not be able to do.

Unless your lender letter is immediately withdrawn, or at least modified to recognize property assessments not as "loans" or otherwise modified to protect existing pace program participants, next week we may be forced to consider suspending all activity at our storefront. It may be necessary to take steps to request that our Board of Supervisors officially close the program. We cannot continue to operate in good faith in light of your position that mere participation by a property owner may create a default in their mortgage.

This will have severe, negative effects on our community. We anticipate that the hundreds of contractors that are being supported by our program may fail, resulting potentially in hundreds of real defaults on FNMA-held mortgages. Hundreds of thousands of dollars of public money spent establishing

this program, which would have been recouped over time if the program continued, will have been wasted--this in a time of severe budget shortfall in our jurisdiction. These consequences will be felt to some extent in all communities that have taken steps to implement PACE programs.

We feel your interpreted position reversal by classifying PACE property transactions as "loans" instead of special assessments is particularly unfair in light of the positive direction otherwise coming from the federal government. National policy coming from the White House and Congress has urged communities to establish PACE programs in a responsible manner as a means of creating employment and reducing energy use. States and communities have attempted to implement this national policy. Your lender letter could bring that movement to a grinding halt.

We urge you to reconsider the consequences of this letter, and act immediately to withdraw it.

Sincerely,

Rodney A. Dole
County of Sonoma Auditor-Controller-Treasurer-Tax Collector and
Sonoma County Energy Independence Program Administrator

cc:

President Barack Obama
Vice President Joe Biden
Speaker Nancy Pelosi
Governor of California, Arnold Schwarzenegger
Congressman Mike Thompson
Congresswoman Lynn Woolsey
California Attorney General, Jerry Brown
Acting Director FHFA, Edward J. DeMarco
FHFA general counsel

EXHIBIT E

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And Reap The Benefits.

MARKETPLACE

BCBR ARTICLE

County suspends ClimateSmart loans

By David Clucas

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May 14, 2010 --

Boulder County officials have temporarily suspended issuing new residential ClimateSmart loans due to new federal guidelines and challenges from the government-backed lending giants Fannie Mae and Freddie Mac.

The Boulder County ClimateSmart Loan Program provides local residents and businesses with affordable financing to make energy efficiency and renewable energy upgrades to their properties. The owner repays the loans via an assessment on the property's annual tax bill, which stays with the property, not the initial borrower, throughout a five- to 15-year period. In November 2008, Boulder County voters authorized the county to issue up to $40 million in bonds - ultimately funded by outside investors - to support the program. In 2009, Boulder County allocated 612 ClimateSmart loans worth about $9.8 million in the first two rounds of financing to the residential real-estate sector. A third round of $12 million available to residential owners began on March 15, with applications due April 28.

The latest round of applications is now on hold, county officials said, due to new guidelines just issued from the U.S. Department of Energy.

"In order to make sure that we are in compliance with these new guidelines, it is necessary to delay our loan application process for 60 days," county officials said in a statement. "This means that our application process will be put on hold until late July. During this period, we are keeping our online application open to allow residents to continue to apply for loans."

At the same time, ClimateSmart is facing challenges from the government-backed lending giants Fannie Mae and Freddie Mac as a type of Property Assessed Clean Energy, or PACE, loan.

Regulators with Fannie and Freddie are questioning the structure of PACE loans being repaid through the property's tax bill. As a property tax, the PACE loans gain seniority over first and second mortgages on the homes. It's a key component for investors backing the PACE loans - it provides them the extra security to offer lower rates.

But for Fannie and Freddie, which own half of the nation's residential mortgages, the risk goes up with PACE ahead of them. If the home were to be foreclosed on, the PACE loan would be repaid prior to the main mortgage (s) on the home.

"The goal of enhancing energy efficiency, which we share, should not overcome the need for prudent underwriting," Alfred Pollard, general counsel for the mortgage companies' regulator, the Federal Housing Finance Agency, told the Wall Street Journal in a recent article.

Residents who have ClimateSmart loans could face the possibility of Fannie and Freddie denying to back future loans on the properties. Another

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Chris Wood

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« May 2010 »

S	M	T	W	T	F	S
25	26	27	28	29	30	1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
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Submit an event
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WEATHER
Boulder, CO
64°F
Fair

BCBR Poll
Should local and state governments create laws and codes that require businesses and individuals to adopt energy-efficient practices?

- Yes to both businesses and individuals.
- Yes to businesses

only.

Yes to individuals only.

No. The decision should be left to businesses and individuals.

Submit poll

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possibility could be that Fannie and Freddie, or any other mortgage lender for that matter, could require higher interest rates on future first and second mortgages for properties with any kind PACE loan, such as ClimateSmart in place.

Sixteen states, including Colorado, have allowed their municipalities to institute PACE programs.

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COUNTY SUSPENDS CLIMATESMART LOANS

submit a comment

* denotes a required field

Your Name

Your Email

Your Location

* **comment text** (maximum 1000 characters)

Submit Your Comment

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EXHIBIT F

Department of Energy
Washington, DC 20585

Guidelines for Pilot PACE Financing Programs

May 7, 2010

This document provides best practice guidelines to help implement the Policy Framework for PACE Financing Programs announced on October 18, 2009.[1] Property Assessed Clean Energy (PACE) financing programs allow state and local governments, where permitted by state law, to extend the use of land-secured financing districts to fund energy efficiency and renewable energy improvements on private property.[2] PACE programs attach the obligation to repay the cost of improvements to the property, not to the individual borrower. After consultation within the federal government and with other stakeholders, the Department of Energy has prepared the following Best Practices to help ensure prudent financing practices during the current pilot PACE programs.

These best practice guidelines are significantly more rigorous than the underwriting standards currently applied to land-secured financing districts. Especially in light of the exceptionally challenging economic environment and recovering housing market, the following best practice guidelines for pilot PACE financing programs are important to provide an extra layer of protection to both participants who voluntarily opt into PACE programs, and to lenders who hold mortgages on properties with PACE tax liens. These best practice guidelines may evolve over time as we learn more about the performance of PACE programs and are able to identify new best practices.[3] All pilot PACE financing programs are strongly encouraged to follow these best practice guidelines. This document is divided into two sections: Program Design Best Practice Guidelines and Assessment Underwriting Best Practice Guidelines.

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[1] The Policy Framework for PACE Financing Programs is available here: http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf.

[2] For more information on PACE programs, please visit: http://www1.eere.energy.gov/wip/solutioncenter/financialproducts/PACE.html. PACE programs are paid through a tax lien on the property. Lien priority is a matter of state law, and these best practices do not (and cannot) pre-empt state law.

[3] These best practice guidelines are primarily for the residential market. Different standards may be appropriate in non-residential markets.

Program Design Best Practice Guidelines:

Local governments should consider the following program design features to increase the reliability of energy and economic performance for the benefit of program participants, mortgage holders, and investors.

1. Expected Savings-to-Investment Ratio (SIR) Greater Than One[4]

The primary rationale for PACE programs is to pursue a legally-defined "public purpose", which generally includes environmental, health, and energy independence benefits.[5] Although traditional land-secured assessment districts do not require projects to "pay for themselves", PACE financing should generally be limited to cost effective measures to protect both participants and mortgage holders until PACE program impacts become more widely understood.

The financed package of energy improvements should be designed to pay for itself over the life of the assessment. This program attribute improves the participant's debt-to-income ratio, increasing the participant's ability to repay PACE assessments and other debt, such as mortgage payments. Local governments should consider three program design features to ensure that the expected SIR is greater than one:[6]

- An energy audit and modeling of expected savings to identify energy efficiency and renewable energy property improvement measures that are likely to deliver energy and dollar savings in excess of financed costs over the assessment term. Local governments should limit investment to those identified measures.

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[4] SIR = [Estimated savings over the life of the assessment, discounted back to present value using an appropriate discount rate] divided by [Amount financed through PACE assessment]
Savings are defined as the positive impacts of the energy improvements on participant cash flow. Savings can include reduced utility bills as well as any payments for renewable energy credits or other quantifiable environmental and health benefits that can be monetized. Savings should be calculated on an annual basis with an escalator for energy prices based either on the Energy Information Agency (EIA) U.S. forecast or a substantiated local energy price escalator.

[5] Specific public purposes are defined by the state's enabling legislation, which may vary somewhat between states. Existing legislation is available here:
http://www.dsireusa.org/incentives/index.cfm?EE=1&RE=1&SPV=0&ST=0&searchtype=PTFAuth&sh=1

[6] These program options are not mutually exclusive and programs should consider deploying them in concert. In addition, these measures could be coordinated with the proposed HOMESTAR's Silver and Gold guidelines. More information on HOMESTAR is available here:
http://www.whitehouse.gov/the-press-office/fact-sheet-homestar-energy-efficiency-retrofit-program

- In lieu of audits, programs may choose to limit eligibility to those measures with well-documented energy and dollar savings for a given climate zone. There are a number of energy efficiency and renewable energy investments that are most likely to yield a SIR of greater than one for most properties in a region.
- Encourage energy efficiency before renewable energy improvements. The economics of renewable energy investments can be enhanced when packaged with energy efficiency measures. The SIR should be calculated for the entire package of investments, not individual measures.

2. The Term of the Assessment Should Not Exceed the Useful Life of the Improvements

This best practice guidelines document is intended to ensure that a property owner's ability to repay is enhanced throughout the life of the PACE assessment by the energy savings derived from the improvements. It is important to note that the useful life of the measure often exceeds the assessment term.

3. Mortgage Holder of Record Should Receive Notice When PACE Liens Are Placed

Mortgage holders should receive notice when residential property owners fund improvements using a PACE assessment.[7]

4. PACE Lien Non-Acceleration Upon Property Owner Default

In states where non-acceleration of the lien is standard for other special assessments, it should also be standard for PACE assessments. After a foreclosure, the successor owners are responsible for future assessment payments. Non-acceleration is an important mortgage holder protection because liability for the assessment in foreclosure is limited to any amount in arrears at the time; the total outstanding assessed amount is not due in full.

5. The Assessment Should Be Appropriately Sized

PACE assessments should generally not exceed 10% of a property's estimated value (i.e. a property value-to-lien ratio of 10:1). In addition, because of the administrative requirements of administering PACE programs, assessments should generally not be issued for projects below a minimum cost threshold of approximately $2500. These measures ensure that improvements are "right-sized" for properties and for the administrative costs of piloting PACE programs. PACE programs may also choose to set the maximum assessment relative to median home values.

[7] A different standard may apply to non-residential properties.

6. Quality Assurance and Anti-Fraud Measures

Quality assurance and anti-fraud measures are essential protections for property owners, mortgage holders, investors, and local governments. These measures should include:

- Only validly licensed auditors and contractors that adhere to PACE program terms and conditions should be permitted to conduct PACE energy audits and retrofits. Where feasible or necessary, auditors and contractors should have additional certifications appropriate to the installed measures.
- Inspections should be completed on at least a portion of participating properties upon project completion to ensure that contractors participating in the PACE program are adequately performing work.
- If work is not satisfactorily completed, contractor payment should be withheld until remedied. If not satisfactorily remedied, programs should disqualify contractors from further PACE-related work.
- Property owners should sign-off before payment is issued for the work.

7. Rebates and Tax Credits

The total amount of PACE financing should be net of any expected direct cash rebates for the energy efficiency or renewable energy improvements chosen. However, other non-direct cash incentives can be more difficult to manage. For example, calculating an expected income tax credit can be complicated, as not all participants will have access to the tax credit and there will be time lags between project completion and tax credit monetization. Programs should therefore consider alternative structures for financing this gap, including assignment of rebates and tax credits to repay PACE assessments, short-term assessment additions, and partnering with third party lenders that offer short-term bridge financing. At the minimum, programs should provide full disclosure to participants on the implications and options available for monetizing an income tax credit.

8. Participant Education

PACE may be an unfamiliar financing mechanism to program participants. As such, it is essential that programs educate potential participants on how the PACE model works, whether it is a property owner's most appropriate financing mechanism, and the opportunities and risks PACE program participation creates for property owners. Programs should clearly explain and provide disclosures of the following:

- How PACE financing works

- Basic information on other financing options available to property owners for financing energy efficiency and renewable energy investments, and how PACE compares
- All program fees and how participants will pay for them
- Effective interest rate including all program fees, consistent with the Good Faith Estimate (GFE) of the Real Estate Settlement Procedure Act (RESPA) and the early and final disclosure of the Truth in Lending Act (TILA).
- PACE assessment impact on escrow payments (if applicable)
- Risk that assessment default may trigger foreclosure and property loss
- Information on transferring the assessment at time of sale
- Options for and implications of including tax credits in the financed amount

9. Debt Service Reserve Fund

For those PACE programs that seek third party investors, including investors in a municipal bond to fund the program, an assessment reserve fund should be created to protect investors from late payment or non-payment of PACE assessments.

10. Data Collection

Pilot programs should collect the data necessary to evaluate the efficacy of PACE programs. Examples of typically collected data would include: installed measures, investment amount, default and foreclosure data, expected savings, and actual energy use before and after measures installation. To the extent possible, it's important that programs have access to participant utility bills, ideally for 18 months before and after the improvements are made. The Department of Energy will provide more detailed information on collecting this data, obtaining permission to access utility bills, and how to report program information to enable a national PACE performance evaluation.

Assessment Underwriting Best Practices Guidelines:

Local governments should design underwriting criteria to reduce the risk of default and impairment to the property's mortgage holders. Many best practices for reducing these risks are included in the previous section. In addition, underwriting criteria for individual assessments should include the following:

1. Property Ownership

- Check that applicant has clear title to property and that the property is located in the financing district.

- Check the property title for restrictions such as details about power of attorney, easements, or subordination agreements.

2. Property-Based Debt and Property Valuation

- Estimated property value should be in excess of property owner's public and private debt on the property, including mortgages, home equity lines of credit (HELOCs), and the addition of the PACE assessment, to ensure that property owners have sufficient equity to support the PACE assessment. Local governments should be cautious about piloting the PACE model in areas with large numbers of "underwater" mortgages.
- To avoid placing an additional tax lien on properties that are in distress, have recently been in distress, or are at risk for distress, the following should be verified:
    - There are no outstanding taxes or involuntary liens on the property in excess of $1000 (i.e. liens placed on property for failure of the owner to comply with a payment obligation).
      Property is not in foreclosure and there have been no recent mortgage or other property-related debt defaults.
- Programs should attain estimated property value by reviewing assessed value. This is typically used in assessment districts. If assessed value appears low or high, programs should review comparable market data to determine the most appropriate valuation. If programs believe the estimated value remains inaccurate or there is a lack sufficient comparable market data to conduct an analysis, they should conduct a desktop appraisal.[8]

3. Property Owner Ability to Pay

PACE programs attach the obligation to repay the cost of improvements to the property (not to the individual borrower). The standard underwriting for other special assessments only consists of examining assessed value to public debt, the total tax rate, and the property tax delinquency rate. However, we deem certain precautions important due to the current vulnerability of mortgage lenders and of the housing market in many regions. These precautions include:

- A Savings-to-Investment Ratio (SIR) greater than one, as described above, to maintain or improve the property owner's debt-to-income ratio.
- Property owner is current on property taxes and has not been late more than once in the past 3 years, or since the purchase of the house if less than three years.[9]

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[8] A desktop appraisal involves a licensed appraiser estimating the value of a property without a visual inspection. These appraisals cost approximately $100.

[9] Applicants that have purchased the property within 3 years have recently undergone rigorous credit analyses that compensate for the short property tax payment history.

- Property owner has not filed for or declared bankruptcy for 7 years.

These best practice guidelines will evolve over time with continued monitoring of the performance of pilot PACE financing programs.

WRCOG HERO Financing™ Application

Phone: (877) 747-4889
Fax: (858) 385-0379
Email: wrcog@herofinancing.com

Address: 4080 Lemon Street, 3rd Floor, MS1032
Riverside, CA 92501

The Western Riverside Council of Governments ("WRCOG") Energy Efficiency and Water Conservation Program for Western Riverside County (the "Program") finances installation of renewable energy, or energy or water efficiency products that are permanently fixed to a property owner's real property ("Eligible Products"). Eligible Products will be financed upon the signing of an assessment contract between WRCOG and the property owner ("Assessment Contract"). WRCOG has retained Renovate America, Inc. ("RA") to facilitate the Program, and you will see this name throughout the Program materials. WRCOG and RA are referred to collectively therein as "Program Administrator."

Property Owner Acknowledgments

In order to participate in the Program, I understand that I need to meet the qualifications listed below. By signing this Application, I acknowledge and represent that to the best of my knowledge that I and any other owner(s) of the property which is the subject of this application (the "Property") meet these qualifications and I authorize the Program Administrator to obtain a credit report for each of the property owner(s) and/or trustees whose social security number is provided on this application.

- I am current on all property taxes for the Property.
- I certify that I have not had a late payment on the property taxes levied on the Property more than once during the prior three (3) years (or since the purchase of the Property if owned less than three (3) years).
- I am current on property debt on the Property, and have not had more than one 30 day mortgage late payment over the previous 12 months.
- I am not aware of any involuntary liens, defaults or judgments on the Property.
- I have the authority to authorize the Program Administrator to obtain a credit report for each of the property owner(s) and/or trustee(s) whose social security number(s) is provided on this application.
- I have not declared bankruptcy in the last seven (7) years and the Property is not currently an asset in a bankruptcy proceeding. However, if the bankruptcy is more than two years old, and if the property owner has no additional late payments more than 60 days past due in the last 24 months, the property owner may be approved.
- I understand that to qualify for the Program the Property must meet the following requirements:
  - a) The amount to be financed under the Program may not exceed 15% of the value of the Property.
  - b) All existing debt recorded against the Property may not exceed 90% of the value of the Property.
  - c) The combined amount to be financed under the Program plus the mortgage related debt must not exceed 100% of the value of the property.
  - d) I understand that, following approval, my contractor or I must call the Program to identify the Eligible Products I would like to purchase and must receive Notification to Proceed from the Program before beginning the installation of any Eligible Products. Products which have not been approved by the Program will not be funded.
  - e) I understand that interest rates may change from this approval date to receiving Notification to Proceed.

By signing this Application, I hereby declare under penalty of perjury under the laws of the State of California all of the following:

1. That the information provided in this Application is true and correct as of the date set forth opposite my signature on the Application and that I understand that any intentional or negligent misrepresentation(s) of the information contained in this Application may result in civil liability and/or criminal penalties including, but not limited to, imprisonment or both and liability for monetary damages to WRCOG, its agents, or successors and assigns, insurers and any other person who may suffer any loss due to reliance upon any misrepresentation which I have made in this Application.
2. I have received, read and understood all documents comprising the Program, which, in addition to information on the Program website, include the following:
   a. This Application;
   b. Privacy Policy Notice;
   c. Assessment Contract (sample); and
   d. Program Handbook.

I have had an opportunity to ask Program representatives and/or my legal counsel any questions I have regarding the documents listed above. I understand I will be asked to sign the Assessment Contract, among other documents, as a pre-condition to the closing of the financing.

3. I am applying to participate in the Program. I have the authority, without the consent of any third party, to execute and deliver this Application, the Assessment Contract, and the various other documents and instruments referenced herein.
4. I understand that the financing provided pursuant to the Assessment Contract will be repayable through an assessment levied against the Property. I understand that an assessment lien will be recorded by WRCOG against the Property in the office of the County Recorder of the County of Riverside upon execution of the Assessment Contract. The property tax bill (which includes my assessments) for the Property will increase by the amount of these assessment installment payments. The Assessment Contract will specify the amount of the assessment, the assessment installments and the interest on the assessment to be collected on the tax bill for the Property each year during the term specified in the Assessment Contract. The assessment and the interest and any penalties thereon will constitute a lien against the Property until they are paid. As with all tax and assessment

Attach. C

Phone: (877) 747-4889
Fax: (858) 385-0379
Email: wrcog@herofinancing.com
Address: 4080 Lemon Street, 3rd Floor, MS1032
Riverside, CA 92501

liens, this lien will be senior to all existing and future private liens against the Property, including mortgages, deeds of trust and other security instruments

Disclosures

The following describes some (but not all) characteristics and risks of participation in the Program as well as laws to which the Program is subject. A full understanding of any item listed below can be gained only by reviewing the relevant laws, policy statements, and/or the contractual documents related to the Program. The Program Administrator is committed to your understanding each of the items listed below, and invites you to ask Program representatives any questions regarding these items or if you need copies of any document related to the Program.

1. Program Disclosures and Disclaimers.

   a. **Existing Mortgage.** The Program establishes the manner by which WRCOG may finance, pursuant to Chapter 29 of Part 3 of Division 7 of the California Streets and Highways Code (commencing with Section 5898.10), the installation of Eligible Products. Eligible Products will be financed pursuant to an Assessment Contract between you and WRCOG.

   BEFORE COMPLETING A PROGRAM APPLICATION, YOU SHOULD CAREFULLY REVIEW ANY MORTGAGE AGREEMENT(S) OR OTHER SECURITY INSTRUMENT(S) WHICH AFFECT THE PROPERTY OR TO WHICH YOU AS THE PROPERTY OWNER ARE A PARTY. ENTERING INTO A PROGRAM ASSESSMENT CONTRACT WITHOUT THE CONSENT OF YOUR EXISTING LENDER(S) COULD CONSTITUTE AN EVENT OF DEFAULT UNDER SUCH AGREEMENTS OR SECURITY INSTRUMENTS. DEFAULTING UNDER AN EXISTING MORTGAGE AGREEMENT OR SECURITY INSTRUMENT COULD HAVE SERIOUS CONSEQUENCES TO YOU, WHICH COULD INCLUDE THE ACCELERATION OF THE REPAYMENT OBLIGATIONS DUE UNDER SUCH AGREEMENT OR SECURITY INSTRUMENT. IN ADDITION, ON AUGUST 31, 2010, FANNIE MAE AND FREDDIE MAC STATED THAT THEY WOULD NOT PURCHASE HOME LOANS WITH ASSESSMENTS SUCH AS THOSE OFFERED BY WRCOG. THIS MAY MEAN THAT PROPERTY OWNERS WHO SELL OR REFINANCE THEIR PROPERTY MAY BE REQUIRED TO PREPAY SUCHASSESSMENTS AT THE TIME THEY CLOSE THEIR SALE OR REFINANCING.

   If your lender requires an impound for your property taxes, please consider notifying them of the annual assessment payment amount so they can adjust your impound amount.

   b. **Interest Rate.** You will be charged a fixed interest rate on your total financed amount. Your interest rate will be set at the time your Financing Documents are issued.

   c. **Program Administration Fee.** At the time of closing, WRCOG will charge you a one-time administration fee of 6.35% of the principal amount of the assessment on the Property to cover the costs of administering the Program. This fee will be added to the assessment amount.

   d. **Recording Fee.** At the time of closing, WRCOG will pass-through the assessment recording fee of approximately $95 to you to cover the costs of recording the assessment. This fee will be added to the assessment amount.

   e. **Assessment Administration Fee.** Each year, an annual assessment administrative fee will be added to the assessment lien amount on your property tax bill. These costs will be $25 at the time the WRCOG HERO Program is launched, will not exceed $95, and will be adjusted in subsequent years for cost of living increases.

   f. **Interest Before First Payment:** Based on the date an assessment is recorded on your property, payments may not begin until the following year's tax statement. This is the amount of interest that is added to the assessment amount for the period between your closing date and the date of your first assessment payment. The maximum amount of interest will be listed on your Assessment Cost and Payment Summary, which will be provided with your Financing Documents.

   g. **Automated Valuation Model Disclosure.** You have the right and obligation to a copy of the automated valuation model (AVM) report used in connection with your application for credit. If you want to obtain a copy, please write to us at the mailing address we have provided. We must hear from you no later than 90 days after we provide you with a notice of the action taken on your application or a notice of incompleteness, or in the case of a withdrawn application, 90 days after the withdrawal. An AVM is not an appraisal. It is a computerized property valuation system that is used to derive a real property value.

   h. **Foreclosure.** Not later than October 1 each year, WRCOG shall determine whether any annual assessment is not paid when due and shall have the right and obligation to order that any such delinquent payment and its associated costs be collected by an action brought in Superior Court to foreclose the lien of the delinquent assessment installment in the manner provided and to the extent permitted by applicable law.

   i. **Mandatory Prepayment Redemption.** You have the option to pay off your assessment lien amount in full, or in increments of $5,000, at any time. However, if you do so, you will have to pay (i) the principal amount of the assessment to be prepaid (the "Assessment Prepayment Amount"), (ii) a prepayment premium computed as set forth below, (iii) interest on the Assessment Prepayment Amount to the earlier of March 2 or September 2 occurring at least 90 days following the date the prepayment is made, and (iv) a processing fee (not to exceed $500).

   The prepayment premium is determined as follows:

Year 1:	5% of Prepaid Assessment Amount
Year 2:	4% of Prepaid Assessment Amount
Year 3:	3% of Prepaid Assessment Amount
Year 4:	3% of Prepaid Assessment Amount
Year 5:	3% of Prepaid Assessment Amount
Years 6-20:	No penalty.

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Address: 4080 Lemon Street, 3rd Floor, MS1032
Riverside, CA 92501

Disclosures Continued

j. **No Endorsement, Warranty or Liability.** WRCOG, Renovate America, Inc. and the Program do not endorse any manufacturer, contractor, product, or system, or in any way warranty such equipment, installation, or the efficiency or production capability of any equipment. WRCOG, Renovate America, Inc. and the Program make no representations and have no responsibility regarding the equipment and its installation, including the quality, safety, cost savings, efficiency or production capability of any equipment; or any compliance of the equipment or its installation with any applicable laws, regulations, codes, standards or requirements. Further, WRCOG, Renovate America, Inc. and the Program shall not be in any way liable for any incidental or consequential damages resulting from the equipment or its installation.

k. **Validation.** The Program may validate that installed Eligible Products meet Program eligibility requirements including requiring the applicant to provide additional sales receipts, contractor invoices, serial numbers or other identifying details, portions of packages or stickers originally attached to the installed Eligible Products beyond what the Program already requires to be provided. The Program may also conduct an inspection to validate installation of Eligible Products at qualified locations. You, by submitting this application, consent to any such onsite validations, which shall be conducted during normal business hours following advance notice to you. By submitting this application, you also agree to sign the authorization form to participate in billing energy usage analysis to measure Program impact savings and participant satisfaction.

2. Legal Disclosures

a. **Equal Credit Opportunity Act (ECOA).** The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against Credit Applicant(s) on the basis of race, color, religion, national origin, sex, marital status, age (provided that the applicant has the capacity to enter into a binding contract); because all or part of the applicant(s) income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal Agency that administers compliance with this law concerning this creditor is the Federal Trade Commission, Division of Credit Practices, Washington, D.C. 20580.

b. **Fair Credit Reporting Act.** As part of assembling your Program application, WRCOG has requested a consumer report bearing your credit worthiness, credit standing and credit capacity. This notice is given to you pursuant to the Fair Credit Reporting Act.

c. **The Housing Financial Discrimination Act Of 1977.** It is illegal to discriminate in the provision of or in the availability of financial assistance because of the consideration of:

   i. trends, characteristics or conditions in the neighborhood or geographic area surrounding a housing accommodation, unless the financial institution can demonstrate in the particular case that such consideration is required to avoid an unsafe and unsound business practice; or

   ii. race, color, religion, sex, marital status, domestic partnership, national origin or ancestry.

d. **Patriot Act Disclosure.** To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account. What this means for you: As part of applying to the Program, WRCOG may be required to ask for your name, address, date of birth, and other information that will allow it to identify you. WRCOG may also need a copy of the driver's license or other identifying documents from any and all borrowers and guarantors.

e. **Communications with Legal Advisers.** If you have any questions about any agreements or security instruments which affect the Property or to which you are a party, or about your authority to execute the Program Application or enter into an Assessment Contract with WRCOG without the prior consent of your existing lender(s), the Program strongly encourages you to consult with your own legal counsel and your lender(s). Program staff cannot provide you with advice about existing agreements or security instruments.

Property Owner Signature(s)

I declare that (i) I have received, read and understand the risks and characteristics of the Program described in the Property Owner Acknowledgments and Disclosures set forth in this Application and (ii) I have been informed that I must take the sole responsibility to satisfy myself that executing the Assessment Contract, receiving financing for Eligible Products, and consenting to the assessment levied against the Property will not constitute a default under any other agreement or security instrument (specifically the terms of any mortgage on the Property) which affects the Property or to which I am a party.

Property Owner 1 Signature	Date	Property Owner 2 Signature	Date

WRCOG HERO Financing™ Application

Phone: (877) 747-4889
Fax: (858) 385-0379
Email: wrcog@herofinancing.com

Address: 4080 Lemon Street, 3rd Floor, MS1032
Riverside, CA 92501

FOR CONTRACTOR CALL IN ONLY	Contractor ID#	HERO ID#

Property Address

Property Type: ☐ Single Family Home ☐ Condo/Townhome ☐ Manufactured/Mobile Home ☐ Multi Family Home (1-4 units)

Property Address

City State Zip Code

Property Owner

Ownership Type: ☐ Individual ☐ Joint ☐ Trust ☐ Corporation/LLC/etc. ☐ Other: _____

First Name M. Initial Last Name

Social Security Number - - DOB Month / Day / Year Phone Number

Email Address

Mailing Address (if different from Property Address)

City State Zip Code

Property Owner 2

First Name M. Initial Last Name

Social Security Number - - DOB Month / Day / Year

Property Owner Signature(s)

I declare that I have the authority, without the consent of any third party which has not been previously obtained, to execute and deliver the Application, Assessment Contract, and the various documents and instruments referenced therein.

Property Owner 1 Signature Date Property Owner 2 Signature Date

If you do NOT wish to receive email communications from the Program and would prefer all communications to occur through the U.S. mail instead, please contact us.

☐ Please check this box if you do NOT want to receive newsletters or other marketing materials from the Program or Renovate America, Inc.

HERO Program – Homeowner Considerations

City Sponsorship via Program Participation Authorization

Property owners need to perform their own diligence to compare other available financing programs/terms before opting into the HERO Program in order to obtain the best financing terms possible.

- If the City authorizes participation in the program, it is recommended that the authorizing resolution and City links to the program specify that the City has not made any assessment that the program provides the best financing terms for any individual property owner, nor is it endorsing the HERO Program over any other financing program or terms that may be available to the property owner.

- There should be additional caution that property owners consider the FHFA restriction risks.

Potential Risks Due to FHFA Restrictions:

1. Reduced Ability to Refinance

Participating homeowners may face difficulties in obtaining a willing lender to refinance their existing mortgages.

2. Potential Default on Mortgage

An existing mortgager may consider a subordination of the mortgage lien to the PACE lien as a default on the loan, effectively calling the mortgage due immediately, which could result in the repossession of the house.

3. Reduced Ability to Sell the Property

Interested homebuyers may not be able to obtain financing that will allow the senior PACE lien, and, therefore, limit the potential buyer universe.

4. Mandatory Early Lien Pay-off

Any of the above situations could result in the need to pay off the entire lien early. There are penalties for lien pay-offs made within the first five years of the financing. This could defeat one of the key benefits of PACE programs (i.e., that the lien remains with the property).

Financing Program:

Interest Rates – Per the department review, as of January 2014 the HERO Program indicated interest rates ranging from 5.95% for a five year loan to 8.95% for a 25 year loan, subject to change.

-Lower rates seem possible to attain, depending on credit status of applicant. This may be particularly important if the key benefit of passing the assessments on with the property is negatively impacted by the FHFA restrictions.

Other Costs and Fees –According to the HERO Program Guide (October 2013), the current program fees include: a one-time administration fee equal to 6.95% of the loan amount; a recording fee of $95; and an annual assessment administration fee of $25 to cover the cost of managing the assessment on the property tax rolls every year. Depending on the timing of the first assessment levy with the County, capitalized interest may also be required. Additionally, provisions for a debt service reserve fund exist within the legislation (AB 811).

- These program and administration fees are generally within the range of what has been seen for other programs (the initial administration fee is higher, but the on-going fee is lower)

- Capitalized interest would increase the overall borrowing cost and could be a factor when comparing the program to other non-PACE financing mechanisms. Applicant needs to verify the costs with the HERO Program administrators.

- If the program requires the funding of a debt service reserve fund, this could also impact the overall financing cost. However, in a traditional assessment financing, the debt service reserve fund is available for the final assessment payment, assuming no draws on the fund have been made, and, if a prepayment of the lien occurs, the property owner is credited with a proportionate share of the reserve. If a reserve fund is required, it should be confirmed by the HERO Program administrators that the program offers similar credits back to participants. This is especially important due to the FHFA restrictions and possible early pay off-requirements. If credits are not provided, it could make the program less cost effective than other financing mechanisms.

Early Lien Pay-off Penalties – According to the HERO Program Guide (October 2013), there are pay-off penalties for early payment of the assessment lien (listed below). While pre-payment premiums are typically required for traditional assessment districts when liens are pre-paid in the early years, this situation is typically voluntary on the part of the homeowner. In the case of PACE programs, such as the HERO Program, the homeowner may be forced to pre-pay the assessment due to the FHFA restrictions and, therefore, the penalties should be carefully considered. In addition to a $500 processing fee, below are the prepayment penalties:

Year 1:	5% of Prepaid Assessment Amount
Year 2:	4% of Prepaid Assessment Amount
Year 3:	3% of Prepaid Assessment Amount
Year 4:	3% of Prepaid Assessment Amount
Year 5:	3% of Prepaid Assessment Amount
Years 6-20:	No Penalty.

Foreclosure Requirements - As with a typical assessment district, foreclosure can occur much more quickly if assessments are delinquent as compared to delinquent ad valorem property taxes.

Credit Standards – Credit/underwriting standards have been established for the program. These can help minimize situations in which participating property owners are unable to make assessment payments; however, it is possible for 100% of the equity in the home to be stripped through participation in the program, which could be of concern if the real estate market falls. Below are the standards as described by the HERO Program Guide (October 2013):

- Mortgage-related debt on property must not exceed 90% of the value of the property.
- Property taxes have not been paid late more than once in the past three years.
- Maximum amount available through program is 15% of property market value.
- Combined amount to be financed under the program plus mortgage related debt must not exceed 100% of the value of the property.

Project Benefit vs. Financing Cost - If the improvement/benefit (i.e., energy savings) is not on par or greater than the assessment amount, the net value of a participant's property could decrease.

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