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Slowing the PACE of Recovery: Why Property Assessed Clean Energy Programs Risk Repeating the Mistakes of the Recent Foreclosure Crisis

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SLOWING THE PACE OF RECOVERY: WHY PROPERTY ASSESSED CLEAN ENERGY PROGRAMS RISK REPEATING THE MISTAKES OF THE RECENT FORECLOSURE CRISIS

I. INTRODUCTION

Since taking office in 2009, President Obama has stressed the need to retrofit America's buildings with alternative forms of sustainable energy.¹ Increased reliance on one form of sustainable energy, solar power, will conserve fossil fuels and reduce greenhouse gas emissions.² Despite the many attractive benefits, homeowners are reluctant to invest in solar energy retrofits because of the high upfront cost of installation.³ To help homeowners overcome these costs, states are experimenting with different financing methods.⁴ Property Assessed Clean Energy ("PACE") programs are one financing method that allow local governments to use special assessment districts to finance these home installations.⁵ PACE programs represent the most recent in a long line of

¹ See generally MIDDLE CLASS TASK FORCE & COUNCIL ON ENVIRONMENTAL QUALITY, RECOVERY THROUGH RETROFIT (2009), available at http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf (describing the White House's energy policy).

² See Energy Kinetics, *Sustainability*, SYSTEM 2000, <http://www.energykinetics.com/sustainability.shtml> (last visited Oct. 15, 2011) (explaining how solar energy can benefit the environment).

³ See Robert C. Barnes, *The Promise and Peril of Assembly Bill 811's Contractual Assessments*, CAL. REAL EST. J., Jan. 26, 2009, at 14 (reporting that "solar energy systems . . . can cost up to \$40,000 per installation"). The average contract in Palm Desert, California, was \$33,000. *Id.*; see also Progress Report, *Reality Check: The Powers That Be*, U.S. NEWS & WORLD REP., Apr. 2010, at 27 (reporting that despite a fifty percent drop in price, the costs need to drop an additional twenty-five to fifty percent from current levels before solar systems will be economical).

⁴ See *Property-Assessed Clean Energy (PACE) Programs*, U.S. DEP'T ENERGY, <http://www1.eere.energy.gov/wip/solutioncenter/PrintableVersion/financialproducts/pace.html> (last visited July 28, 2011) (explaining the advantages and disadvantages of PACE projects). Supporters also assert that these programs will increase demand for homes and increase home values. ETHAN N. ELKIND ET AL., *SAVING ENERGY: HOW CALIFORNIA CAN LAUNCH A STATEWIDE RETROFIT PROGRAM FOR EXISTING RESIDENCES AND SMALL BUSINESSES* 14 (May 2010), available at [http://www.law.berkeley.edu/files/Saving_Energy_May_2010\(1\).pdf](http://www.law.berkeley.edu/files/Saving_Energy_May_2010(1).pdf); see also MARK ZIMRING & MERRIAN FULLER, *CLEAN ENERGY FINANCING POLICY BRIEF: ACCELERATING THE PAYMENT OF PACE ASSESSMENTS* 3 (May 4, 2010), available at http://eetd.lbl.gov/ea/ems/reports/ee-policybrief_050410.pdf (claiming that "energy savings [from solar panel installation] will offset and, in some cases, exceed the assessment payments," thereby reducing the risk of default on the PACE assessment).

⁵ *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4; see also Cisco DeVries & Christopher Lynch, *How Cool: Changes to Municipal Finance Law Address Global Warming*,

state and local initiatives, but previous programs have only been met with limited success.⁶

However, critics have been quick to point out that these programs have various legal and financial risks that could repeat the financial crisis of 2008.⁷ In particular, critics argue that these programs are loans instead of traditional property assessments. Since they are not assessments, PACE loans are not entitled to a senior lien position ahead of preexisting mortgages.⁸ The resolution of all of these financial and legal challenges depends on whether PACE programs can be classified as property tax assessments with senior lien status. In reality, PACE programs are actually loan programs, not an extension of the special assessment statutory authority. As such, the tax lien provisions in PACE statutes are invalid, and PACE programs are not entitled to a senior lien position ahead of preexisting mortgages.

This Note begins by explaining the history of PACE statutes and the controversy surrounding them in Part II.⁹ Part II also examines the

Create Green Jobs and Promote Energy Independence, 3 BLOOMBERG L. REP. 1, 1 (2010), available at <http://pacenow.org/documents/Bloomberg%20Law%20Article.pdf> (explaining that such special assessment districts, or “land-secured finance districts,” could “essentially eliminate upfront cost barriers and spread the cost of energy efficiency improvements over their useful life”). PACE programs are also known as Voluntary Environmental Improvement Bonds, Energy Loan Tax Assessment Programs, or Energy Efficiency/Renewable Energy Contractual Assessment Districts in some states. SANJAY RANCHOD ET AL., THE CONSTITUTIONALITY OF PROPERTY ASSESSED CLEAN ENERGY (PACE) PROGRAMS UNDER FEDERAL AND CALIFORNIA LAW 3 (May 28, 2010), available at <http://votesolar.org/wp-content/uploads/2010/05/PHJW-PACE-White-Paper.pdf> (listing other names).

⁶ DeVries & Lynch, *supra* note 5, at 4. See generally SHARON STANTON WHITE, MUNICIPAL BOND FINANCING OF SOLAR ENERGY FACILITIES (1979) (analyzing the possibility of bond financing for solar energy projects in the late 1970s).

⁷ See generally Barnes, *supra* note 3, at 1 (arguing that PACE programs risk creating the same conditions that led to the Great Recession); David A. Felt, *PACE Loans – Another Subprime Mortgage Crisis?*, MKT. SOLUTIONS, June 2010, at 1 (arguing that PACE risks outweigh benefits). The Financial Crisis Inquiry Commission recently concluded that the 2008 financial crisis resulted in part from “shoddy mortgage lending.” Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. TIMES, Jan. 26, 2011, at A1. According to financial publications, PACE programs represent “a new and potentially devastating shock to the mortgage securities markets and the financial system.” Felt, *supra*, at 1. These programs “threaten to undermine the already battered mortgage market in the United States.” *Id.*

⁸ Press Release, Fed. Hous. Fin. Agency, FHFA Statement on Certain Energy Retrofit Loan Programs (July 6, 2010), available at http://www.fhfa.gov/webfiles/15884/PACE_STMT7610.pdf [hereinafter July 6, 2010 FHFA Press Release]. A first mortgage or lien on a piece of property “has first priority” over subsequent mortgages and liens, so it is senior. DAVID A. SCHMUDDE, A PRACTICAL GUIDE TO MORTGAGES AND LIENS 113 (2004). All mortgages and liens recorded after this senior mortgage “are called ‘junior’ mortgages.” *Id.*

⁹ See *infra* Part II (chronicling the history of PACE programs and explaining why these programs are so controversial).

theory behind tax liens and municipal bond financing and concludes by examining the specific elements of special assessments.¹⁰ Next, Part III analyzes PACE statutes and ultimately determines that these statutes are drastically different from traditional special assessment statutes.¹¹

Part IV attempts to resolve the controversy between PACE supporters and the Federal Housing Finance Agency (“FHFA”) by focusing on Maine’s statute.¹² Maine’s statute does not conflict with the FHFA’s guidelines because it requires PACE programs to impose junior liens.¹³ Therefore, states should amend their statutes to model the Maine statute, while at the same time adopting the Department of Energy’s (“DOE”) Best Practices Guidelines.¹⁴ If states make these changes, investors will once again support PACE programs.

II. BACKGROUND

Investors have stopped supporting PACE programs and homeowners have not reaped PACE’s benefits because of the uncertain tax lien status of PACE statutes. Part II begins with a general overview of PACE programs before analyzing whether recently enacted PACE statutes can be classified as valid property assessments.¹⁵ Following the historical discussion of PACE programs, Part II.B introduces various proposals to resolve the controversy.¹⁶ Part II.C then examines the PACE statutes, the theory behind municipal bond financing, and tax liens.¹⁷ Finally, Part II.D discusses the specific elements of special assessment districts.¹⁸ PACE statutes’ tax lien provisions are at the heart of the controversy surrounding these programs.

¹⁰ See *infra* Part II.D (describing the elements for a valid property assessment lien).

¹¹ See *infra* Part III (analyzing whether PACE programs conform to the guidelines for valid property assessments).

¹² See *infra* Part IV (proposing an amended PACE statute).

¹³ See *infra* note 44 (explaining that FHFA lending guidelines prohibit property owners from taking out loans with repayment provisions senior to an existing FHFA loan); see also *infra* note 40 (noting that Maine’s statute is the only statute that currently makes PACE liens junior to preexisting liens).

¹⁴ See *infra* Part IV (proposing a model statute).

¹⁵ See *infra* Part II.A (explaining the theory behind PACE statutes and the reasons why these statutes were originally codified).

¹⁶ See *infra* Part II.B (explaining the FHFA’s objections to PACE programs).

¹⁷ See *infra* Part II.C (describing the elements of valid property assessments); see also Part III (analyzing PACE programs and concluding that they do not meet the requirements for a valid assessment).

¹⁸ See *infra* Part II.D (discussing the legal and financial aspects of tax liens and explaining why they are crucial to determining whether PACE programs are valid assessments).

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A. PACE Programs in General

Local governments currently have statutory authority to use special assessment districts, also known as land-secured finance districts, to finance a number of public improvements.¹⁹ PACE statutes essentially amend these preexisting municipal financing statutes to allow municipalities to finance home energy improvements.²⁰ To date, more than twenty states have enacted PACE statutes in the last three years, and many more are considering similar statutes.²¹ Local governments in California and Colorado have had the most success in implementing PACE programs.²²

Local governments typically issue bonds to raise revenue.²³ Once a local government raises money through a bond issue, homeowners who

¹⁹ See, e.g., CAL. GOV'T CODE § 53340(e) (West 2010). Such special assessment districts "are an essential building block of municipal finance . . . used to finance projects including street paving, parks, open space, water and sewer systems, and street lighting." DeVries & Lynch, *supra* note 5, at 2. Municipalities also use special assessment districts to finance "seismic improvements, geologic hazard abatement and toxic remediation . . . [and] septic tank replacement." *Id.* at 4. Assessments are also used to finance road improvements, "bury[] power lines, [and] extend[] public services into neighborhoods." JASON COUGHLIN ET AL., CLEAN ENERGY FINANCING POLICY BRIEF: TRANSFERRING PACE ASSESSMENTS UPON HOME SALE 2 (Apr. 12, 2010), available at http://eetd.lbl.gov/ea/emp/reports/ee-policybrief_041210.pdf.

²⁰ See DeVries & Lynch, *supra* note 5, at 4 (explaining that states must slightly modify their special assessment district legislation to allow local governments to finance "energy efficiency and solar projects on private property").

²¹ The following states have enacted PACE legislation: California, CAL. PUB. RES. CODE § 26100 (West Supp. 2011); Colorado, COLO. REV. STAT. § 30-20-606 (2002 & Supp. 2010); Florida, FLA. STAT. ANN. § 189.402 (West 2000); Georgia, GA. CODE ANN. § 36-42-3 (2006 & Supp. 2011); Illinois, 65 ILL. COMP. STAT. 5/1-1-11 (Supp. 2011); Hawaii, HAW. REV. STAT. § 46-80 (1993); Maine, ME. REV. STAT. tit. 35A, § 10152 (2010); Maryland, MD. CODE ANN. art. 24, § 9-1501 (West 2009); Minnesota, MINN. STAT. § 216C.43 (West 2010); Missouri, MO. REV. STAT. § 67.2800 (Supp. 2011); Nevada, NEV. REV. STAT. § 271.010 (2011); New Hampshire, N.H. REV. STAT. ANN. § 53-F:1 (2010); New Mexico, N.M. STAT. ANN. § 4-55C-1 (West 2010); New York, N.Y. GEN. MUN. LAW § 119-gg (McKinney 2009); North Carolina, N.C. GEN. STAT. § 160A-459 (2009); Ohio, OHIO REV. CODE ANN. § 5727.75 (West Supp. 2011); Oklahoma, OKLA. STAT. tit. 19, § 460.2 (Supp. 2011); Oregon, OR. REV. STAT. § 470 (2009); Texas, TEX. LOC. GOV'T CODE ANN. § 376 (West Supp. 2010); Vermont, VT. STAT. ANN. tit. 24, § 1714(3) (2009); Virginia, VA. CODE ANN. § 15.2-958.3 (Supp. 2011); and Wisconsin, WIS. STAT. § 66.0627 (West 2011).

²² DeVries & Lynch, *supra* note 5, at 5. All of Berkeley, California's slots were filled in less than ten minutes, and Palm Desert, California has funded \$7.5 million worth of projects. Berkeley only made a limited number of slots available to residents and once those slots were filled, residents could no longer apply for PACE loans. *Id.* Boulder County, Colorado has funded 500 projects by selling \$10 million worth of bonds. *Id.*

²³ *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4. While most municipalities use special assessment bonds to finance their PACE programs, some, such as Palm Desert, California, have used different sources of funds. Barnes, *supra* note 3, at 14.

wish to take part in the PACE program apply for a loan from the local government.²⁴ After receiving the loan, property owners in the assessment district repay the cost of the improvement through a senior lien on the property.²⁵ This financing method is attractive to homeowners because it allows them to install a solar panel without the high initial costs.²⁶ Instead of paying for the improvement all at once, the homeowner makes incremental payments for several years until the entire cost is paid off.²⁷ Local governments collect payments from property owners at the same time as property taxes.²⁸ Because PACE programs are voluntary, the local government only assesses liens on homeowners who choose to take part in the program.²⁹ In addition, the

Palm Desert used its general fund to pay for \$2.5 million in PACE contracts, “a fiscal luxury that few cities enjoy today.” *Id.*

²⁴ Glen Anderson, *Financing Renewable Energy and Energy Efficiency*, LEGISBRIEF, Aug.–Sept. 2009, at 1, available at http://www1.eere.energy.gov/wip/solutioncenter/pdfs/NCSL_Property_Tax_Financing_Legisbrief.pdf (explaining that “[r]esidents within these districts then can apply for low-interest loans”).

²⁵ See *id.* (pointing out that homeowners can repay these loans “through an assessment on property taxes or added to the utility bill”); *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4 (“The property owners that benefit from the improvement repay the bond through property assessments, which are secured by a property lien and paid as an addition to the property tax bill.”).

²⁶ *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4. PACE programs allow homeowners “to install renewable energy equipment or upgrade efficiency at a low monthly cost.” Anderson, *supra* note 24, at 1. Additionally, “[t]he work can be completed with no upfront costs and usually no increase in cost to the owner, [because] the energy savings should be equal to or greater than loan payments assessed to the property tax.” *Id.* at 1–2; see also RANCHOD ET AL., *supra* note 5, at 4 (pointing out that many homeowners do not make these upgrades because they face prohibitively high upfront costs, and do not see any economic benefits until later because the “benefits of energy cost savings are distributed over time”).

²⁷ *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4; see also DeVries & Lynch, *supra* note 5, at 4 (explaining that the homeowner “pay[s] back the costs . . . over a fixed period”).

²⁸ See DeVries & Lynch, *supra* note 5, at 4 (explaining that homeowners pay for the improvement “through an addition to their property tax bill”); see also Barnes, *supra* note 3, at 1 (explaining that local governments will use liens to secure these “contractual obligations”); Joel B. Eisen, *Can Urban Solar Become a “Disruptive” Technology?: The Case for Solar Utilities*, 24 NOTRE DAME J.L. ETHICS & PUB. POL’Y 53, 84 (2010) (explaining that these programs allow property owners to reimburse local governments for the upfront costs by “adding specified amounts to their property tax bill[]” for a period of years).

²⁹ See DeVries & Lynch, *supra* note 5, at 4 (explaining that homeowners “only pay additional property taxes if they ‘opt-in,’ and they only pay for the cost of their project”); MERRIAN C. FULLER ET AL., *GUIDE TO ENERGY EFFICIENCY & RENEWABLE ENERGY FINANCING DISTRICTS FOR LOCAL GOVERNMENTS 27* (2009), available at <http://rael.berkeley.edu/sites/default/files/old-site-files/berkeleysolar/HowTo.pdf> (explaining that “a particular parcel of property is not assessed unless that property owner ‘opts-in’ and applies to participate in the program”); RANCHOD ET AL., *supra* note 5, at 3–4 (stating that “taxes or assessments may be levied only where the property owner has expressly consented

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lien runs with the land, meaning that if a homeowner sells the property before the lien is fully paid, the new homeowner, not the original owner, will pay the remainder of the lien.³⁰

These programs are not only beneficial to property owners, but to cities as well. Cities have used special assessments with senior lien provisions to finance local improvements for over one hundred years.³¹ In the 1970s, organizations began looking into financing solar improvements by issuing municipal bonds.³² However, PACE programs, which allow individual property owners to voluntarily opt into financing districts, are new and innovative.³³ This general overview

to participate in the PACE program”) (emphasis added); *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4 (clarifying that the liens only attach to property if property owners “voluntarily choose to attach the cost of their energy improvements to their property tax bill”).

³⁰ See DEP’T OF ENERGY, GUIDELINES FOR PILOT PACE FINANCING PROGRAMS 1 (2010), available at http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf (explaining that “PACE programs attach the obligation to repay . . . to the property, not to the individual borrower”); *Property-Assessed Clean Energy (PACE) Programs*, *supra* note 4 (“If the property is sold before the end of the repayment period, the new owner inherits both the remaining repayment obligation and the financed energy improvements.”). This ensures that the cost of the improvement will be “repaid over the useful life of the financed improvements, regardless of who owns the property.” DeVries & Lynch, *supra* note 5, at 2; see also Anderson, *supra* note 24, at 1 (noting that since the loan is repaid through a tax assessment or a surcharge on utility bills, “the benefits and payments stay with the property”).

³¹ See generally *Guinn v. McReynolds*, 170 P. 421 (Cal. 1918) (explaining that tax liens are senior to other liens); *Spring St. Co. v. Los Angeles*, 148 P. 217 (Cal. 1915) (explaining that assessments in general are valid, but the one at issue in the case was invalid since it was not proportional to the benefits received by the homeowners); *German Sav. & Loan Soc’y v. Ramish*, 69 P. 89 (Cal. 1902) (upholding a state statutory senior lien provision to finance street improvements); *People ex rel. Griffin v. Brooklyn*, 4 N.Y. 419 (N.Y. 1851) (validating a state statute allowing a municipality to use an assessment to finance street improvements); *RANCHOD ET AL.*, *supra* note 5, at 3 (listing types of projects financed through special assessments and explaining that “[s]uch districts have been a part of municipal finance and the tax lien structure for more than a century”); *Water, Wastewater & Wetlands: Betterments*, MASS. DEP’T ENVIL. PROT., <http://www.mass.gov/dep/water/betters.htm> (last visited Oct. 15, 2011) (explaining that homeowners can take part in these programs to finance septic tank improvements).

³² See generally WHITE, *supra* note 6, at 2 (listing the types of solar energy improvements that could be financed through municipal bonds).

³³ See DeVries & Lynch, *supra* note 5, at 1 (describing the PACE program as “an innovative municipal finance model”); Nick Timiraos, *Fannie and Freddie Resist Loans for Energy Efficiency*, WALL ST. J. (Mar. 25, 2010), <http://online.wsj.com/article/SB10001424052748704534904575132123115802584.html> (describing PACE as “a novel financing mechanism”); see also THE NAT’L RES. DEF. COUNCIL ET AL., WHITE PAPER: HELPING ACHIEVE ENVIRONMENTAL SUSTAINABILITY AND ENERGY INDEPENDENCE, IMPROVING HOMEOWNER CASH FLOW AND CREDIT PROFILE, PROTECTING MORTGAGE LENDERS, AND CREATING JOBS 3 (May 3, 2010) (describing these programs as “innovative and cost effective”); Todd Woody, *Loan Giants Threaten Energy-Efficiency Programs*, N.Y.

applies to most PACE programs, but several state statutes have unique attributes that make their programs significantly different.

1. State Statutes

PACE programs are entirely voluntary, but once a homeowner opts into the program, most statutes allow local governments to impose a property tax assessment on the property.³⁴ Most statutes require homeowners to pay this assessment through a lien on the property.³⁵ Although some proponents claim that these assessments are not loans, many statutes specifically refer to PACE financing as a loan.³⁶ Several PACE statutes allow homeowners to repay this loan through a surcharge on the homeowner's utility bill as an alternative to assessments and liens,

TIMES (June 30, 2010), <http://www.nytimes.com/2010/07/01/business/energy-environment/01solar.html> (describing PACE programs as "innovative"); *AIA Urges Congress to Save Clean Energy Bond Program*, ARCHINNOVATIONS (July 20, 2010), <http://www.archinnovations.com/news/architecture-practice/aia-urges-congress-to-save-clean-energy-bond-program/> (listing the many benefits of this innovative tool).

³⁴ See, e.g., 65 ILL. COMP. STAT. 5/1-1-11 (Supp. 2011) ("A municipality may enter into *voluntary* agreements with the owners of property within the municipality to provide for contractual assessments to finance the installation of distributed generation renewable energy sources or energy efficiency improvements that are permanently fixed to real property.") (emphasis added).

³⁵ See CAL. STS. & HIGH. CODE § 5898.30 (West Supp. 2011) ("Assessments levied pursuant to this chapter . . . shall constitute a lien against the lots . . . of land on which they are made . . ."); COLO. REV. STAT. § 30-20-610 (2002 & Supp. 2010) (explaining that the "[a]ssessment constitutes a lien"); OKLA. STAT. tit. 19, § 460.5(C) (2009) (explaining that PACE loans "shall constitute a lien"); OR. REV. STAT. § 470.36(2) (2009) (explaining that once a homeowner takes out a PACE loan, "[t]he department shall record a lien"); TEX. LOC. GOV'T CODE ANN. § 376.008 (West Supp. 2010) ("An assessment imposed under this chapter . . . constitutes a lien . . ."); VT. STAT. ANN. tit. 24, § 3262(c)(2) (2009) (explaining that when property is sold "future payments [on PACE loans] shall constitute as a lien").

³⁶ See Brief for Plaintiff, *California v. Fed. Hous. Fin. Agency*, C10-03084 (filed Jul. 14, 2010), available at [http://ag.ca.gov/cms_attachments/press/pdfs/n1951_final_pace_complaint_&_exhibits_\(stamped\).pdf](http://ag.ca.gov/cms_attachments/press/pdfs/n1951_final_pace_complaint_&_exhibits_(stamped).pdf) (arguing that in California, PACE financing uses liens not loans). But see ME. REV. STAT. ANN. tit. 35-A, § 10153.4 (2010) ("PACE mortgage" means a mortgage securing a *loan* made pursuant to a PACE program to fund energy savings improvements on qualifying property.") (emphasis added); OR. REV. STAT. § 470.500(1) (2009) ("The Director of the State Department of Energy shall administer the energy efficiency and sustainable technology *loan* program for the purpose of providing financing, promotion and technical support . . .") (emphasis added); VA. CODE ANN. § 15.2-958.3(B) (Supp. 2011) ("Any locality may, by ordinance, authorize contracts to provide *loans* for the initial acquisition and installation of clean energy improvements with free and willing property owners . . .") (emphasis added); Eisen, *supra* note 28, at 86 (describing PACE as more like loans).

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and two statutes even allow for an alternate secondary form of repayment known as a Loan Loss Reserve Fund (“Reserve Fund”).³⁷

The most significant difference between the various state PACE statutes is the seniority of the lien: most statutes require the lien to be senior to all other mortgages and liens, just like property taxes.³⁸

³⁷ See, e.g., OR. REV. STAT. § 470.680(3) (2009) (“An energy efficiency and sustainable technology loan must provide for repayment through an on-bill financing system unless . . . the department and the borrower specify the alternative repayment method in the loan agreement.”); VA. CODE § 15.2-958.3(B) (“The locality may combine the loan payments required by the contracts with billings for water or sewer charges, real property tax assessments, or other billings . . .”). Maine’s statute is more open-ended: “PACE assessments do not constitute a tax but may be assessed and collected by the trust, a municipality or an agent designated by the trust or a municipality in any manner allowed under the PACE program, consistent with applicable laws.” ME. REV. STAT. tit. 35-A, § 10156.1 (2010). North Carolina’s statute provides for repayment through a Revolving Loan Fund as an alternative method of secondary repayment:

Financing Assistance— A city may establish a revolving loan fund and a loan loss reserve fund for the purpose of financing or assisting in the financing of the purchase and installation of distributed generation renewable energy sources or energy efficiency improvements that are permanently fixed to residential, commercial, or other real property. A city may establish other local government energy efficiency and distributed generation renewable energy source finance programs funded through federal grants. A city may use State and federal grants and loans and its general revenue for this financing.

N.C. GEN. STAT. § 160A-459.1(b) (2009). Likewise, Hawaii’s statute provides for a reserve fund:

Reserve funds for payment of improvements. . . . As used in this section, “reserve fund” means any fund established by a county to provide security, in addition to any special fund made up of moneys collected on account of assessments and interest for improvements, for the payment of principal and interest on bonds issued for such improvements where moneys in the special fund are insufficient for this purpose.

HAW. REV. STAT. § 46-81 (1993). The federal grants referenced in the North Carolina statute can come from a variety of programs. One program in particular, the Community Development Block Grant (“CDBG”), was championed during the Clinton Administration. See Patricia E. Salkin, *Smart Growth and Sustainable Development: Threads of a National Land Use Policy*, 36 VAL. U. L. REV. 381, 394-95 (2003) (describing the Housing and Urban Development’s grant program). These grant funds can be used for “construction of public facilities and improvements, such as water and sewer facilities, streets, neighborhood centers, and the conversion of school buildings for eligible purposes; and provision of assistance to profit-motivated businesses to carry out economic development and job creation or retention activities.” *Id.* at 395.

³⁸ See, e.g., CAL. STS. & HIGH. CODE § 5898.30 (“[T]he collection of assessments [are] in the same manner and at the same time as the general taxes of the city or county on real property, and any penalties and remedies in the event of delinquency and default.”); COLO. REV. STAT. § 30-20-614 (2002 & Supp. 2010) (explaining that installments “shall be [paid at] the same . . . time[] [as] payment for installments of property taxes”); N.M. STAT. ANN. § 5-18-7.B (West 2010) (“The special assessment shall be . . . collected at the same time and in

Oregon's statute departs from the majority position by not specifying the lien's seniority.³⁹ Maine's statute makes the greatest departure from the majority position because the statute specifically requires the lien to be subordinate to preexisting mortgages and liens.⁴⁰ Many mortgage industry groups have strongly criticized the majority's senior lien position.

2. How PACE Programs Conflict with Fannie/Freddie Lending Guidelines

The most vocal opposition to PACE programs has come from the Government Sponsored Enterprises ("GSEs"): the Federal National Mortgage Association ("Fannie Mae"); the Federal Home Loan Mortgage Corporation ("Freddie Mac"); and their conservator, the FHFA.⁴¹ On

the same manner as property taxes"); WIS. STAT. § 66.0627 (2009) (explaining that the special assessment may be included as a charge on the resident's property tax bill); *see also* City of Phoenix v. Wayland, 167 P.2d 933, 934 (Ariz. 1946) (explaining that if two taxes or assessments are collected at the same time, they have the same priority).

³⁹ OR. REV. STAT. § 470.680(2)-(3) (2009).

(2) The department shall record a lien on the real property benefited by the loan for those indebtedness amounts that are not secured by a fixture filing. . . . (3) An energy efficiency and sustainable technology loan must provide for repayment through an on-bill financing system unless . . . the department and the borrower specify the alternative repayment method in the loan agreement.

Id.

⁴⁰ ME. REV. STAT. tit. 35-A, § 10156.3-3A (2010).

3. Priority. Except as provided in paragraph A, the priority of a PACE mortgage created under subsection 2 is determined based on the date of filing of notice required under subsection 2 and applicable law. A PACE mortgage is not entitled to any special or senior priority.

A. If a property owner's PACE assessment payments are current, upon the refinancing, sale or transfer of the qualifying property, other than a judicial sale or foreclosure, the PACE mortgage is junior and subordinate in priority to the first mortgage used to refinance an existing mortgage or a first mortgage of a subsequent purchaser or transferee, regardless of the date of the recording of the refinanced first mortgage or the first mortgage of the subsequent purchaser or transferee.

Id.

⁴¹ *See* Geof Koss, *Cities, Businesses Look for Help in Fight Over 'PACE' of Retrofits*, CQ TODAY (Sept. 20, 2010), <http://pacenow.org/blog/2010/09/cq-today-cities-businesses-look-for-help-in-fight-over-%E2%80%98pace%E2%80%99-of-retrofits/> (reporting that businesses and cities are urging Congress to settle the "dispute with the [FHFA]," which is hindering PACE programs); Timiraos, *supra* note 33 (reporting that the GSEs are resisting PACE programs); Woody, *supra* note 33 (reporting that the GSEs likely will not accept loans that have PACE liens). Fannie Mae and Freddie Mac are the two main "secondary mortgage market" participants. MARGARET C. JASPER, HOME MORTGAGE LAW PRIMER 8 (3d ed. 2009). The "secondary [mortgage] market" is a government created market where

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May 5, 2010, Fannie Mae and Freddie Mac issued letters warning lenders that PACE programs violate their lending standards because of the senior lien provisions.⁴² In July, the FHFA issued two lender letters warning Fannie Mae and Freddie Mac to avoid taking on loans associated with PACE programs.⁴³ The FHFA also set out specific guidelines that required future mortgages in states with PACE programs to satisfy loan-to-value (“LTV”) limits, approval requirements, increased debt-to-income ratios, and assurances that mortgages comply with state and federal laws.⁴⁴ PACE supporters responded to these criticisms through a variety of legal means.

Fannie Mae and Freddie Mac purchase “first mortgages from various lenders [which] frees the lender’s [sic] finances so that they can make additional loans.” *Id.* Fannie Mae and Freddie Mac each have unique requirements that must be met before they purchase a mortgage, but in general their requirements and conditions are very strict. *Id.* at 7–8. For another discussion of the secondary mortgage market, see Quintin Johnstone, *Land Transfers: Process and Processors*, 22 VAL. U. L. REV. 493, 515–16 (1988).

⁴² See Industry Letter from Freddie Mac to Freddie Mac Seller/Servicers (May 5, 2010), available at <http://www.freddiemac.com/sell/guide/bulletins/pdf/iltr050510.pdf> [hereinafter Freddie Mac Letter] (“[R]emind[ing] Seller/Servicers that an energy-related lien may not be senior to any Mortgage delivered to Freddie Mac.”); Lender Letter LL-2010-06 from Fannie Mae to All Fannie Mae Single-Family Sellers and Servicers (May 5, 2010), available at <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/II1006.pdf> [hereinafter Fannie Mae Letter] (advising lenders that “Fannie Mae/Freddie Mac Uniform Security Instruments prohibit loans that have senior lien status to a mortgage”).

⁴³ See July 6, 2010 FHFA Press Release, *supra* note 8 (urging state governments to reconsider the programs); Press Release from Federal Housing Finance Agency (July 14, 2010), available at http://www.fhfa.gov/webfiles/15963/PACE_ststament_7_14_10.pdf (proclaiming that the FHFA “will defend vigorously its actions that aim to protect taxpayers, lenders, Fannie Mae and Freddie Mac”) [hereinafter July 14, 2010 FHFA Press Release]. Fannie Mae, Freddie Mac and the FHFA are not the only entities concerned about PACE programs. “The Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp[oration]” are concerned that PACE loans’ “priority status . . . raises safety and soundness concerns” and that “PACE loans may be made without appropriate disclosures.” 29 No. 8 BANKING & FIN. SERVICES POL’Y REP. 34, 35 (2010). Finally, “[t]he FHFA and OCC also noted the possibility that PACE loans could affect the value of mortgage-backed securities that are based on mortgages secured by properties in places where the loans are available. This could affect secondary market participants.” *Id.*

⁴⁴ July 6, 2010 FHFA Press Release, *supra* note 8. This letter grandfathered in existing PACE loans with senior lien provisions, but made clear no new senior PACE loans would be insured. *Id.* Fannie Mae/Freddie Mac Single-Family Uniform Instrument Form 3005 requires a “[b]orrower [to] promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender.” See Letter from Chris Lynch to PACE Working Group, available at <http://pacenow.org/documents/7a.%20JH%20Lien%20Issue%20Paper%20CLN.pdf> (last visited Feb. 1, 2011) (reproducing the Uniform Instrument Form 3005 language).

B. Efforts to Resolve the Issues Through the DOE, the Courts, and Congress

PACE supporters have attempted to ease the GSEs' concerns through executive, judicial, and legislative actions. The DOE released Best Practices Guidelines, which were designed to ensure that PACE loans do not impact preexisting mortgage holders.⁴⁵ Former California Attorney General Edmund Brown filed a complaint in federal court seeking declaratory relief against the FHFA, and recently, other parties have also filed suit in federal court.⁴⁶ Finally, members of Congress introduced two bills late in the 110th Congressional Term to resolve the uncertainty.⁴⁷

1. DOE Letter to FHFA and Best Practices Guidelines

The DOE made the first attempt to ease the GSEs' concerns when it issued Best Practices Guidelines on May 7, 2010.⁴⁸ The first section of the document suggests ways for local governments to structure the programs to be more efficient for all stakeholders.⁴⁹ The second section of the document, addressing "Assessment Underwriting," suggests stringent underwriting criteria to "reduce the risk of default."⁵⁰

⁴⁵ See *infra* Part II.B.1 (explaining the DOE's Best Practices Guidelines).

⁴⁶ See *infra* Part II.B.2 (describing California's suit against the FHFA).

⁴⁷ See *infra* Part II.B.3 (explaining Congressional efforts to resolve the PACE controversy).

⁴⁸ See generally DEP'T OF ENERGY, *supra* note 30 (listing the DOE's guidelines).

⁴⁹ See *id.* at 2-5. The DOE suggested that local governments only approve cost-effective projects with assessment values of only ten percent of the property's value and an assessment term shorter than the estimated useful life of the home improvement being installed. *Id.* at 2-3.

⁵⁰ See *id.* at 5-7. Here the DOE recommended only property owners with a higher property value than the owner's combined "public and private debt" be able to qualify for PACE programs, as well as safeguards aimed at ensuring property owners be able to pay the assessment. *Id.* at 6. Members of the mortgage industry received these voluntary guidelines favorably, but expressed concern that the guidelines did not go far enough. Letter from John Courson, President & Chief Exec. Officer, Mortg. Bankers Ass'n, to Shaun Donovan, Sec'y Dep't of Hous. & Urban Dev., & Steven Chu, Sec'y Dep't of Energy (July 9, 2010) (expressing appreciation for the DOE's guidelines but noting that there are still problems with PACE loans). For an example of a PACE statute with detailed underwriting requirements, see ME. REV. STAT. ANN. tit. 35-A, § 10155.1 (2010):

A PACE agreement entered into pursuant to a PACE program must comply with underwriting requirements established by rule by the trust. . . . Underwriting requirements established by the trust must, at a minimum:

- A. Limit the amount of a PACE mortgage for qualifying property that is residential property to \$15,000;
- B. Require debt-to-income ratios of not more than 50% for qualifying property that is residential property;

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Then, on May 24, 2010, the DOE sent a letter to the Director of the FHFA asking the FHFA and GSEs to clarify their objections to PACE programs.⁵¹ The DOE also asked the FHFA to agree in writing to treat property owners with preexisting PACE assessments as compliant with the GSEs' Uniform Security Instrument provisions.⁵² Shortly after the DOE issued these guidelines, California's Attorney General filed suit against the FHFA in federal court.

2. *California ex rel Brown v. FHFA*

On July 14, 2010, California Attorney General Edmund Brown filed suit against the FHFA in the U.S. District Court for the Northern District of California.⁵³ The complaint accused Fannie Mae, Freddie Mac, and

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- C. Provide that the term of the PACE agreement not exceed the estimated useful life of the financed energy savings improvements;
 - D. Require that financed energy savings improvements are cost-effective. . . .

Id.

⁵¹ Letter from Cathy Zoi, Assistant Sec'y of Dep't of Energy, to Edward DeMarco, Acting Dir. of Fed. Hous. Fin. Agency (May 24, 2010), available at [http://www.mpowerplacerr.org/forms/L%20DOE%20Letter%20to%20Edward%20DeMarco%20Acting%20FHFA%205-24-10%20\(2\).pdf](http://www.mpowerplacerr.org/forms/L%20DOE%20Letter%20to%20Edward%20DeMarco%20Acting%20FHFA%205-24-10%20(2).pdf) [hereinafter Letter from DOE]. The letter specifically asked the FHFA to develop guidelines that PACE programs should implement to be in accordance with the GSE's lending standards. *Id.*

⁵² Letter from Cathy Zoi, *supra* note 51. The FHFA ultimately complied with this request. See *supra* note 44 (describing the FHFA's promise to grandfather in PACE loans that existed before July 6, 2010).

⁵³ See generally Brief for Plaintiff, *supra* note 36 (alleging that the FHFA is prohibiting PACE programs). Former California Attorney General Brown has long been a vocal critic of the GSEs' actions. In May, he sent a letter to the FHFA reminding Acting Director Edward DeMarco of conversations between Brown's office and the FHFA in 2009. Letter from Edmund Brown, Cal. Attorney Gen., to Edward DeMarco, Acting Dir. of Fed. Hous. Fin. Agency (May 18, 2010), available at <http://ag.ca.gov/newsalerts/release.php?id=1920&>. According to Brown, during the 2009 discussions, the FHFA assured the California Attorney General that the FHFA would work with Brown's office "on issues related to PACE." *Id.* The letter goes on to outline disruptions in PACE programs caused by Fannie Mae's and Freddie Mac's lender and industry letters. *Id.* The letter concluded by requesting immediate written confirmation from the FHFA that California's programs do not violate Fannie Mae's or Freddie Mac's lending guidelines. *Id.* If Brown did not receive such written confirmation, he threatened to file suit seeking declaratory relief. *Id.* Apparently, he never received such written confirmation because he filed suit on July 14, 2010. Brief for Plaintiff, *supra* note 36, at 2. In a press release that day, Brown explained that he decided to sue the FHFA "to stop the regulatory strangulation of the state's grass-roots program." Press Release, Cal. Attorney Gen. Edmund Brown, Brown Demands Feds Preserve an Innovative and Successful California Clean Energy Program (May 18, 2010), available at <http://ag.ca.gov/newsalerts/release.php?id=1920&>. He also sent a letter to President Obama, that same day, explaining his reasons for filing suit and urging the President "to do everything in [his] power to reverse [the FHFA's] illegal and short-sighted

the FHFA of misrepresenting PACE programs to benefit their own financial interests at the expense of California property owners.⁵⁴ California alleged that the GSEs inaccurately characterized PACE programs as loans, which would seriously harm California's PACE programs.⁵⁵ The complaint argued that PACE liens have priority over mortgages because they are valid property assessments.⁵⁶ According to the complaint, PACE senior lien provisions comply with Fannie Mae and Freddie Mac guidelines because the GSEs have historically accepted senior lien provisions in other assessment programs.⁵⁷

3. Congressional Efforts to Resolve the Standoff

Throughout the entire PACE controversy, members of Congress have been active spectators, writing letters to the President and

actions" and to provide "leadership on this most important matter." Letter from Edmund Brown, Cal. Attorney Gen., to President Barack Obama 1-2 (July 14, 2010), *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1951_ar-m355n_20100714_124838.pdf.

Five other claims have been filed in federal district court. Complaint, City of Palm Desert v. Fed. Hous. Fin. Agency, No. 4:10CV04482 (N.D. Cal. Oct. 4, 2010), 2010 WL 4236788; Complaint, Cnty. of Sonoma v. Fed. Hous. Fin. Agency, No. 4:10CV03270 (N.D. Cal. July 26, 2010); Complaint, Natural Res. Def. Council v. Fed. Hous. Fin. Auth., No. 1:10CV07467 (S.D.N.Y. Oct. 6, 2010), 2010 WL 4000042; Complaint, Sierra Club v. Fed. Hous. Fin. Agency, No. 4:10CV03317 (N.D. Cal. July 29, 2010), 2010 WL 3593758; Town of Babylon v. Fed. Hous. Fin. Agency, No. 2:10CV04916 (E.D.N.Y. Oct. 28, 2010).

⁵⁴ Brief for Plaintiff, *supra* note 36, at 2. California's complaint specifically alleges that the "government-sponsored, shareholder-owned private corporations," Fannie Mae, Freddie Mac, and the FHFA, are "misrepresenting . . . PACE programs and municipal financing." *Id.* As a result, the GSEs are putting their financial interests ahead of the well-being of California residents, according to the complaint. *Id.* More specifically, the complaint accused the GSEs of trying to change the priority of assessments from a senior lien to a junior lien "for their own benefit in violation of California law." *Id.* at 8. As a result, the GSEs' opposition to PACE programs has "severely hamper[ed] California's efforts to assist thousands of California homeowners to reduce their energy and water use, help drive the state's green economy, and create significant numbers of skilled, stable and well paying jobs." *Id.* at 2.

⁵⁵ *Id.* at 3. The complaint noted that the FHFA acknowledged that its public statements have "effectively stopp[ed] PACE programs . . . with no clear indication of when, if ever, such programs would be allowed to move forward in the future." *Id.*

⁵⁶ *Id.* The complaint additionally seeks a declaration that the FHFA must "conduct [an] environmental review under [the National Environmental Policy Act] before taking any action that will limit or foreclose PACE in California." *Id.*

⁵⁷ *See id.* at 5-6 (asserting that "[u]nder the plain language of California law, any liens that result from PACE assessments have priority over mortgages, operating in the same way as other assessments"). Municipal corporations are authorized to set up PACE programs pursuant to the Mello-Roos Act, CAL. GOV. CODE § 5331, "which has been in existence since 1982." Brief for Plaintiff, *supra* note 36, at 5-6. *But see* Eisen, *supra* note 28, at 86 (describing PACE programs as "more like . . . lending program[s] and less like . . . a tax").

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introducing bills, but taking no definitive action.⁵⁸ In October 2009, Congressman Steve Israel introduced a bill in the House of Representatives to help homeowners obtain private financing for energy retrofits.⁵⁹ Congress became more active as the standoff between PACE supporters and the GSEs came to a head in the summer of 2010.

Congressman Mike Thompson and Senator Barbara Boxer, both from California, introduced identical bills in the House and Senate to amend Fannie Mae's and Freddie Mac's underwriting standards to comply with the DOE's PACE guidelines.⁶⁰ Under the proposed legislation, any lien provisions that complied with the DOE's standards would automatically comply with Fannie Mae's and Freddie Mac's Uniform Instruments.⁶¹ The bills prohibit the GSEs from requiring homeowners to repay PACE liens before being able to refinance or dispose of their property.⁶² Under

⁵⁸ See Letter from Congress to President Barack Obama (July 19, 2010), available at <http://www.seia.org/galleries/pdf/PACE%20Letter%20to%20President%20Obama%207.19.10.pdf> (expressing strong Congressional support for PACE programs). See generally H.R. 5766, 111th Cong. (2d Sess. 2010) (proposing "[t]o ensure that the underwriting standards of Fannie Mae and Freddie Mac facilitate the use of property assessed clean energy programs"); S. 3642, 111th Cong. (2d Sess. 2010) (proposing a plan identical to the plan set forth in H.R. 5766); H.R. 3836, 111th Cong. (1st Sess. 2009) (proposing "[t]o authorize the Secretary of Energy to provide credit support to enhance the availability of private financing for clean energy technology deployment").

⁵⁹ See H.R. 3836 (enabling the Secretary of Energy to provide credit to homeowners for these projects). The bill was referred to the House Energy and Commerce Committee on October 15, 2009, and the Committee has taken no further action. *Bill Summary & Status 111th Congress (2009-2010) H.R. 3836*, LIBRARY CONG.: THOMAS, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:h.r.03836:#> (last visited Oct. 15, 2011).

⁶⁰ H.R. 5766; S. 3642. In a press release from Senator Barbara Boxer's office, Boxer described the current uncertainty as "unacceptable," while Senator Jeff Merkey of Oregon described PACE programs as "a job creation trifecta" because these programs save homeowners and businesses money, create jobs, and support the development of clean energy. Press Release, Senator Barbara Boxer, Boxer, Colleagues Introduce Legislation to Protect Clean-Energy Initiatives (July 22, 2010), available at <http://boxer.senate.gov/en/press/releases/072210.cfm>. According to the release, the bill requires Fannie and Freddie to "adopt new, sound underwriting standards that support PACE financing programs, rather than stymie them [and] treat PACE assessments the same as other property tax assessments . . ." *Id.* The Senate version has four co-sponsors, while the identical House version has twenty co-sponsors. *Id.*

⁶¹ H.R. 5766; S. 3642. The bills explain that:

Liens or other property obligations that secure property taxes or assessments under a PACE program and are consistent with such standards shall be considered to comply with the Uniform Instruments of such Association and Corporation and shall not constitute a default on an existing mortgage or trigger the exercise of lender's remedies for a property with such a lien.

Id.

⁶² See H.R. 5766; S. 3642 (stipulating that "the Association and the Corporation shall not require repayment of a PACE program tax or assessment in order for a property owner to finance, refinance or transfer the property").

these bills, if a property owner becomes delinquent in his or her PACE payments, the property owner only owes “the unpaid delinquent amount along with applicable penalties, interest and costs” in a foreclosure.⁶³ Finally, the bill prohibits the GSEs from implementing different lending criteria for communities with PACE programs and communities without PACE programs.⁶⁴

Though these two bills represented Congress’s strongest attempt to resolve the PACE controversy, they did not become law before the Congressional term ended; each had only a small number of co-sponsors, and neither made it out of committee.⁶⁵ The inadequacy of these solutions becomes apparent when examining the policy behind municipal financing and tax liens.

C. *The Relationship Between Bonds and Tax Liens*

While local governments typically issue bonds to finance improvements in special assessment districts, they can only use bonds to finance public projects, and the bonds must finance capital improvements.⁶⁶ Even if the bond results in a private gift, the bond can still be for a public purpose; thus, it can still be a valid exercise of a

⁶³ H.R. 5766; S. 3642. This is also a provision in the DOE’s Best Practices framework. DEP’T OF ENERGY, *supra* note 30, at 3 (suggesting that local governments utilize non-acceleration clauses so that the defaulting owner only has to pay the delinquent amount, not the total amount, of a PACE lien in a foreclosure). According to the DOE, non-acceleration clauses are an important tool to protect mortgage holders because of the limited liability in a mortgage. *Id.* Under these provisions, subsequent property owners must make future PACE lien payments. *Id.*

⁶⁴ See H.R. 5766; S. 3642 (prohibiting the FHFA, Fannie Mae, and Freddie Mac from “discriminat[ing] against communities implementing or participating in a PACE program, including by prohibiting lending within the community or requiring more restrictive underwriting criteria for properties within the community”).

⁶⁵ See *Bill Summary & Status 111th Congress (2009–2010) H.R. 5766*, LIBRARY CONG.: THOMAS, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR05766:|/home/LegislativeData.php|#> (last visited Oct. 15, 2011) (listing fifty-six cosponsors, and reporting that the last major action occurred on July 15, 2010 when the bill was referred to the House Financial Services Committee); *Bill Summary & Status 111th Congress (2009–2010) S.3642*, LIBRARY CONG.: THOMAS, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:SN03642:|/home/LegislativeData.php> (last visited Oct. 15, 2011) (listing five cosponsors, and reporting that the last major action occurred on July 22, 2010 when the bill was referred to the Senate Banking, Housing, and Urban Affairs Committee).

⁶⁶ See WHITE, *supra* note 6, at 8 (explaining that bonds can only finance public projects, not private gifts). Further, “prohibitions against gifts and loans of credit to individuals and private corporations are the most frequently noted state constitutional limitations affecting municipal bond issuance.” *Id.*; see also CAL. STS. & HIGH. CODE § 5101 (West 2007) (authorizing bond financing for “any . . . streets, places, public ways, or property, easements, or rights-of-way”); N.Y. LOCAL FIN. § 24.00 (McKinney 2009) (authorizing bond financing, termed “tax anticipation notes” for water lighting or refuse and garbage district).

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municipality's financing powers.⁶⁷ Both prohibitions have the same general intent: to prevent taxpayers from having to pay for a bond long after the benefit has gone away.⁶⁸

Aside from these general limitations on bond issues, each particular type of municipal bond is subject to a unique set of limitations.⁶⁹ While municipalities may issue revenue bonds, general bonds, and special assessment bonds, only special assessment bonds and mortgage-backed revenue bonds are relevant to the discussion of PACE programs.⁷⁰ Local governments can issue assessment bonds with senior lien repayment provisions under their assessment authority.⁷¹ The distinction between junior and senior liens is essential to understanding the controversy surrounding PACE programs.

The difference between a senior and junior interest is crucial in determining what a mortgagee or lien holder will receive in a foreclosure

⁶⁷ WHITE, *supra* note 6, at 8. For example, a municipality can "use . . . bond proceeds to enable a private corporation to install pollution control equipment in its manufacturing enterprise . . . because the public purpose is satisfied." *Id.* The public purpose requirement originates from municipalities' early experiences with railroad bonds. *Id.* When a railroad failed, the taxpayers still had to pay the debt from the railroad bond, even though the purpose for which the bond had been raised no longer existed. *Id.*

⁶⁸ See *id.* (explaining that the prohibition of private gifts and requirement of capital improvements lessen the chances that taxpayers will have "to pay for something nonexistent"). Without these requirements, "the burden of bond payment may outweigh the benefit of enjoyment of the service or facility." *Id.*; see also *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032, 1045-46 (Wash. 1987) (noting that residents in a Washington town had to pursue damages against a municipality through various tort and securities law claims after the power utility cancelled a nuclear power plant construction project). The project in *Haberman* never should have been financed through municipal bonds because the power utility engaged in deceptive and fraudulent representations. *Id.* Similarly, in *Ross v. Bank South, N.A.*, developers convinced Vestiva Hills, Alabama to back a bond issuance aimed at raising funds to construct "a residential and medical facility for the elderly." 885 F.2d 723, 726 (11th Cir. 1989). Investors were forced to sue the issuing authority on various federal and state securities law grounds as well as tort law grounds when they lost money because the value of the project was far below the original \$29,950,500 value of the bonds. *Id.* at 725. Finally, in *Ockerman v. May Zima & Co.*, May Zima & Company "publicly sold Mortgage Revenue Bonds issued by the City of Bowling Green, Kentucky, for \$5,500,000.00 . . . to acquire . . . a retirement village in Bowling Green, Kentucky." 27 F.3d 1151, 1153 (6th Cir. 1994). They were forced to sue the issuers under federal securities laws. *Id.* at 1154. In each of these situations, the burden of paying the bonds outweighed the benefit to the public.

⁶⁹ See WHITE, *supra* note 6, at 10 (describing the types of projects that each type of municipal bond may finance and the requirements that must be met before each type of bond can be used).

⁷⁰ See *id.* at 10-11 (noting that "mortgage-backed bonds[] are of particular interest to solar facility financing").

⁷¹ See *id.* (explaining local governments' bond authority).

sale.⁷² When a financial institution forecloses one interest, only interests junior to it are foreclosed.⁷³ In a foreclosure, the property is sold and the sale price is used to satisfy the senior mortgage.⁷⁴ If there is money left, that surplus satisfies junior liens in order of their priority.⁷⁵ These junior

⁷² See RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.4 (1997) (describing the difference between junior and senior liens). All junior mortgages and liens are referred to as “secondary financing.” JASPER, *supra* note 41, at 7 (internal quotation marks omitted). A party holding junior debt will not be fully protected in the event of a foreclosure. See Symposium on Commercial Law, *Foreclosure, Loss, and the Proper Distribution of Insurance Proceeds Under the Open and Standard Mortgage Clauses: Some Observations*, 7 VAL. U. L. REV. 485, 486 (1973) (“The mortgagee’s interest under the policy extends only to a security for his debt, and such interest ceases when the debt is extinguished.”). “A foreclosure of the mortgaged property . . . therefore, totally extinguish[es] the interest.” *Id.*

⁷³ See *Sumitomo Bank v. Davis*, 6 Cal. Rptr. 2d 381, 385 (Cal. Ct. App. 1992) (explaining that a foreclosure sale “removes liens . . . junior to the one being foreclosed”); see also RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.1 (1997) (noting that “a valid foreclosure” of a senior mortgage eliminates all junior mortgages and liens but not senior mortgages or liens); MILTON R. FRIEDMAN, *FRIEDMAN ON CONTRACTS AND CONVEYANCES OF REAL PROPERTY* § 3.163 (James Charles Smith ed., 2010) (explaining that junior interests often contain a clause stipulating that “any default in the first mortgage shall, ipso facto, constitute a default in the junior mortgage and permit its foreclosure”). Comment a explains that in general mortgage and lien seniority is “determined by the chronological order of their creation.” RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.1 cmt. a (1997).

⁷⁴ See *General Bank v. Westbrooke Pointe, Inc.*, 548 So. 2d 736, 736 (Fla. Dist. Ct. App. 1989) (noting the well established Florida principle that any surplus from a foreclosure should be distributed to “junior lienholders” based on the junior lien’s priority); see also RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.4 (1997) (“When the foreclosure sale price exceeds the amount of the mortgage obligation, the surplus is applied to liens and other interests terminated by the foreclosure in order of their priority and the remaining balance, if any, is distributed to the holder of the equity of redemption.”); JASPER, *supra* note 41, at 7 (explaining that junior mortgages and liens have high risk because the lender only has a property interest in the surplus after all prior mortgages have been satisfied). If the property owner does not have enough equity in the property to cover all senior mortgages and junior liens, the junior lien holders will not receive any compensation in a foreclosure. *Id.* “[E]quity” is defined as “the difference between the current market value of the property and the total debt obligations against the property, including any prior mortgage loans.” *Id.* In determining a property’s equity, lenders look at the property’s LTV, which is calculated by “divid[ing] the total loan amount by the value of [the] home.” *Id.* at 43–44. Each additional mortgage or lien increases the property’s LTV, which increases the likelihood that the mortgages will not be repaid. *Id.* at 44.

⁷⁵ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.4 cmt. a (1997); see also JASPER, *supra* note 41, at 85–86 (noting that a “foreclosure . . . put[s] the foreclosure sale purchaser in the shoes of the borrower at the time he executed the mortgage being foreclosed”); GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* 696 (5th ed. 2007) (“[T]he surplus represents the remnant of the equity of redemption . . . [and] [c]onsequently . . . stands in the place of the foreclosed real estate and the liens and interest that previously attached to that real estate now attach to the surplus.”). People who held interests in the land are “paid out of the surplus in the order of priority they enjoyed prior to foreclosure.” *Id.* at 697.

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liens are paid in the same order of priority as before the foreclosure.⁷⁶ A property owner can change the order of priority by subordinating a mortgage to another lien, but in general, the person whose interest is being subordinated must consent to the change.⁷⁷ Subordination is usually disadvantageous to the holders of senior interests.⁷⁸

The difference between junior and senior liens also affects the bond's rating.⁷⁹ Bonds with subordinate or junior repayment provisions are termed "junk bonds" because they are less likely to be repaid.⁸⁰

⁷⁶ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.4 cmt. b (1997). Also, "foreclosed junior lienors are entitled to surplus even though their liens are not in default at the time of foreclosure." *Id.* Finally, the claim of the holder of the foreclosed equity of redemption to the surplus is subordinate to the claims of all other holders of liens and interests terminated by the foreclosure. *Id.*; see also *Brown v. Crookston Agric. Ass'n*, 26 N.W. 907, 907 (Minn. 1886) (explaining that once a property is foreclosed, "the junior mortgagee is transferred . . . to the surplus of the money arising from the sale . . . [and] the court will apply the [surplus] in accordance with their rights as they existed with respect to the land").

⁷⁷ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.7 (1997).

A mortgage, by a declaration of its mortgagee, may be made subordinate in priority to another interest in the mortgaged real estate . . . if the interest to which the mortgage is being subordinated is described with reasonable specificity in the declaration. A subordination that would materially prejudice the mortgagor or the person whose interest is advanced in priority is ineffective without the consent of the person prejudiced.

Id.; see also THOMAS D. CRANDALL ET AL., THE LAW OF DEBTORS AND CREDITORS § 8.09(2)(b) (1991) (describing the two methods of subordination).

⁷⁸ See RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.7 cmt. a (1997) (explaining that subordination "reduce[s] the mortgage's priority below that of some other interest . . . to which the mortgage would otherwise be superior"); see also CRANDALL, *supra* note 77, § 8.09(2)(a) (noting that lenders will hesitate to lend if the property is already subject to a senior interest because of "the legitimate concern of the potential lender that his later-in-time mortgage may be subordinate to an existing interest").

⁷⁹ See Georgette C. Poindexter et al., *Selling Municipal Property Tax Receivables: Economics, Privatization, and Public Policy in an Era of Urban Distress*, 30 CONN. L. REV. 157, 171 (1997) (explaining that a lien's priority is its "determinative and crucial factor" in assessing the value of the lien because "[a]n inferior lien . . . is of less value to the purchaser" since these liens are satisfied only after all superior liens have been satisfied). See generally Johnstone, *supra* note 41, at 516 (explaining that lenders will take secondary market purchasers' preferences into account when making a loan, which means that "resale marketability is usually a consideration during the mortgage loan origination stage").

⁸⁰ See WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 244 (6th ed. 2008) (explaining that Moody's and Standard & Poor's rate an issuing entity's "likelihood of default"). Under Standard & Poor's rating system, "rates [range] between AAA and D (default), [where] [j]unk is below BBB." *Id.*; see also *Fitch Affirms Cape Coral, FL's Outstanding Water & Sewer Revs, BANs & Special Assessment Debt*, BUSINESSWIRE (May 27, 2010, 5:47 PM), <http://www.businesswire.com/news/home/20100527006879/en/Fitch-Affirms-Cape-Coral-FLs-Outstanding-Water> (reporting on two Cape Coral Florida bond issues, one which was rated A+, and the other was rated BBB+). The A+ rated bond had a senior lien payback provision but the BBB+ rated bond had a subordinate repayment

Investors often hesitate to invest in these junk bonds because they are not guaranteed a return on their investment.⁸¹ Conversely, investors willingly invest in bonds with senior repayment provisions, typically referred to as AAA or AA bonds, because they are fairly certain to receive a return on their investment.⁸² Since AAA or AA bonds are much more likely to attract investors than junk bonds, programs with senior lien provisions are more likely to successfully finance the proposed improvement.⁸³ This means that a bond's value is directly related to a lien's priority.

While mortgage or lien priority is generally determined by the "first in time, first in right" principal, there are several important exceptions.⁸⁴

provision. *Id.* But see *Fitch Rates Bay Area Toll Bridge, CA Seismic Bonds 'AA'*, FREE LIBRARY (July 24, 2003), <http://www.thefreelibrary.com/Fitch+Rates+Bay+Area+Toll+Bridge,+CA+Seismic+Bonds+'AA'.-a0105782041> (reporting on a plan in California to make two bond issues, one with a senior lien priority and one with a junior lien priority to finance bridge upgrades). The California plan's second lien priority is significant because it shows that junior liens are a feasible means of raising revenue. *Id.*

⁸¹ See STANDARD & POOR'S, *THE TIME DIMENSION OF STANDARD & POOR'S CREDIT RATINGS* 11 (2010), available at <http://www2.standardandpoors.com/spf/pdf/media/TheTimeDimensionOfStandardPoorsCreditRatings.pdf> (explaining that "rating definitions are phrased in terms of an obligor's capacity to meet its financial commitment") (internal quotations omitted); see also STONE & YOUNGBERG, *LAND-SECURED MUNICIPAL DEBT: A GUIDE TO BUYING NON-RATED, LAND-SECURED BONDS* 3 (2007) (urging investors to invest in land-secured bonds if "[t]he value of the land being taxed [or] assessed is at least three times the bond lien" to "offset credit weaknesses" inherent in land-secured municipal financing).

⁸² STANDARD & POOR'S, *supra* note 81, at 11 ("The actual language of the definitions uses different adjectives . . . to describe the obligor's capacity as follows: 'AAA' (extremely strong), 'AA' (very strong), 'A' (strong), and 'BBB' (adequate)."). The S&P guidelines break down the obligor's ability to pay into four categories. See *id.*

⁸³ See *Urbish v. City of Dallas*, 260 S.W.2d 148, 150 (Tex. App. 1953) (explaining that if municipal bonds are offered with junior lien repayment provisions, the government's purpose behind issuing the bonds would not be funded); see also Letter from Chris Moriarty, Dir., & John Rhoads, Senior Vice President, Barclays Capital, to Jeffrey Tannenbaum, Fir Tree Partners (Sept. 14, 2009), available at http://pacenow.org/documents/Pace%20letter%20sept%202009%20re%20liens%20_2_%20_2_%20-%20Barclays%20209-14-09%20_3_.pdf [hereinafter *Barclay's Letter*] (arguing that Standard and Poor's rating system applies to PACE bonds and that junior PACE liens would generate "little to no meaningful bond buyer interest").

⁸⁴ The "'first in time, first in right" principle means that "[t]he first lien recorded generally gets priority over later-recorded liens." SCHMUDDE, *supra* note 8, at 307; see CRANDALL ET AL., *supra* note 77, § 8.09(b) (noting that "'first in time, first in right' is the basic priority rule regarding interests in real estate, including mortgages"); JASPER, *supra* note 41, at 86 (explaining that the "first in time, first in right" priority is "established by compliance with the recording acts"); see also *Vesta Holdings I, LLC v. Tax Comm'r of Fulton Cnty.*, 578 S.E.2d 293, 295 (Ga. Ct. App. 2003) (explaining that the "first in time, first in right" principle applies to "mortgages . . . and nontax liens"); *Pelican Homestead & Sav. Ass'n v. Sec. First Nat'l. Bank*, 532 So. 2d 397, 400 (La. Ct. App. 1988) (holding that "[t]he priority of competing mortgages" is determined by when the mortgages were filed and not

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PACE supporters argue that PACE programs fall within one exception, the tax lien.⁸⁵ State legislatures have the power to create tax liens and determine their priority relative to that of other types of liens and property interests, even if the tax lien was created after other property interests came into existence.⁸⁶ While a state may give a tax lien any

by the parties' intent); *Valley Fed. Sav. & Loan Ass'n. v. T-Bird Home Centers, Inc.*, 741 P.2d 826, 828 (N.M. 1987) (holding that T-Bird's lien is senior because T-Bird's workers began work before Valley Federal's mortgage was recorded). This rule "applies to resolving . . . priority disputes between mortgages, [and] to disputes between a mortgagee and another form of interest." CRANDALL ET AL., *supra* note 77, § 8.09(b). *But see* RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.1 cmt. a (1997) (noting that the "first in time, first in right" rule "is subject to a multitude of limitations"). Priority rules developed in the English colonies and in the early years of the American Republic. *See* George Lee Flint, Jr. & Marie Juliet Alfaro, *Secured Transactions History: The Impact of English Smuggling on Chattel Mortgage Acts in the Spanish Borderlands*, 37 VAL. U. L. REV. 703, 755-56 (2003) (examining early recording statutes that "were mandatory for realty mortgages" that mandated "priority by time of filing"). Indeed, the "first in time, first in right" principle was so well-settled in American property law, that Chief Justice John Marshall "believed [it] to be universal" only a half-century after the founding of the Republic. *Rankin & Schatzell v. Scott*, 25 U.S. 177, 179 (1827). "[A] prior lien gives a prior claim" and "[i]t has never been supposed that a subsequent mortgage could . . . obtain precedence over a prior mortgage." *Id.*

⁸⁵ *See* DeVries & Lynch, *supra* note 5, at 6 (arguing that these "programs are a legal exercise of the municipal taxing power"). According to PACE proponents, the liens imposed by these programs are valid tax assessment liens. *Id.*

⁸⁶ *See* EUGENE MCQUILLIN, *THE LAW OF MUNICIPAL CORPORATIONS* § 44.142 (3d ed. 2011) (noting that "[T]he legislature has the full power to determine and fix the priority of tax liens [and] has unquestioned power to make these liens prior and superior to other liens and encumbrances"); *see also In re Boerne Hills Leasing Corp.*, 15 F.3d 57, 59 (5th Cir. 1994) (holding that state taxing entities' liens are senior to other creditors' liens); *City of Phoenix v. Wayland*, 167 P.2d 933, 934 (Ariz. 1946) (explaining that the state "[l]egislature has full power" to make tax liens senior to all other liens "[u]nless restricted by the state Constitution"); *ITT Diversified Credit Corp. v. Couch*, 669 P.2d 1355, 1362 (Colo. 1983) (noting that the state legislature has the power to "establish the relative priority of tax liens"); *Vesta Holdings I, LLC*, 578 S.E.2d at 294-95 (holding that the legislature has the power to rank tax liens ahead of other types of mortgages and liens); *Baldwin v. Moroney*, 91 N.E. 3, 5 (Ind. 1910) (explaining that the state legislature can impose assessment liens superior to "pre-existing mortgages"); *Licking v. Hays Lumber Co.*, 19 N.W.2d 148, 150 (Neb. 1945) (explaining that tax lien priority is determined by "local constitutions and statutes" and legislatures can make such liens senior to any preexisting liens or mortgages); *First NH Bank v. Town of Windham*, 639 A.2d 1089, 1091 (N.H. 1994) (noting that tax liens may become "superior encumbrances" either by express or implied statutory provisions); *State ex rel. Comm'r Land Office v. Passmore*, 115 P.2d 120, 121 (Okla. 1941) (describing tax liens as "creatures of the [state] Constitution or statutes"); *Union Cent. Life Ins. Co. v. Black*, 247 P. 486, 487 (Utah 1926) (explaining that the state legislature can make a tax lien superior to "all other liens of whatsoever nature"); *Bd. of Cnty. Comm'rs v. Bench Canal Drainage Dist.*, 108 P.2d 590, 593 (Wy. 1940) (explaining that the state legislature has the power to fix the priority of assessment liens); 72 AM. JUR. 2D *State and Local Taxation* § 806 (2001) ("Statutes may make tax liens a first lien upon the property of the taxpayer, giving them priority over a mortgage or any other lien existing against the property, whether

priority, state statutes usually give municipal tax liens a senior lien position because this is the only way that local governments can collect the money from the property owner.⁸⁷

created before or after the assessment of the tax.”); 72 AM. JUR. 2D *State and Local Taxation* § 798 (2001) (pointing out that the priority of tax liens is determined by “local constitutions and statutes”). *But see Wayland*, 167 P.2d at 934 (explaining that tax or assessment liens from different state entities (i.e. state taxes and county taxes) only have the equal priority if “they are all collected together at one time,” otherwise the tax collected later is junior to the tax collected earlier).

⁸⁷ See *Scottish Am. Mortgage Co., Ltd. v. Minidoka Cnty.*, 272 P. 498, 500 (Idaho 1928) (explaining that if tax liens were not senior to all other liens, “the state would be powerless to collect her revenue” since other liens often exceed the property’s value); *Minneapolis Threshing Machine Co. v. Roberts Cnty.*, 149 N.W. 163, 164 (S.D. 1914) (“It is essential, in order that the state may collect its revenue and carry on the public business, to make such a tax a paramount lien . . .”); *Urbish*, 260 S.W.2d at 150 (explaining that tax or assessment liens exist to ensure that a governmental project is properly financed); 72 AM. JUR. 2D *State and Local Taxation* § 806 (2001) (maintaining that a senior tax lien is constitutional, and “essential, in order that the state may collect its revenue and carry on the public business . . .”); see also *Freeman Furniture Factories v. Bowlds*, 136 F.2d 136, 140 (6th Cir. 1943) (explaining that only “state and county taxes . . . and prior improvement taxes” are senior to local assessments) (internal quotation marks omitted); *Cal. Loan & Trust Co. v. Weis*, 50 P. 697, 698 (Cal. 1897) (validating the legislature’s power to impose senior assessment liens); *Horn v. City of Miami Beach*, 194 So. 620, 624 (Fla. 1940) (holding that lawful tax liens create a lien senior “to all other liens”); *Riviera Club v. Belle Mead Dev. Corp.*, 194 So. 783, 785 (Fla. 1939) (holding that mortgage rights must be junior to “proper and lawful taxes”); *City of Lake Worth v. McLeod*, 151 So. 318, 319 (Fla. 1933) (explaining that “municipal special assessments” and state statutory tax liens only have the same priority if the state statute explicitly provides so); *Wabash E. Ry. Co. v. Comm’rs of E. Lake Fork Special Drainage Dist.*, 25 N.E. 781, 785 (Ill. 1890) (explaining that a purchaser and lender enter into a mortgage with notice that local governments have an implied right to create liens senior to their mortgage); *Joe Self Chevrolet, Inc. v. Bd. of Cnty. Comm’rs*, 802 P.2d 1231, 1240 (Kan. 1990) (noting that state legislatures may make tax liens senior to other liens or mortgages since the priority is “determined by the constitution and statute”); *Rosenthal v. Floor Coverings, Inc.*, 73 So. 2d 39, 41 (La. Ct. App. 1954) (noting that the tax collector can demand payment of delinquent taxes before payment of other debts); *Collector of Taxes of Lowell v. Slafsky*, 127 N.E.2d 309, 312 (Mass. 1955) (explaining that tax payments are supposed to be paid before payments to creditors); *Krull v. Bennett Homes & Lumber Co.*, 258 A.D. 10, 13 (N.Y. App. Div. 1939) (explaining that courts must look at state statutes when determining whether municipal tax liens have the same priority as state tax liens); *Dunkirk Trust Co. v. Dunkirk Laundry Co.*, 182 N.Y.S.2d 381, 383 (Chautauqua County Ct. 1959) (explaining that New York statutes stipulate that “local taxes, assessments and water rates” are senior to other liens); *Pope v. Knoxville Indus. Bank, Inc.*, 121 S.W.2d 530, 532 (Tenn. 1938) (reversing a lower court ruling which “den[ie]d priority in payment of the tax debt”); *Herbert C. Heller & Co. v. P. O. Duncan*, 159 S.E. 52, 53 (W. Va. 1931) (holding that both paving liens and sewer liens are senior to other liens); Poindexter, *supra* note 79, at 157 (explaining that tax liens “usually have super priority over all other liens except those imposed by the federal or state government”). Additionally, real estate taxes are extremely efficient, in large part because the first priority position of property taxes “virtually ensur[es] that it can be paid from the proceeds of the sale of the property.” SCHMUDDE, *supra* note 8, at 263.

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In recent years, many local governments have privatized their collection of real estate taxes, which serves to make the collection even more efficient and to ensure that local governments “efficiently collect their real estate taxes.”⁸⁸ The ultimate resolution of these financial and legal disputes depends on whether PACE programs can be classified as property tax assessments with senior lien status.⁸⁹

D. The Specific Elements of a Valid Special Assessment District

A valid property assessment must meet several elements: For instance, it must serve a public purpose and must provide a local improvement.⁹⁰ The improvement must also benefit the public at large,

⁸⁸ SCHMUDDE, *supra* note 8, at 264. This process is known as “tax farming” and is now used in most U.S. jurisdictions. *Id.* This process allows municipal corporations to hold a first priority lien on property with delinquent taxes, and sell the lien to an investor. *Id.* The investor must pay cash for the lien and then either collects delinquent money from the property owner or forecloses on the property. *Id.* In exchange, the municipal corporation is able to shift the collection and foreclosure burden to a third party and receive full payment for the debts owed. *Id.*

⁸⁹ See *infra* Part III (analyzing whether PACE programs satisfy the requirements of valid property assessments).

⁹⁰ See *Ruel v. Rapid City*, 167 N.W.2d 541, 544 (S.D. 1969) (explaining that local governments use special assessments to raise funds for a specific “municipal purpose,” and as a result, only apply the assessment to a specific portion of the municipality). Special assessments have the same practical effect as taxes, but are not, in a legal sense, taxes. FRIEDMAN, *supra* note 73, § 4.73; see also *In re Peplinski’s Estate*, 39 A.2d 271, 274 (Pa. Super. Ct. 1944) (explaining that assessments “are not taxes in a strict sense of the word”); 70C AM. JUR. 2D *Special or Local Assessments* § 2 (2010) (explaining that while the terms “tax” and “assessment” are often used interchangeably, they are not the same). An assessment is a “distribution of a burden that would otherwise be imposed on the public.” 70C AM. JUR. 2D *Special or Local Assessments* § 2 (2010). Additionally, an assessment is a “specific levy designed to recover the costs of improvements that confer local and peculiar benefits upon property within a defined area.” *Id.* The bond must finance “an improvement that confers a general benefit upon the public at large within the assessing entity [and] must . . . support . . . an improvement that confers a special benefit upon the individual properties assessed.” WHITE, *supra* note 6, at 15; see also *Lipscomb v. Lenon*, 276 S.W. 367, 368 (Ark. 1925) (explaining that the improvement must “peculiarly and especially benefit[]” property in the district); *Bank v. Bell*, 217 P. 538, 543 (Cal. 1932) (explaining that legislatures have discretion in defining a public purpose); *Daggett v. Colgan*, 28 P. 51, 52 (Cal. 1891) (explaining that the legislature must decide “what is for the public good, and what are public purposes”); *City of Waukegan v. DeWolf*, 101 N.E. 532, 533 (Ill. 1913) (explaining that an assessment must primarily provide a public improvement for the specific residents of the district, though it may provide an incidental benefit for the general public as well). In *Saunders v. Mayor of Arlington*, the Georgia Supreme Court reasoned that if the city’s maintenance of an ice plant was “for the public good” it could be upheld. 94 S.E. 1022, 1024 (Ga. 1918). The Georgia Supreme Court upheld the public financing of an ice plant because the installation of such a plant clearly benefits the “health and comfort of the citizens.” *Id.* Another example of a local improvement is the installation of utility poles. *Ewart v. Vill. of W. Springs*, 54 N.E. 478, 480 (Ill. 1899). A tax, on the other hand, “is

and not just the property owner, to meet the public purpose test.⁹¹ Additionally, assessments can only be applied to lands that receive special benefits.⁹² The benefits must be based on something more than

an enforced contribution to provide for the support of government. *United States v. La Franca*, 282 U.S. 568, 572 (1931); *see also* *U.S. v. Reorganized CF&I Fabricators of Utah*, 518 U.S. 213, 224 (1996) (applying the definition in *La Franca* to a case dealing with the federal Bankruptcy Code). The debate over the definition of a tax is playing out in the federal courts as part of the legal challenge to the Affordable Care Act. *See* *Thomas More Law Center v. Obama*, No. 10-2388, 2011 WL 2556039, at *20 (6th Cir. June, 2011) (applying the *La Franca* definition to hold that the disputed provision is not a tax).

⁹¹ *Halsted v. Sacramento*, 52 Cal. Rptr. 637, 642 (Cal. Ct. App. 1966); *see also* *City of Whittier v. Dixon*, 151 P.2d 5, 7 (Cal. 1944) (holding that an assessment to finance construction of parking lots is a public improvement because parking lots benefit neighboring properties by leading to economic development in the assessed community); *Irish v. Hahn*, 281 P. 385, 387 (Cal. 1929) (holding that a municipality's installation of underground conduits for electric wires was a public improvement, and citing precedent cases which held construction of a tunnel and construction of lights for a trolley as public improvements); *City of Edwardsville v. Jenkins*, 33 N.E. 2d 598, 601 (Ill. 1941) (holding that improvement of a sewer system was a public improvement); *Hamilton v. Portland Pier Site Dist.*, 112 A. 836, 840 (Me. 1921) (explaining that a municipality could finance the construction of a *public* dock, but could not finance the construction of a *private* dock); *Hinman v. Temple*, 274 N.W. 605, 607 (Neb. 1937) (holding that construction of a viaduct over a busy railroad right of way is a public benefit). In *Hamilton*, the Maine Supreme Court held that South Portland, Maine could finance the construction of a public dock because the dock would benefit the local community by allowing businesses to transport goods from the highway to a shipping line by water. *Hamilton*, 112 A. at 840. The court distinguished such docks from purely private docks where "[t]he owner . . . may have the right to the exclusive enjoyment of the structure, and to exclude all other persons from its use." *Id.* (internal quotations omitted). Although the Maine statute in question allowed South Portland to finance public and private docks, the court only invalidated that provision, while allowing the municipality to continue financing public docks. *Id.*

⁹² *See Halsted*, 52 Cal. Rptr. at 642 (reasoning that property assessments are based on the theory that the property owner receives a benefit from the improved property); *Dixon*, 151 P.2d at 7 (holding that assessed property must receive a special benefit). Further, an assessment can only be applied to a piece of property if the property is actually benefited. *Halsted*, 52 Cal. Rptr. at 642. The court noted, however, that the assessment will possibly satisfy the benefit requirement if "the property can be presumed to have received an especial benefit" from the work completed. *Id.* (emphasis omitted); *see also* *Martin v. Dist. of Colombia*, 205 U.S. 135, 140 (1907) (explaining that "the apportionment is to be limited to the benefit"); *Baldwin v. Moroney*, 91 N.E. 3, 5 (Ind. 1910) (reasoning that property owners take property with the understanding that the local government may impose a burden on the property to pay for improvements that provide a special benefit to the property); *Fisher v. City of Astoria*, 269 P. 853, 856 (Or. 1928) (explaining that an improvement must "substantial[ly] benefit" a property before a local government can impose an assessment); *In re Peplinski's Estate*, 39 A.2d at 274 (Assessments "are based on a theory of special benefit to the property against which the assessments are levied"); *Ruel*, 167 N.W.2d at 545 (local governments make special assessments if the assessed property receives a special benefit); MCQUILLIN, *supra* note 86, § 38.37 (explaining that in general only property receiving a benefit may be assessed). The Oregon Supreme Court reasoned that an assessment will be valid if it primarily benefits the district and incidentally benefits the entire city, but will not

speculation, but it is not necessary that the property directly benefit from the assessment.⁹³

Furthermore, assessment values cannot account for a large proportion of the property's value, nor can they be disproportionately larger than other assessments on the property.⁹⁴ Unless a state statute requires a certain formula to determine an assessment's proportionality, local governments can use any equitable method to calculate an assessment's benefits to a property.⁹⁵ Even if a statute does not proscribe a certain formula, the statute might set a maximum assessment amount. For example, an assessment may not exceed twenty-five percent of the property value.⁹⁶ Finally, the government may construct the

be valid if it only incidentally benefits the district while primarily benefiting the entire city. *Fisher*, 269 P. at 856-57.

⁹³ See *Kansas City S. Ry. Co. v. Road Improvement Dist. No. 3 of Sevier Cnty. Ark.*, 266 U.S. 379, 388 (1924) (upholding an assessment with an indirect benefit because that benefit was calculated based on estimations); WHITE, *supra* note 6, at 16 (warning that benefits measured by an estimated increase or decrease in the fair market value of the property could lead to "allegations that the assessments are based merely upon speculation or conjecture"); see also *Hamilton*, 112 A. at 836, 839 (reasoning that the "benefit and burden" must be reasonably proportionate); *Clark v. City of Royal Oak*, 38 N.W.2d 413, 418-19 (Mich. 1949) (holding that drains serve a public benefit because they improve "the sanitation and health of the residents" even though the benefit cannot be put in monetary terms). In *Hamilton*, the Maine Supreme Court found that the proposed improvement was beneficial because a new port, combined with Maine's "advantageous geographical position" will lead to more commerce, which in turn will make the state more prosperous and increase the general welfare. 112 A. at 839-40.

⁹⁴ WHITE, *supra* note 6, at 16; see *Gast Realty & Inv. Co. v. Schneider Granite Co.*, 240 U.S. 55, 59 (1916) (explaining that an assessment is invalid if "the parties will be taxed disproportionately to each other and to the benefit conferred"); *Houck v. Little River Drainage Dist.*, 239 U.S. 254, 265 (1915) (explaining that the assessment must be proportional "to position, frontage, area, market value, or to benefits estimated by commissioners"); *Spring St. Co. v. City of Los Angeles*, 148 P. 217, 220 (Cal. 1915) (invalidating an assessment because it was not proportional); *Hamilton*, 112 A. at 836 (explaining that the statute appears to apply a proportional benefit on the assessed properties); MCQUILLIN, *supra* note 86, § 38.37 (explaining that since the assessment amount and the value of the benefit must be proportional, a lack of proportionality could constitute a confiscation of property in violation of due process of law). The Maine Supreme Court reasoned that the assessment was proportional because of the dramatic increases in maritime commerce that would result from the new port and the resulting increases in prosperity and welfare. *Hamilton*, 112 A. at 839-40.

⁹⁵ WHITE, *supra* note 6, at 16; see MCQUILLIN, *supra* note 86, § 38.37 (explaining that while local governments must consider increases in property values when determining an assessment value, they must not limit the analysis to such figures since "benefits cannot always be translated into dollar terms" and benefits may only occur at some future time).

⁹⁶ See JOHN RAO ET. AL, FORECLOSURES: DEFENSES, WORKOUTS, AND MORTGAGE SERVICING 441 (3d ed. 2010) (explaining that the assessment is levied "at a percentage set by statute"); WHITE, *supra* note 6, at 16 (noting that "express limitations are common . . . as that the burden shall not exceed twenty, twenty-five, forty . . . percent of the value of the land or property assessed"); see also DEP'T OF ENERGY, *supra* note 30, at 3 (suggesting that PACE

improvement “without the consent of the particular individuals affected.”⁹⁷ If the government needs the property owners’ consent to construct the improvement, it is simply a private improvement that cannot be financed by assessment bonds.⁹⁸

A large body of case law supports the proposition that a property tax assessment legally constitutes a senior lien on a homeowner’s property.⁹⁹ For instance, in *German Savings & Loan Society v. Ramish*, Los Angeles residents asked the town to change the street grade to benefit the general public.¹⁰⁰ The council established a special assessment district encompassing the properties along the road to pay the costs of upgrading the right-of-way, and charged the project’s costs to the

programs “not exceed [ten percent] of a property’s estimated value”). Several cases set specific percentages. Cf. *Withrow v. City of Nashville*, 224 S.W. 614, 614 (Ark. 1920) (allowing a 20% limit); *City Street Improvement Co. v. Quigley*, 215 P. 390, 391 (Cal. 1923) (allowing a 50% limit); *Uhlenhake v. City of Ossian*, 418 N.W.2d 642, 648 (Iowa 1988) (allowing a 25% limit); *Ward v. City of Louisville*, 138 S.W.2d 461, 462 (Ky. 1940) (allowing a 75% limit); *In re Local Improvement Dist.* 417, 268 P. 164, 166 (Wash. 1928) (allowing a 40% limit).

⁹⁷ *Halsted*, 52 Cal. Rptr. at 642; see also *Davis v. McLean Cnty.*, 204 N.W. 459, 462 (N.D. 1925) (holding that a voluntary indemnity program did not create a senior tax lien since property owners could freely opt into and out of the program). Twelve years later, the North Dakota Supreme Court reasoned that a similar program cannot be classified as either a valid tax lien or assessment lien because of the program’s voluntary nature. *Fed. Farm Mortg. Corp. v. Falk*, 270 N.W. 885, 888 (N.D. 1937). But see *Fed. Deposit Ins. Corp. v. New Iberia*, 921 F.2d 610, 616 (5th Cir. 1991) (holding that the Federal Deposit Insurance Company (“FDIC”) could not challenge the validity of a special assessment on property to which it held a mortgage because the property owners voluntarily requested the local government to impose the assessment).

⁹⁸ *Halsted*, 52 Cal. Rptr. at 642; see also *Hamilton*, 112 A. at 840 (distinguishing between public and private docks and holding that a municipality can only finance construction of a public dock).

⁹⁹ See generally *Guinn v. McReynolds*, 170 P. 421 (Cal. 1918) (concluding that tax liens can constitute senior liens as long as the legislature gives the liens that priority); *German Sav. & Loan Soc’y v. Ramish*, 69 P. 89, 92 (Cal. 1902) (“The power to levy a tax for general purposes, which shall be a lien superior to all other liens prior or otherwise, is not doubted”); *People ex. rel Griffin v. Brooklyn*, 4 N.Y. 419 (N.Y. 1851) (explaining that tax liens are senior to preexisting mortgages). Some statutes permit “secondary repayment sources for assessment financing” to provide security “[i]n addition to the security offered by the assessment and consequent lien.” WHITE, *supra* note 6, at 17. White listed “a guaranty fund” as one method of secondary security. *Id.* A guaranty fund, sometimes called a Loan Loss Reserve Fund (“Reserve Fund”) is an “interest-bearing Deposit Account” used to pay shortages in a loan program. What is the Loan Loss Reserve Fund?, 13 C.F.R. § 120.710(a) (2010). Reserve Funds help “achieve economies of scale by aggregating projects either geographically or by project type.” U.S. DEP’T OF ENERGY, LOAN LOSS RESERVES: LESSONS FROM THE FIELD (TEXT VERSION) 8 (2010), available at <http://sustainableconnections.org/energy/energychallenge/loan-loss-reserves>.

¹⁰⁰ 69 P. 89, 91 (Cal. 1902). They requested the city council to improve the city streets. *Id.*

residents in the district.¹⁰¹ Several lots in the district were eventually sold because the property owners did not pay bonds issued to finance the street improvement.¹⁰² The property owners then filed suit for an injunction to prevent Los Angeles' treasurer from deeding the property to a third party.¹⁰³ The California Supreme Court denied the property owners' request and noted that this tax is a lien senior to all other liens so that local governments can finance governmental duties.¹⁰⁴ The court also concluded that maintaining and improving roads is a valid public purpose, and it can be financed through a special tax assessment with a senior lien provision.¹⁰⁵ The court reasoned that because the special assessment statute required a senior lien, the parties to a mortgage entered into their agreement knowing that the city could impose a senior lien on the property.¹⁰⁶

However, another body of state case law supports the proposition that a local government cannot classify a lien as a tax lien or a property assessment lien when homeowners voluntarily opt into or out of the program that imposes the lien.¹⁰⁷ In *Davis v. McLean County*, North Dakota passed a statute establishing an "indemnity hail tax" program that required homeowners to pay a tax on each acre of their property unless they opted out of the program.¹⁰⁸ Revenue from this tax went into a special fund to indemnify residents whose crops were damaged by hail.¹⁰⁹ When the homeowners foreclosed on their land, they claimed that the hail tax was not a valid tax because it was voluntary, and the program did not constitute a senior lien on their property.¹¹⁰ The North Dakota Supreme Court agreed with the homeowners, reasoning that

¹⁰¹ *Id.* The city council justified creating a special assessment district because road improvement provided a public benefit to the local community. *Id.*

¹⁰² *Id.*

¹⁰³ *See id.* at 91-92 (explaining the nature of this injunctive action).

¹⁰⁴ *See id.* at 92 (explaining that tax liens must be senior to all preexisting and subsequent liens so that local governments can "rais[e] revenue . . . to execute the functions of government").

¹⁰⁵ *Id.* Specifically, the court noted that "the principles on which the system of general taxation depends, and which govern in the enforcement of tax levies for general purposes, are also applicable to taxation for the improvement of streets, the construction of sewers, and other like public work." *Id.*

¹⁰⁶ *See id.* at 92 (explaining that "a purchaser takes title with the implied paramount right of the public for the uses named").

¹⁰⁷ *See generally* *Davis v. McLean Cnty.*, 204 N.W. 459 (N.D. 1925) (invalidating a senior lien provision in a voluntary indemnity hail tax provision).

¹⁰⁸ *Id.* at 459.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 462.

because the program operated like a contract between the local government and property owners, it did not impose a senior tax lien.¹¹¹

More recently, in *City of Gainesville v. Florida*, the Florida Supreme Court ruled that a voluntary storm water management system was a fee instead of a special assessment.¹¹² The program imposed a fee on Gainesville residents, but residents could opt out if they did not use the service.¹¹³ The court noted the factors that distinguish fees from assessments, and ultimately concluded that this program was a fee.¹¹⁴ For instance, fees pay for a benefit to a specific property, while assessments confer a benefit on a property in a specific area; fees are only imposed on participants, while assessments are imposed on everyone.¹¹⁵ Having explained each of the elements of a valid property assessment and the function of tax and assessment liens, the following question remains: Do PACE statutes qualify as valid property assessments that enable local governments to impose senior tax liens on participating homeowners?

III. ANALYSIS

Before local governments can validly impose property assessment liens on participating properties, PACE programs must meet the

¹¹¹ See *id.* at 463 (reasoning that the indemnity program is not an actual tax because the state does not compel residents to pay; instead residents may voluntarily take part in the program). The court continued that taxes are neither express nor implied contracts between parties, but rather “positive acts of the government . . . binding upon the inhabitants.” *Id.* at 462 (internal quotation marks omitted). The court specifically noted that the government does not need property owners’ consent to impose taxes. *Id.* The North Dakota Supreme Court used similar analysis in *Federal Farm Mortgage Corp. v. Falk* twelve years later, invalidating an amended version of the indemnity hail tax statute. 270 N.W. 885 (N.D. 1937). The court once again struck down the program, finding that it was neither a valid tax nor a valid assessment. *Id.* at 888. The court further reasoned that “the Legislature cannot, by mere definition, transform an ordinary debt arising out of a contract into a tax.” *Id.* at 889.

¹¹² 863 So. 2d 138, 145 (Fla. 2003).

¹¹³ See *id.* at 146 (noting that the fee only applies to participating properties and not to “undeveloped” properties or properties that “implement ways to retain all stormwater on site”).

¹¹⁴ *Id.* at 144. The court stated that fees:

[A]re charged in exchange for a particular governmental service which benefits the party paying the fee in a manner not shared by other members of society, and they are paid by choice, in that the party paying the fee has the option of not utilizing the governmental service and thereby avoiding the charge.

Id. (quoting *State v. City of Port Orange*, 650 So. 2d. 1, 3 (Fla. 1994)).

¹¹⁵ See *id.* at 145 (listing the factors courts must look at when determining if a program is an assessment or a fee).

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following six elements to qualify as valid property assessments.¹¹⁶ The Analysis begins, in Part III.A.1, by addressing the first three elements: public benefits, local benefits, and benefits conferred to the public at large.¹¹⁷ Next, Part III.A.2 examines whether PACE assessments only apply to property receiving benefits.¹¹⁸ After that, Part III.A.3 addresses whether the PACE assessment is proportional to the value of the property and to other assessments.¹¹⁹ The consent element is examined in Part III.A.4 to determine whether PACE programs can be imposed without the owner's consent.¹²⁰ Part III.B.1 reveals that PACE programs do not satisfy several of these elements, so local governments cannot impose senior liens on participating properties under their assessment authority.¹²¹ Finally, Part III.B.2 evaluates proposed resolutions to the PACE controversy and concludes that none of these solutions adequately resolves the dispute.¹²²

A. *PACE Programs do not Fulfill the Requirements of Assessment Districts*

A valid property assessment must include several elements: it must be for a public purpose, provide a local improvement, and benefit the public at large.¹²³ Next, the property assessment lien must only be applied to properties in the specific geographic area receiving the benefit.¹²⁴ Also, the cost of the assessment to the homeowner must be proportional to the value of the assessed property.¹²⁵ Finally, the municipality does not need to obtain a homeowner's consent before

¹¹⁶ See *supra* Part II.D (listing the elements for an assessment).

¹¹⁷ See *infra* Part III.A.1 (analyzing whether PACE programs provide public benefits to the specific area assessed instead of private benefits).

¹¹⁸ See *infra* Part III.A.2 (analyzing whether the program applies to all residents in an area).

¹¹⁹ See *infra* Part III.A.3 (analyzing whether the assessment is proportional to the value of the property and to other liens on the assessed property).

¹²⁰ See *infra* Part III.A.4 (analyzing whether these programs are voluntary).

¹²¹ See *infra* Part III.B.1 (explaining that local governments can only impose senior liens under their assessment authority if the program meets all the requirements of a valid assessment).

¹²² See *infra* Part III.B.2 (analyzing the effectiveness of solutions currently being proposed by supporters and opponents of PACE programs).

¹²³ See *supra* note 91 (explaining that property assessments can only finance projects that result in public benefits to the community at large and not projects that primarily benefit private individuals).

¹²⁴ See *supra* note 92 (explaining that local governments can only apply assessments to properties that are benefited from the improvement and explaining the policy rationale behind this requirement).

¹²⁵ See *supra* notes 94–96 and accompanying text (explaining the proportionality requirement and also describing various ways of measuring an assessment's proportionality).

imposing a property assessment.¹²⁶ If a program satisfies each of these elements, the program qualifies as a property assessment, and the municipality can validly impose a senior lien on the assessed properties.¹²⁷ PACE programs meet few of these elements because they have unique features, which distinguish them from traditional property assessments.

1. PACE Programs Serve a Public Purpose and Confer Local Benefits to the Public at Large

At the threshold level, PACE programs must be for a public purpose and provide benefits both to the public at large and to the assessed property.¹²⁸ Property assessments have financed many different types of public projects, and many early cases upheld a local government's ability to finance projects ranging from road and sidewalk improvements to the construction of public docks using property assessments.¹²⁹ More recently, municipalities have used property assessments to finance improvements on private property.¹³⁰ Cities in California finance seismic retrofits on buildings to make them more resistant to earthquakes, and Massachusetts replaces property owners' septic tanks using assessments with optional senior lien provisions.¹³¹

In the above examples, the public benefits of improved roads, sidewalks, and new docks are clear: residents are able to travel with greater ease; however, courts have limited such projects to public projects.¹³² Both California and Massachusetts provide public benefits beyond that of property improvements. When buildings receive

¹²⁶ See *supra* notes 107-15 (explaining that assessments cannot depend on the consent of homeowners).

¹²⁷ See *supra* notes 86-87 (explaining that local governments can make assessment liens senior to all preexisting mortgages and liens under its assessment authority).

¹²⁸ See *supra* notes 91-92 and accompanying text (listing the elements of an assessment and explaining the public purpose and public benefit elements).

¹²⁹ See COUGHLIN ET AL., *supra* note 19, at 2 (noting that local governments often use special assessments to finance road improvements, "bury[] power lines, [and] extend[] public services into neighborhoods").

¹³⁰ See generally *supra* note 80 (listing types of improvements to private property, including "seismic improvements, geologic hazard abatement and...septic tank replacement").

¹³¹ See FREE LIBRARY, *supra* note 80 (reporting on the California Infrastructure and Economic Development Bank Bay Area's Toll Bridge's plan to make two bond issues, one with a senior lien priority and one with a junior lien priority to finance bridge upgrades); MASS. DEP'T ENVTL. PROTECTION, *supra* note 31 (describing Betterment agreements that allow homeowners to obtain financing from local governments for septic replacements). The Bay Area Plan's second lien priority is significant because it shows that junior liens are a feasible means of raising revenue. FREE LIBRARY, *supra* note 80.

¹³² See *supra* notes 90-91 (describing the distinction between public and private benefits).

upgrades, those buildings will sustain less damage in an earthquake and reduce property damage to the community as a whole.¹³³ Furthermore, septic tank improvements would reduce the danger of sewage leaching into the land and polluting neighboring residents' water supplies.¹³⁴

Although the above mentioned benefits are undisputed, the public benefits resulting from PACE programs are less clear. For instance, proponents claim that PACE programs will benefit individual property owners by improving the exact value of their property and reducing utility bills, which is a dubious claim at best, because no one can accurately predict the value of a home until the property is sold.¹³⁵ Nonetheless, PACE proponents assert that individuals looking to buy a house will be more willing to buy an energy-efficient home with solar panels and will pay more for these houses than for comparable houses without solar panels.¹³⁶ Homeowners would certainly like to sell their homes for more money, but benefits based on projected increases in property values are not likely to survive judicial scrutiny because benefits cannot be based on mere conjecture.¹³⁷ Improvements to increase property values seem to be private improvements, like the proposed construction of a private dock in *Hamilton v. Portland Pier Site*

¹³³ See *supra* note 31 (discussing seismic upgrades in California).

¹³⁴ See *supra* note 31 (discussing septic tank replacement in Massachusetts).

¹³⁵ See ZIMRING & FULLER, *supra* note 4, at 3 (“[E]nergy savings [from solar panel installation] will offset and, in some cases, exceed the assessment payments,” thereby reducing the risk of default on the PACE assessment); NAT’L RES. DEF. COUNCIL, *supra* note 33, at 4 (claiming that PACE programs will give homeowners more disposable income since “lower utility bills offset the cost of the assessment”). *But see* Cent. Sav. Bank v. City of New York, 18 N.E.2d 151, 155–56 (N.Y. 1938) (noting that expenditures “may or may not add anything to the land value, and on foreclosure sale might not bring one penny more to the mortgagee”); Felt, *supra* note 7, at 9 (arguing that since “the entire balance of the loan remains as an encumbrance on the property, continuing to impair the value of the mortgagee’s collateral and lowering the amount available to mortgagees in a foreclosure . . . or other resolution of defaulting mortgage” the claim that PACE programs improve the value of property is highly suspect).

¹³⁶ See ELKIND ET AL., *supra* note 4, at 15 (asserting that solar panels would increase demand for homes and homes would sell for more money than comparable houses without solar panels). *But see* Felt, *supra* note 7, at 3 (explaining that projected increases in property values are speculative because these “improvements do not increase the value of property dollar for dollar”). Projected increases in property values are suspect for another reason: if homeowners do not maintain and repair their solar panels, these improvements might be “worthless long before the PACE loan is paid.” *Id.*

¹³⁷ See *supra* note 93 and accompanying text (explaining that assessments do not need to directly benefit the property, but should be based on something other than projected increases in fair market value); see also *Kansas City S. Ry. Co. v. Road Improvement Dist. No. 3*, 266 U.S. 379, 387–88 (1924) (explaining that assessments can be “based on a solid premise of fact and experience,” but not on “mere speculation and conjecture”). In *Kansas City Southern Railway Co.*, the U.S. Supreme Court upheld an assessment because the benefits were based on reasonable increases in railroad traffic. *Id.* at 388.

District.¹³⁸ Homeowners can enjoy the same “right to the exclusive enjoyment of the structure” as the dock owners in *Hamilton*.¹³⁹ The Maine Supreme Court found that justification insufficient, and a court would likely find the same justification insufficient as applied to PACE programs.

PACE supporters also assert that solar retrofits financed through PACE programs benefit the environment as a whole, because clean energy, such as solar power, reduces the nation’s dependence on fossil fuels, which in turn reduces greenhouse gas emissions and global warming.¹⁴⁰ A court might find combating global warming to be a public benefit, even though the benefit is more tenuous than street improvements or seismic upgrades, because courts give great deference to legislative findings of public benefits when those benefits are based on measurable criteria.¹⁴¹

In addition to serving a public purpose and providing a public benefit, PACE programs must provide a local benefit to constitute a valid property assessment.¹⁴² The benefit can come in the form of any of the benefits mentioned in Part III.B.1, but it must specifically apply to the properties in the assessed district.¹⁴³ PACE programs do not meet these requirements. Although they provide jobs for local construction companies and reduce greenhouse gas emissions in local communities, these benefits are not specific to the properties assessed; they benefit the

¹³⁸ In *Hamilton*, the Maine Supreme Court invalidated a plan to finance a private dock because the owners of the dock enjoyed exclusive access to the dock. 112 A. 836, 840 (Me. 1921). Similarly, PACE programs finance private improvements because homeowners enjoy exclusive access to their home. *Id.*

¹³⁹ *Id.*

¹⁴⁰ See DeVries & Lynch, *supra* note 5, at 2 and accompanying text (explaining that PACE programs can reduce greenhouse gas emissions and combat global warming).

¹⁴¹ See *Kansas City S. Ry. Co.*, 266 U.S. at 388 (upholding an assessment with an indirect benefit because that benefit was calculated based on “forecast and estimate”). Decreases in greenhouse gas emissions, and a resulting reduction in global warming are indirectly related to PACE programs, but these benefits are calculated based on forecasts and estimates of reductions. *Id.* Therefore, the global warming rationale would likely fall within *Kansas City Southern Railway Co.’s* “forecast and estimate” standard and be upheld. *Id.*

¹⁴² See *City of Whittier v. Dixon*, 151 P.2d 5, 7 (Cal. 1944) (holding that “a special assessment is justified if the improvement is a public one *and the property to be assessed will receive a special benefit*”) (emphasis added); *Irish v. Hahn*, 281 P. 385, 387 (Cal. 1929) (noting that one of the limitations on a municipality’s assessment power is “that the improvement . . . must confer a special benefit upon the property assessed”).

¹⁴³ See *supra* notes 90-91 (explaining that to meet the public purpose requirement, assessments must benefit the public within the assessment district and confer a specific benefit on the assessed property).

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community as a whole.¹⁴⁴ Homeowners who otherwise would not be able to finance these improvements are able to obtain financing through PACE programs, but this benefit fails the public benefit requirement so it cannot be used as a justification.¹⁴⁵ For these reasons, courts would likely find that PACE programs do not serve a public purpose or provide a local benefit to the public at large.¹⁴⁶ The remaining elements do not fare any better.

2. PACE Assessments do not Apply to All Properties in a Distinct Geographic Area

Typical property assessments, or special assessments, are only applied to residents living in a distinct geographic area receiving the benefit of the assessment.¹⁴⁷ For example, if a local government widens A Street, the local government can impose a special assessment on all

¹⁴⁴ See *supra* note 91 (explaining that special assessments may incidentally benefit the community at large as long as it primarily benefits the assessed property and as long as the local benefit is distinguished from the general benefit); see also NAT'L RES. DEF. COUNCIL, *supra* note 33, at 3 (claiming that PACE programs can lead to "[s]ignificant job creation" because even "[m]odest implementation nationally for PACE financing of solar PV and energy efficiency retrofits can create about 160,000 long-term, green jobs for our economy . . . in the communities that adopt PACE"). Additionally, according to PACE supporters, these programs can lead to a "[s]ubstantial reduction in greenhouse gas emissions" because "[a] standard retrofit package in an individual home can reduce CO₂ emissions by 60–100 tons over its useful life." *Id.* Global warming is being blamed for "melting glaciers, droughts, [and] plumes of jellyfish devastating fisheries, . . . dramatic wildfires plaguing much of the West and drought affecting large swaths of the Southeast and West." DeVries & Lynch, *supra* note 5, at 3.

¹⁴⁵ See NAT'L RES. DEF. COUNCIL, *supra* note 33, at 4 (noting that PACE programs are available to "[m]any segments of society that are underserved by traditional financial options"). PACE supporters also claim that "PACE can be a smart choice for homeowners of all income levels." *Id.* However, PACE supporters are quick to note that homeowners of all income levels can benefit from PACE programs, which they allege minimizes the risks to mortgage holders of moral hazard and adverse selection. *Id.* They claim that "[a]dverse selection would occur if, out of the pool of potential participants, only the weakest and most likely to go delinquent would apply." *Id.* "Moral hazard would occur if, either directly or indirectly, participation in the program would actually increase the likelihood of nonpayment." *Id.*

¹⁴⁶ See DeVries & Lynch, *supra* note 5, at 3 (noting that "courts defer to legislative bodies in their declaration of a public purpose" and that courts have broadly defined public purposes).

¹⁴⁷ See *supra* note 92 (explaining that assessments can only apply to property receiving the benefit and citing relevant case law for this proposition). For instance, the property must be either "actually or presumptively" benefited to be included in the assessment district, but "the property can be presumed to have received an especial benefit." *Halsted v. Sacramento*, 52 Cal. Rptr. 637, 642 (Cal. Ct. App. 1966) (emphasis omitted).

residents living on A Street.¹⁴⁸ Conversely, the government cannot impose the assessment on residents of Z Street on the other side of town because those residents are not living within the assessment district.¹⁴⁹ However, if the program applies on a house-by-house basis depending on whether the property owners opt in, the program is more like a fee than an assessment.¹⁵⁰ PACE assessments only apply to residents who take part in the program, regardless of where they live.¹⁵¹ PACE programs are different from normal assessment programs because residents in the PACE assessment district do not necessarily live along one street or on one city block.¹⁵² Residents are included in the PACE assessment district on a house-by-house basis, rather than a block-by-block or street-by-street basis.¹⁵³ This means that PACE programs are more like fees than special assessments.¹⁵⁴

3. The Value of the Improvement is Proportional to the Property's Value

The value of property assessments must be proportional to both the value of the property and to other assessments on the property.¹⁵⁵ In

¹⁴⁸ See *Halsted*, 52 Cal. Rptr. at 642 (explaining that the assessments can only be levied on houses that benefit from the improvement).

¹⁴⁹ See also *STONE & YOUNGBERG*, *supra* note 81 (explaining that municipalities create assessment districts in a certain portion of the city and the district encompasses houses within that portion of the city).

¹⁵⁰ See *supra* notes 114–15 (explaining the distinction between fees and assessments).

¹⁵¹ See *DeVries & Lynch*, *supra* note 5, at 4 (explaining that “PACE programs are entirely *voluntary*” and therefore the programs do not apply to residents who choose not to “opt-in” to the program) (emphasis added) (internal quotation marks omitted); *FULLER*, *supra* note 29, at 27 (explaining that property is not assessed unless the “owner ‘opts-in’”).

¹⁵² See generally *FULLER*, *supra* note 29, at 27 (comparing typical assessment districts where “the governing body must designate the geographic boundaries of the district, and all parcels of property on the tax roll for such designated area are included in the district” with PACE assessment districts, which require property owners to opt-into the program before becoming part of the assessment district).

¹⁵³ See *supra* note 24 (explaining that since PACE programs are voluntary, individual households determine whether they want to voluntarily opt into the program); *cf.* *German Sav. & Loan Soc’y v. Ramish*, 69 P. 89, 91 (Cal. 1902) (holding that all residents on the street are required to be members of the assessment district). For purposes of this element, the distinction between a house-by-house assessment and a block-by-block assessment is immaterial because the assessment district only consists of residents who receive the program’s benefits. *Id.*

¹⁵⁴ See *supra* note 115 (explaining that fees apply only to property owners who opt into a program while assessments apply to all residents in a given district).

¹⁵⁵ See *WHITE*, *supra* note 6, at 16 (explaining that the assessment must be proportionate not only to the benefit conferred on the property, but also must be “proportionate to other property assessments”); see also *Gast Realty & Inv. Co. v. Schneider Granite Co.*, 240 U.S. 55, 59 (1916) (explaining that an assessment is invalid if “the parties will be taxed

other words, the assessment typically cannot account for more than a particular percentage of the property's value.¹⁵⁶ This requirement has strong practical considerations because a lien on a property, whether arising from an assessment or a loan, is difficult to pay off if it is worth more than a small percentage of the property.¹⁵⁷

PACE programs that adhere to the DOE's Best Practices Guidelines also have strict loan limits.¹⁵⁸ The Guidelines specifically suggest that PACE assessments not account for more than ten percent of the property's value.¹⁵⁹ These DOE Guidelines satisfy the proportionality requirement for property assessments, and provide more protection than is typically required by case law.¹⁶⁰ While PACE programs satisfy the proportionality requirement, they fail the consent element.¹⁶¹

disproportionately to each other and to the benefit conferred"); *Houck v. Little River Drainage Dist.*, 239 U.S. 254, 265 (1915) ("The state in its discretion may lay such assessments in proportion to position, frontage, area, market value, or to benefits estimated by commissioners."); *Martin*, 205 U.S. at 140 (explaining that an assessment statute is valid if "the apportionment is . . . limited to the benefit"). Courts have upheld various formulae used to calculate proportionality. *Id.*

¹⁵⁶ See *WHITE*, *supra* note 6, at 16 (explaining that statutes often contain "express limitations" mandating that the burden "shall not exceed" a certain percentage of the property's value). Often, property assessments cannot account for more than twenty-five percent of a property's value, though some case authority allows assessments to account for as much as seventy-five percent of the property's value. *MCQUILLIN*, *supra* note 86; see also *supra* note 96 (providing case law for twenty, twenty-five, and forty percent limits).

¹⁵⁷ See *STONE & YOUNGBERG*, *supra* note 81 (advising potential investors on how to invest in municipal investment bonds).

¹⁵⁸ See, e.g., *DEP'T OF ENERGY*, *supra* note 30 (setting forth suggested loan guidelines to ensure that PACE loans offer more protection to preexisting mortgage holders).

¹⁵⁹ See *id.* at 3 (suggesting that "PACE assessments should generally not exceed 10% of property's estimated value (i.e. a property value-to-lien ratio of 10:1)"). The Guidelines further recommend that "assessments should . . . not be issued for projects below a minimum cost threshold of approximately \$2500 [to] . . . ensure that improvements are 'right-sized' for properties and for the administrative costs of . . . PACE programs." *Id.* Opponents counter that these protections are not adequate because PACE liens still subordinate preexisting mortgages and interests, which lowers the value of those interests. *Felt*, *supra* note 7, at 3. PACE loans increase the LTV ratio of the first mortgage. *Id.* The LTV "is the ratio of the amount of the mortgage loan to the value of the home that provides collateral. The higher the LTV, the less valuable is the mortgage. . . . [E]very PACE loan that is made on a mortgaged property will" substantially decrease the value of preexisting mortgages. *Id.*

¹⁶⁰ See *DEP'T OF ENERGY*, *supra* note 30, at 3 (urging ten percent limits on PACE assessments); cf. *Withrow v. City of Nashville*, 224 S.W. 614, 614 (Ark. 1920) (allowing a twenty percent limit); *City St. Improvement Co. v. Quigley*, 215 P. 390, 391 (Cal. 1923) (allowing a fifty percent limit); *Uhlenhake v. City of Ossian*, 418 N.W.2d 642, 648 (Iowa 1988) (allowing a twenty-five percent limit); *Ward v. City of Louisville*, 138 S.W.2d 461, 462 (Ky. 1940) (allowing a seventy-five percent limit); *In re Local Improvement Dist.* 417, 268 P. 164, 166 (Wash. 1928) (allowing a forty percent limit).

¹⁶¹ See *supra* notes 90-98 and accompanying text (describing the elements of valid property assessments).

4. PACE Programs Fail the Consent Element

PACE programs do not satisfy the final requirement either because they require the property owner's consent.¹⁶² Early cases clearly establish that property assessments cannot be dependent on the property owner's consent.¹⁶³ In other words, if a property owner must consent to an "assessment," the program must be classified as a loan or a fee.¹⁶⁴ PACE proponents correctly analogize PACE programs to the voluntary Massachusetts septic tank replacement programs.¹⁶⁵ However, these programs have not been challenged in court, so there is no case law upholding their voluntary nature.¹⁶⁶ PACE programs are more like fees than assessments because they only apply to homeowners who participate.¹⁶⁷ The only case law dealing with voluntary property assessment programs strikes down those programs, and PACE programs

¹⁶² See *supra* notes 90–98 (listing the elements of a valid property assessment).

¹⁶³ See *Davis v. McLean Cnty.*, 204 N.W. 459, 463–64 (N.D. 1925) (analyzing the validity of voluntary "assessments"). In *Davis*, the North Dakota Supreme Court held that a voluntary indemnity insurance program was not a valid tax because residents could voluntarily opt into the program. *Id.* at 463. In a subsequent case, the North Dakota Supreme Court held that an amended program could not be classified as a property assessment with senior lien provisions, again because the program was voluntary. *Fed. Farm Mortg. Corp. v. Falk*, 270 N.W. 885, 889 (N.D. 1937). These invalid hail insurance programs are analogous to PACE programs since both programs allow property owners to decide whether they want to take part in the program. *Id.*

¹⁶⁴ See *Halsted v. Sacramento*, 52 Cal. Rptr. 637, 642 (Cal. Ct. App. 1966) ("[T]he public, acting through its government, may construct [the improvement] without the consent of the particular individuals affected."). If this element is absent, the program "is essentially a private improvement" and the local government cannot use its property assessment authority to finance the improvement "no matter how useful or advantageous it may be" to the property owners. *Id.*

¹⁶⁵ See MASS. DEP'T ENVTL. PROT., *supra* note 31 (describing the requirements of Betterment Agreements). Like PACE programs, Betterment Agreements are "[f]inancial [a]greement[s] between a homeowner and the community." *Id.* Also like PACE programs, the local government pays the upfront costs of septic improvements and the homeowner repays the local government through a line item on the property tax. *Id.* Finally, if the homeowner does not repay the loan, the local government may obtain a senior "municipal lien" on the property to obtain repayment from the homeowner. *Id.* In all relevant aspects, Massachusetts's Betterment Agreements are identical to PACE programs. See *supra* notes 23–37 and accompanying text (describing the features of PACE programs).

¹⁶⁶ The author utilized a Westlaw and Lexis search using the terms "Betterment Agreement!" and lien on October 22, 2011. This search retrieved no cases. The author ran this search to find any cases challenging the legal authority of Massachusetts' Betterment Agreements, but because he found no cases, it appears these programs have not been challenged yet.

¹⁶⁷ See *supra* notes 114–15 (comparing assessments to the fee programs in *City of Gainesville*).

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would likely suffer a similar fate.¹⁶⁸ According to PACE proponents, a major selling point of the program is its voluntary nature, but this provision will ultimately be PACE programs' undoing.¹⁶⁹

B. PACE Programs do not Meet the Requirements for Valid Assessments

As the above analysis indicates, PACE programs fail to satisfy several elements; thus, they cannot be classified as property assessments with senior lien provisions.¹⁷⁰ PACE programs meet the proportionality requirement because the assessment value is proportional to the value of the property.¹⁷¹ They also arguably serve a public purpose, but they benefit private individuals instead of providing a local benefit for the public.¹⁷² PACE liens are only applied to property if the property owner participates in the program, not to all properties in a distinct geographic area.¹⁷³ However, the programs also fail the test for a valid assessment, because PACE statutes expressly require that the programs be voluntary.¹⁷⁴ Well-settled case law establishes the principle that programs requiring property owners' consent cannot be labeled property assessments with senior lien provisions.¹⁷⁵ As such, PACE programs

¹⁶⁸ See *supra* notes 107–15 (explaining the reasons for invalidating voluntary programs in *Davis* and *City of Gainesville*).

¹⁶⁹ See DeVries & Lynch, *supra* note 5, at 4 (explaining that PACE programs benefit from the voluntary lien provisions because homeowners who do not wish to take part in the program are not burdened in any way).

¹⁷⁰ See *supra* note 97 (explaining that assessments cannot turn on a property owner's consent). PACE proponents argue that PACE programs are not the only examples of voluntary assessments, saying that "in California, land-secured financing districts are commonly used by land developers, who voluntarily assess their undeveloped property to finance the public improvements." DeVries & Lynch, *supra* note 5, at 5. However, voluntarily creating a district is distinct from voluntarily opting into or out of a district. *Id.* Indeed, in *German Savings & Loan Society v. Ramish*, the court noted that the residents who opposed the district could have voiced their opposition before the city created the district and could have prevented the city from creating the district. 69 P. 89, 92 (Cal. 1902).

¹⁷¹ See *supra* Part III.A.3 (explaining that PACE programs are proportional to the value of the assessed property and to other liens on that property, thus satisfying this requirement for a valid assessment).

¹⁷² See *supra* Part III.A.1 (explaining that, while a court might find PACE programs are for a public purpose, they will find that the programs do not provide a local benefit and instead benefit the general public).

¹⁷³ See *supra* Part III.A.2 (explaining that PACE programs apply only to property if the owner opts into the program, and not to all properties in the area).

¹⁷⁴ See *supra* Part III.A.4 (explaining that PACE programs are strictly voluntary, thus failing the requirement that assessments not be voluntary).

¹⁷⁵ See *supra* notes 107–11 and accompanying text (stating that property taxes are not voluntary; rather a property tax must be imposed by the government without the owner's consent, as explained in *Davis v. McLean County*); see also *Fed. Farm Mortg. Corp. v. Falk*, 270 N.W. 885, 889 (N.D. 1937) (explaining that voluntary programs with senior lien repayment provisions exceed a local government's assessment authority and are invalid).

cannot impose a senior lien on participating properties under the guise of a property assessment or special assessment.¹⁷⁶

1. Voluntary PACE Loans Cannot Receive Senior Tax Lien Status

The “first in time, first in right” principle is the general rule governing mortgages, where the first mortgage or lien on a property receives senior lien status; however, there are several exceptions to this general rule.¹⁷⁷ Local governments can make tax or assessment liens senior to all other preexisting or subsequent liens.¹⁷⁸ This exception is justified because local governments must be able to receive money owed to them by property owners in the event of a default, because the local government finances projects of general public benefit.¹⁷⁹ Other taxpayers and residents should not be left financing the portion of a public project that a delinquent property owner should have paid.¹⁸⁰

This policy rationale does not extend to private loans, even if those private loans are obtained through the local government for an ostensibly public purpose, like PACE projects.¹⁸¹ Private loans must generally adhere to the “first in time, first in right” principle.¹⁸² As such, property owners can freely opt into PACE programs, but they must do so under the assumption that the PACE lien will be junior and subordinate to any preexisting mortgages and liens.¹⁸³ The majority of

¹⁷⁶ See *supra* notes 163–69 (analyzing the essential consent requirement of property assessments, and concluding that PACE programs ultimately fail this requirement).

¹⁷⁷ See *supra* note 84 and accompanying text (explaining that the “first in time first in right” principle is the general rule and as a result, earlier mortgages and property interests receive priority over subsequent property interests). But see *supra* note 84 (explaining that this general rule is subject to a “multitude of limitations”).

¹⁷⁸ See MCQUILLIN, *supra* note 86, § 44.142 (explaining that the general legislative policy has been to regard municipal taxes as liens superior in point of payment to all other liens); *supra* notes 86–87 (explaining that the legislature has the full power to set tax lien priorities, and can legitimately make these liens superior to all prior property interests).

¹⁷⁹ See *supra* note 87 (explaining the policy rationale behind senior tax liens).

¹⁸⁰ See WHITE, *supra* note 6, at 8 (offering perhaps the best example of residents being forced to repay bonds that should have been repaid by another entity). Municipalities aided railroads by financing railroad improvements through bond issues, but mismanaged railroads went out of business and taxpayers were left repaying the bond long after the railroad’s benefits were gone. *Id.*

¹⁸¹ See *supra* note 87 (explaining that tax liens receive a senior lien status to ensure that local governments can finance their operations). The North Dakota Supreme Court reasoned that if a program is not a tax, “then the [l]egislature cannot, by designating it as a tax, give it any greater preference as a lien than could be given it should no such name be affixed to it.” *Davis v. McLean Cnty.*, 204 N.W. 459, 464 (N.D. 1925).

¹⁸² See *supra* note 84 (explaining that although the “first in time, first in right” principle is “subject to a ‘multitude of limitations,’” it is the “general rule”).

¹⁸³ See *supra* note 84 (explaining that the “first in time, first in right” principle is the basic rule governing mortgage seniority).

PACE statutes instead allow local governments to impose senior liens to ensure payback of these voluntary loans, which has led to the dispute between PACE proponents and the GSEs.¹⁸⁴

2. No Proposed Solution Adequately Addresses the Concerns of All Stakeholders

The simple solution to the lien seniority problem appears to be the one advocated by the GSEs: amend the state statutes to make PACE liens junior and subordinate to preexisting property interests, including mortgages.¹⁸⁵ This solution would be relatively simple to implement—state legislatures would essentially strike one phrase, or sometimes even one word, from state statutes. However, this seemingly simple solution would open up more problems from a practical standpoint.

For example, once PACE programs implement a junior lien repayment provision, PACE bonds, which raise the initial capital for the solar energy retrofits, will drop from AAA status to junk bond status.¹⁸⁶ PACE supporters argue that this change will cause investors to shy away from PACE bonds as an investment tool.¹⁸⁷ Although this distinction would not affect the legality of PACE programs, it would create significant financial barriers.¹⁸⁸ For instance, if investors shy away from PACE programs with junior lien repayment provisions, PACE programs will likely remain unfunded, and the programs' many environmental benefits will continue to go unrealized.¹⁸⁹ This is certainly not a viable

¹⁸⁴ See *supra* note 38 and accompanying text (explaining that most state statutes impose a senior lien repayment provision); *supra* note 40 and accompanying text (explaining that Maine's statute is the one notable exception to the senior lien repayment method because Maine's statute specifically requires a subordinate lien repayment system); see also *supra* note 36 (listing statutes, including Wisconsin's statute, which describe PACE programs as loans); *supra* note 34 (listing statutes that specifically mention the voluntary nature of these programs).

¹⁸⁵ See *supra* notes 41–44 (reporting the GSEs' requests that PACE loans achieve a subordinate lien status).

¹⁸⁶ See *supra* note 80 (explaining that the difference between AAA bonds and junk bonds is based on the bond's repayment provisions).

¹⁸⁷ See *supra* note 81 (explaining why investors will hesitate to invest in junk bonds with junior lien repayment provisions); see also Barclay's Letter, *supra* note 83 (applying these concerns to PACE bonds). According to Barclay's Capital, PACE bonds will not be an attractive investment if they have subordinate lien provisions because they will not be investment grade. *Id.*

¹⁸⁸ See *supra* note 81 (explaining that since investors will hesitate to invest in junk bonds, PACE programs are likely to go unfunded).

¹⁸⁹ See DeVries & Lynch, *supra* note 5, at 7 (explaining that local governments will not be able to raise enough revenue to fund solar retrofits if PACE programs do not have senior lien provisions). They go on to claim that if mortgages are senior to PACE liens, ensuring repayment "would be impracticable if not impossible." *Id.*; see also July 14, 2010 FHFA

solution to the PACE issue; even the GSEs point out that they support measures to help the environment as long as those measures do not affect their contract rights.¹⁹⁰

Once a decision is announced in *California ex rel Brown v. FHFA*, all interested parties will have a better idea whether PACE programs constitute valid property assessments with senior lien provisions.¹⁹¹ However, the court system moves notoriously slow, as former California Attorney General Brown acknowledged before filing the case.¹⁹² Furthermore, similar cases have been filed in other circuits, which raises the possibility of a circuit split on the issue.¹⁹³ If that occurs, the mortgage industry will not have a definitive answer unless the Supreme Court takes up the issue. In the meantime, the legality of the senior lien provisions will remain uncertain, and stakeholders will hesitate to invest in PACE programs.¹⁹⁴

Congressional efforts to resolve this issue ultimately proved unfruitful for the following practical and political reasons. As a practical matter, the bills introduced by Congressman Mike Thompson and Senator Barbara Boxer sought to amend the GSEs' lending standards to encompass programs like PACE.¹⁹⁵ This would prevent Fannie Mae, Freddie Mac, and the FHFA from rejecting home mortgages with PACE liens, but it would not solve the underlying structural problems caused

Press Release, *supra* note 43 (claiming that PACE programs are currently dead because of the legal uncertainty surrounding the senior lien provisions).

¹⁹⁰ See July 6, 2010 FHFA Press Release, *supra* note 8 (reaffirming its commitment "to work[] with federal, state, and local government agencies to develop and implement energy retrofit lending programs with appropriate underwriting guidelines and consumer protection standards"); see also Fannie Mae Letter, *supra* note 42 (emphasis added) (stating that Fannie Mae 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"); Freddie Mac Letter, *supra* note 42 (supporting "the goal of encouraging responsible financing of energy efficient and renewable energy home improvements").

¹⁹¹ See *supra* notes 53–57 and accompanying text (explaining that former California Attorney General Brown filed suit in federal district court seeking declaratory judgment against the FHFA to declare that PACE programs are not loans, but rather valid property assessments and do not violate the FHFA's lending standards).

¹⁹² See *supra* note 53 (quoting Brown as urging the FHFA to work with California to resolve the issue before he filed suit because the suit would be more time consuming).

¹⁹³ See *supra* note 53 (listing the other cases filed in federal district court).

¹⁹⁴ See *supra* note 55 (explaining that there is uncertainty surrounding PACE programs and advising potential investors to avoid PACE programs until the legal issues are resolved).

¹⁹⁵ See *supra* note 61 (quoting the bills, which seek to amend the lending standards to comply with PACE program requirements as elaborated in the DOE's Best Practices Guidelines).

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by PACE programs.¹⁹⁶ These programs would still represent another property interest that could push a homeowner's mortgage further underwater and lead to default.¹⁹⁷ From a political standpoint, the 111th Congressional Term is over and neither bill cleared its respective committee, which means each must be reintroduced in the 112th Term before it can be voted on. The measures gathered only meager support from the Democrat-controlled Congress, and will likely gather even less support now that Republicans control the House of Representatives.¹⁹⁸ Any Congressional resolution, however ineffective, is highly unlikely. Therefore, the burden of resolving this controversy falls on state legislatures to amend state statutes in a far more comprehensive manner.

IV. CONTRIBUTION

PACE programs are not valid property assessments, so local governments cannot use their traditional property assessment authority to impose senior lien provisions for PACE programs.¹⁹⁹ This means that PACE statutes must be amended to avoid interfering with mortgagors' contract rights.²⁰⁰ State legislatures must strike the senior lien provisions altogether and adopt a junior lien provision with a loan loss reserve fund for secondary repayment. North Carolina and Hawaii have experimented with this method of repayment for their PACE programs.²⁰¹ Although these programs are too new to provide extensive empirical data as to their effectiveness, Reserve Funds have been used successfully in similar situations.²⁰²

State legislatures must enact a comprehensive PACE reform statute with multiple structural changes to adequately resolve the PACE

¹⁹⁶ See *supra* note 42 and accompanying text (explaining that the FHFA objects to PACE programs because they represent loans without sound underwriting standards).

¹⁹⁷ See *supra* note 74 (describing how PACE loans raise the LTV ratio and could lead to default).

¹⁹⁸ See *supra* note 65 (noting that the bills have few co-sponsors, and no Republican co-sponsors).

¹⁹⁹ See *supra* Part III (analyzing PACE programs and concluding that they are not valid property assessments with senior lien provisions).

²⁰⁰ For purposes of this Contribution, the relevant portions of Maine's PACE statute serve as the basis for the proposed Model PACE Statute with amended provisions in italics. The relevant portions of Maine's statute are ME. REV. STAT. tit. 35-A, §§ 10155 and 10156. The Model Statute keeps the same numbering for clarity's sake and is cited as MOD. REV. STAT. tit. 35-A, §§ 10155 and 10156.

²⁰¹ See *supra* note 37 (explaining that North Carolina and Hawaii have adopted a Revolving Loan Fund provision as an alternate method of repayment).

²⁰² See *supra* note 99 (explaining that Reserve Funds help insure that investors in assessment bonds receive a return on their investment); see also *supra* note 5 (explaining that homeowners often need local government assistance to finance these programs).

controversy. As a preliminary matter, these proposed amendments can only be applied prospectively and not to preexisting PACE loans.²⁰³ Stringent underwriting and program design requirements to satisfy the mortgage industry's concerns are proposed in Part IV.B.²⁰⁴ Next, states should create a third-party trust to manage the collection of PACE loans.²⁰⁵ Furthermore, it is vital that PACE loans follow the "first in time, first in right" principle, but Part IV.D proposes an optional senior lien provision if certain requirements are met.²⁰⁶ Finally, the creation of a loan loss reserve fund is proposed in Part IV.E to ensure that subordinate PACE loans are fully repaid in the event of a default.²⁰⁷ While these amendments can resolve the PACE controversy, they cannot apply retroactively without causing additional problems.

A. All Amendments to PACE Statutes Must Apply Prospectively

The GSEs and the mortgage industry oppose PACE loan programs because these programs interfere with their contract rights by subordinating their senior mortgages to PACE loans.²⁰⁸ If states amend their PACE statutes to apply to preexisting PACE loans, the statutes will still interfere with contract rights. This time the PACE statutes will interfere with the contract rights of people who invested in PACE bonds. These investors purchased PACE bonds with the expectation that the PACE liens would be repaid first in a foreclosure and that they would receive a return on their investment. If existing PACE loans are subordinated, the investors might not receive a return on their investment.²⁰⁹

Therefore, the GSEs should agree to honor all PACE loans already in existence on the condition that all future PACE loans will apply the "first in time, first in right" principle. The FHFA offered to honor these

²⁰³ See *infra* Part IV.A (explaining that if amended PACE statutes applied retroactively, they would impact the contract rights of homeowners who already entered into a PACE loan).

²⁰⁴ See *infra* Part IV.B (proposing underwriting criteria that comply with the FHFA's lending standards).

²⁰⁵ See *infra* Part IV.C (proposing that states establish a trust to free local governments from the burden of collecting PACE loans).

²⁰⁶ See *infra* Part IV.D (proposing PACE statutes adhere to the "first in time, first in right" principle).

²⁰⁷ See *infra* Part IV.E (proposing a loan loss reserve fund to ensure investors get a return on their investment).

²⁰⁸ See *supra* note 42 (explaining the concerns of the GSEs and the mortgage industry); see also *supra* note 78 (explaining why subordination is disadvantageous to senior mortgage holders).

²⁰⁹ See *supra* note 81 (explaining that investors will shy away from bonds with junior repayment provisions because these bonds are less likely to be repaid).

preexisting loans in July 2010.²¹⁰ Few people have taken out PACE loans since July 2010 due to the legal uncertainty surrounding these programs, so the FHFA would not have to honor many more PACE loans than it already offered to honor.²¹¹

B. *PACE Programs Must Adopt Stringent Underwriting and Program Design Requirements*

§ 10155. Consumer underwriting and disclosure

1. Underwriting. A PACE agreement entered into pursuant to a PACE program must comply with *the underwriting standards of the Federal Housing Finance Agency*. In adopting such rules, the trust shall seek advice from the consumer credit industry stakeholders. Underwriting requirements established by the trust must, at a minimum, *comply with the program design and underwriting requirements set forth in the Department of Energy's Best Practices Guidelines*.²¹²

The Model Statute incorporates, by reference, the FHFA's very stringent underwriting requirements.²¹³ This proposal satisfies the complaint that PACE programs lack adequate underwriting criteria.²¹⁴ One principal FHFA criterion is that no loan can subordinate preexisting mortgages and liens.²¹⁵

The Model Statute also incorporates, by reference, the DOE's Best Practice Guidelines, which were received favorably by the mortgage industry.²¹⁶ These guidelines require PACE programs to essentially pay for themselves by requiring expected benefits to exceed costs.²¹⁷ They also require that PACE loans are not more than ten percent of the property's value, which is substantially less than the percentage allowed

²¹⁰ See *supra* note 44 (reporting on the FHFA's offer to honor preexisting PACE loans).

²¹¹ See *supra* note 55 (explaining that the legal uncertainty surrounding PACE programs has caused investors to hesitate before investing in PACE bonds).

²¹² The proposed amendments are italicized and are the contribution of the author. For the original text of the Maine statute, see *supra* note 50. For the DOE guidelines incorporated in the statute, see *supra* Part II.B.1.

²¹³ See JASPER, *supra* note 41, at 7-8 (explaining that the FHFA imposes stringent guidelines for mortgages it backs).

²¹⁴ See *supra* Part II.A.3 (explaining that the GSEs and the mortgage industry oppose PACE programs because of the lack of sound underwriting standards).

²¹⁵ See *supra* note 44 (listing FHFA guidelines).

²¹⁶ See *supra* Part II.B.1 (describing the guidelines and their favorable reception in the mortgage industry).

²¹⁷ See *supra* note 50 (noting that the DOE guidelines suggest that loans only be offered for projects where the costs exceed the benefits).

in typical property assessments.²¹⁸ The FHFA underwriting standards and DOE Guidelines have the combined effect of ensuring that PACE loans are only extended for appropriate projects, which reduces the risk of default.²¹⁹

C. *States Should Allow a Third Party to Collect PACE Loan Revenues*

§ 10156. PACE mortgages; collection of PACE assessments; priority

1. Collection of assessments. PACE assessments do not constitute a tax or assessment but may be collected by the *Energy Efficiency Trust* (“Trust”), a municipality or an agent designated by the Trust or a municipality in any manner allowed under the PACE program, consistent with applicable laws.

A. *The Trust is created to provide a uniform method of collecting PACE loan revenues from participating property owners and repaying investors in PACE bonds.*

B. *The Trust will also operate a Loan Loss Reserve Fund to insure that subordinate PACE loans are fully repaid in the event of a foreclosure. This Loan Loss Reserve Fund may be funded through the general funds of municipalities with PACE programs or from various state and federal grants and loans.*²²⁰

PACE supporters argue that PACE loans must have a senior lien provision because local governments have no other effective means of collecting money from the liens.²²¹ However, another collection method is needed because local governments cannot make PACE loans senior to

²¹⁸ Cf. *supra* note 96 (listing approved percentages ranging from twenty-five percent to seventy-five percent).

²¹⁹ See *supra* note 74 (explaining that property owners with high LTV ratios are likely to foreclose on their property). The DOE guidelines help solve this problem because they limit the amount of debt a property owner can take on when the property owner receives a PACE loan. See *supra* Part II.B.1 (explaining how the DOE guidelines provide this protection); see also *supra* note 41 (asserting that the FHFA requires property owners to meet stringent guidelines before receiving a loan to guard against the risk of foreclosure). Incorporating the DOE and FHFA guidelines means that only very safe PACE loans will be extended.

²²⁰ The proposed amendments are italicized and are the contribution of the author. For the original text of the Maine statute’s collection provision, see *supra* note 37.

²²¹ The argument is questionable because municipalities use other means such as fees to collect revenues for improvement projects. See *City of Gainesville v. Florida*, 863 So. 2d 138, 145 (Fla. 2003). Nevertheless, the concern should be addressed in the Model Statute to ensure an acceptable compromise for all stakeholders.

other property interests. The collection process should be taken out of the hands of local governments altogether to free up valuable municipal resources for other purposes.

States should establish an Energy Efficiency Trust (“Trust”) to administer PACE loan collection. This is a classic example of tax farming, which has become increasingly popular in recent years.²²² The Trust also has the benefit of economies of scale—as a state-wide organization it is larger than a municipal collection entity and therefore has more resources at its disposal.²²³ The Trust operates a Reserve Fund to pay off PACE liens. This ensures that PACE liens will be fully repaid even though they are junior property interests. This insurance should help relieve investors’ concerns about repayment and help ensure PACE programs are fully funded.²²⁴

Money for the Reserve Fund can come from the general fund of participating municipalities. This means it would come from general tax receipts, not just from property owners who take out PACE loans, so the larger tax base would ensure that the Reserve Fund receive more funds. It might also stimulate demand for PACE loans: all property taxpayers would have skin in the game because they would be funding the PACE insurance program and therefore might want to get a direct benefit from their tax dollars.

D. PACE Loans Must Follow the “First in Time, First in Right” Principle

§ 10156. PACE mortgages; collection of PACE assessments; priority

....

3. Priority. Except as provided in paragraph A, the priority of a PACE mortgage created under subsection 2 is determined based on the date of filing of notice required under subsection 2 and applicable law.

A. A PACE mortgage is not entitled to any special priority unless paragraph B is applicable.

B. The PACE loan may constitute a senior lien upon the property on the same level as a property tax assessment only if the property owner agrees in writing to the payment of the

²²² See *supra* note 88 (explaining the process of tax farming and its benefits to local governments).

²²³ See *supra* note 99 (explaining that loan loss reserve funds achieve economies of scale).

²²⁴ See *supra* note 81 (explaining that investors will not invest in bonds with junior lien repayment provisions, which means that PACE programs with junior lien repayment provisions will go unfunded).

*PACE loan in a manner acceptable to the preexisting mortgage lender or lien holder.*²²⁵

Since PACE loans are merely loans for home improvements, they must follow the traditional “first in time, first in right” principle.²²⁶ This is not a departure from Maine’s statute, because Maine already requires PACE loans to be junior to preexisting property interests.²²⁷ It is a drastic change from the majority position, however, because Maine is the only state to require PACE loans to follow the “first in time, first in right” principle.²²⁸

The Model Statute allows for a minor exception to the “first in time, first in right” principle because PACE loans resemble property assessments in some aspects. This exception is particularly appropriate if states require their local governments to administer loan collection instead of the proposed Trust. The exception allows PACE loans to hold a senior lien position, just like valid assessments, if mortgage lenders agree in writing to the lien seniority.

The exception is justified because it requires the parties to negotiate for the lien seniority. The mortgage lender will agree to the change only after receiving some bargained-for exchange. Presumably, lenders will only agree to such a change in seniority if they feel confident that the property owners will not default on their PACE loan. This encourages property owners to only take on reliable PACE programs.

E. States Must Create a Reserve Fund to Ensure PACE Loans are Repaid

§ 10156. PACE mortgages; collection of PACE assessments; priority.

.....

6. *Loan Loss Reserve Fund.* The Trust shall create a *loan loss reserve fund* to protect the trust in the event of a judicial sale or foreclosure of qualifying property subject

²²⁵ The proposed amendments are italicized and are the contribution of the author. For the text of the original Maine statute, see *supra* note 40.

²²⁶ See *supra* note 84 (explaining that the “first in time, first in right” principle is the general rule for lien seniority unless the lien falls within an exception to the rule). PACE programs do not fall within the exception for property taxes or assessments, and therefore must follow the “first in time, first in right” principle. See *supra* Part III.A.4 (analyzing PACE statutes and concluding that they do not fall within the property tax or assessment exception).

²²⁷ See *supra* text accompanying note 40 (explaining that the Maine statute is the only statute with such a provision).

²²⁸ See *supra* text accompanying note 38 (explaining that while some states do not specify the seniority of PACE loans, most states require senior lien provisions).

to a PACE mortgage. *The Reserve Fund is to be used to satisfy junior PACE liens that cannot be satisfied when a senior mortgage is foreclosed. The Reserve Fund must be funded subject to the provisions in section 10156 1.A. at a level sufficient to offset past due balances on PACE assessments and any remaining principal balances on those assessments, as reasonably predicted based on good lending practices.*²²⁹

The Reserve Fund shall only be used for PACE loans that represent junior property interests.²³⁰ The Reserve Fund is not needed when the parties negotiate for a senior PACE lien position because the senior position guarantees PACE loans will be repaid.²³¹ The Reserve Fund will only come into play when the PACE loan is junior to a foreclosed property interest, and PACE investors risk not receiving a return on their investment. The Reserve Fund will also not release money if there is enough surplus from the foreclosure to satisfy the PACE loan.

The Trust is also required to maintain an adequate amount of money in the Reserve Fund to cover all outstanding PACE loans. This means that the Reserve Funds will satisfy the entire PACE loan, not just the amount due at the time of foreclosure. When the property is sold to subsequent property owners, the property will transfer free of any encumbrances.

V. CONCLUSION

Government programs, like PACE programs, represent a serious effort to combat global warming and should be encouraged whenever possible. However, PACE programs also have significant unintended consequences that could cause the United States housing market to once again experience the painful recession that began in 2008.²³² That recession began in part because homeowners were using their homes as collateral while taking on inappropriate levels of debt.²³³ PACE

²²⁹ The proposed amendments are italicized and are the contribution of the author. For examples of an existing Revolving Loan Fund statute, see *supra* note 37.

²³⁰ See *supra* Part IV.C (discussing the proposed Reserve Fund).

²³¹ See *supra* notes 74–75 (explaining that senior liens are paid off first in foreclosure and junior liens are only repaid if there is a surplus after the senior liens are repaid); see also *supra* Part IV.D (explaining how the proposed statute is designed to foster negotiations among the parties and ultimately lead to more feasible PACE projects).

²³² See *supra* note 7 (explaining how PACE statutes as currently codified could risk repeating the mortgage meltdown of 2008).

²³³ See *supra* note 7 (explaining that the recent recession started because of problems with mortgage lending policies). Homeowners' property became too highly leveraged and

programs potentially enable homeowners to take on inappropriate debt levels and even make that debt senior to preexisting mortgages. PACE programs must be amended because of their ability to increase a property's debt load and because of their interference with preexisting contract rights.

To date, none of the solutions to the PACE controversy proposed by PACE supporters or mortgage industry groups adequately resolve the problem, so a new solution must be proposed. The solution must require PACE loans to follow the "first in time, first in right" principle and provide adequate safeguards to ensure that investors get a return on their investment. This solution addresses the two main competing concerns and would allow PACE programs to become a successful option for homeowners looking to reduce their greenhouse gas emissions. Any other solution will, at minimum, slow the "pace" of our nation's recovery.

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property owners defaulted on their mortgages. *See supra* note 74 (explaining the problems with high LTV ratios).

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