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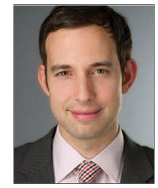
Revised PACE Financing Guidelines: What To Know



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Property owners, ground lessees and real estate developers in New York City recently gained a new potential source of financing capital. On March 4, 2022, the New York City Mayor's Office of Climate & Environmental Justice and the New York City Energy Efficiency Corporation (NYCEEC) issued revised guidelines (the "Revised Guidelines") for the City's sustainable energy loan program known as the NYC Accelerator Property Assessed Clean Energy (PACE) financing program.

Notably, the Revised Guidelines detail the expansion of the scope of the program to include financing for new construction and major renovation projects and confirm that ground lessees are eligible to apply for PACE loans. Given the wider availability of this new source of capital in New York City, it is worthwhile to (re-)examine the program.

This article lays out the basic framework of a PACE loan, including what it is, where it comes from, who qualifies and how it works. We will also discuss the potential benefits of the program and its interplay with traditional real estate financings (including mortgage loans). Although the PACE financing program also has certain residential applications, this article will focus on Commercial Property Assessed Clean Energy (C-PACE) financing.

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What is C-PACE Financing?

As described in the Revised Guidelines, C-PACE financing "is a voluntary financing mechanism that allows property owners to borrow money to improve their new or existing property to reduce utility costs, energy consumption and greenhouse gas emissions." C-PACE programs are generally not publicly funded; private lenders make PACE loans in accordance with a statutory and/or regulatory framework. C-PACE financing differs from traditional financing in several ways. C-PACE loans provide 100% of the upfront capital needed for qualified improvements at closing with no initial expenditures required from the borrower.

C-PACE loans are repaid in installments, each of which is charged as a separate line item on the subject property's tax bill. PACE financing is considered a special assessment on the real property, for which the new owner automatically becomes responsible after a sale of the property. Further, PACE loans are secured by municipal liens on the property which are senior to all liens other than tax liens. Finally, PACE loans typically have longer terms than traditional real estate loans and have a fixed rate of interest throughout such term.

Authority

New York State's PACE statute (N.Y. State General Municipal Law § 119-gg), enacted in 2009, authorizes municipalities throughout the state to establish sustainable energy loan programs. Pursuant to such statute, a financing guidance document published by the New York State Energy Research and Development Authority (NYSERDA)

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outlines many of the rules to which local programs must adhere.

In 2019, as part of the City's sweeping Climate Mobilization Act, the City passed legislation (Local Law 96, N.Y.C. Administrative Code § 11-3001 *et seq.*) authorizing the establishment of the NYC Accelerator PACE program. As originally enacted, the legislation only permitted loans to fund "Energy Efficient Improvements" and "Renewable Energy Systems" at existing buildings. For example, the first C-PACE financing in New York City, which closed in June of 2021, was an $89 million loan used to fund the energy-efficient retrofitting of the former Citibank building at 111 Wall Street in order to comply with the City's increasing carbon emissions restrictions. According to counsel for the building's owners, the financing was expected to save those owners $2.5 million per year in energy costs and help them avoid approximately $750,000 per year in environmental fines.

In April of 2021, the New York City Council enacted Local Law 42 (the "2021 Amendment"), which amended the City's C-PACE law and expanded the program to include new construction projects and major renovations. The New York City Department of Finance implemented the 2021 Amendment by issuing an amended rule that became effective November 7, 2021. However, in practice, the expanded program only went live with the recent issuance of the Revised Guidelines.

Who is Eligible?

Pursuant to the City's PACE law, financing is available to "owners of real property located within the city." However, there are certain restrictions that could prohibit eligibility. Per NYSERDA guidance, the property owner must not be: (i) in bankruptcy (nor may the property be subject to any bankruptcy proceeding), (ii) behind in its payments on any existing mortgages, or (iii) delinquent in the payment of any real estate taxes pertaining to the subject property. The Revised Guidelines provide further that a PACE applicant must not be (a) directly or indirectly affiliated with, owned or controlled by the lender, or (b) delinquent in the payment of any civil penalties, water or sewer charges or other debt to the City at the time the loan is made.

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The 2021 Amendment set forth a definition of "real property" that includes any *recordable interest in property*, thereby clarifying that many ground lessees will now be eligible for loans under the expanded C-PACE program. Per the Revised Guidelines, for a leasehold interest to qualify, (i) the lease must have a remaining term equal to or greater than the term of the PACE loan, (ii) the lessee/borrower must be designated as the party to receive the applicable property tax bills, and (iii) the leasehold interest must constitute the entirety of the subject property, which property must be a single tax lot.

In many cases, an applicant for a PACE loan will need to obtain certain third-party consents for its application. If the subject property is encumbered by a mortgage or similar security instrument, the lender must provide its consent before the owner's PACE loan application can be considered. Additionally, in response to public comments made during the rule-making process, the 2021 Amendment requires that the holder of a leasehold interest obtain the consent of the fee owner before applying for PACE financing.

Eligible Improvements

PACE loans can be used to fund "Energy Efficient Improvements" or "Renewable Energy Systems." Energy Efficient Improvements are improvements that reduce energy consumption (such as window or door replacements, weatherstripping, air sealing, insulation, or heating and cooling system upgrades), so long as such improvements attach to the property. Renewable Energy Systems are certain pre-qualified energy-producing systems, including (among others) solar, wind and geothermal energy systems. In either case, a loan application will only be approved if the projected savings to investment ratio (SIR) is 1.0 or greater, as determined by a mandatory technical certification given pursuant to an audit and/or feasibility study performed by an NYCEEC-approved contractor or engineer.

Pursuant to the 2021 Amendment and the Revised Guidelines, PACE loans may be made for new construction or major renovation projects even where they do not meet the required SIR threshold if the improvements funded by the loan consist solely of Energy Efficient Improvements and/or pre-qualified Renewable Energy Systems, except that the PACE loan proceeds can be applied to the funding of ancillary improvements necessary for the construction of the qualified improvements. However, under the Revised Guidelines, new construction and/or major renovations only qualify for PACE loans if the project entails the "design, development and construction of an All Electric Building." This means the building must be designed, developed, operated and maintained such that no device, machinery, equipment, components, systems or elements, if installed or used in such building, would cause or otherwise involve any type of combustion within or on such building of any substance that emits 25 kilograms or more of carbon dioxide per million British thermal units of energy.

According to the Revised Guidelines, retroactive C-PACE financing is also available for improvement projects that meet the qualifying standards, so long as the improvements were completed within the three years immediately preceding the date of the loan application.

C-PACE Loan Process And Terms

In order to apply, a property owner would contact a qualified private capital provider. A current list of participating and qualified lenders is available at the NYC Accelerator PACE program website at https://www1.nyc.gov/site/nycaccelerator/resources/pace.page. The lender delivers the loan application to NYCEEC, which in turn qualifies the project according to (i) the requirements set forth in the New York General Municipal Law (§ 119-gg), the New York City Administrative Code (§ 11-3001 *et seq.*), and the Rules of the City of New York (Chapter 58 of Title 19) and (ii) regulatory guidance provided by NYSERDA and the Revised Guidelines. Other than in the case of new construction projects consisting solely of pre-qualified energy efficient improvements, the approval process must include the performance of either an energy audit for energy efficiency improvements or a renewable energy system feasibility study. If approved, the C-PACE loan may retroactively be applied to the cost of such audit or study.

After a project is approved but before the PACE loan is effective, the property owner must enter a financing agreement with the capital provider. The terms of the financing agreement must provide for the funding at closing of 100% of the amount needed to construct the qualified improvements, including ancillary hard or soft costs. In the case of new construction or major renovation projects, the amount of the PACE loan is capped at 25% of the total project cost. The term of the loan must be less than or equal to the average weighted useful life of the financed improvements and the loan must be provided at a fixed rate of interest.

Following the making of a loan, a notice of the loan must be recorded in the applicable land records. The Revised Guidelines resolved an open question, as discussed in a previous article in this publication (Thomas O'Connor and YuhTyng Patka, *PACE Goes Live in New York: Watch Out for the Pot Holes*, 226 N.Y. Law Journal 58 (Oct. 13, 2021)), by confirming that the filing of such notice does not in and of itself create a lien on the subject property and thus no mortgage recording tax should become due in connection with a PACE financing loan.

During the term of the loan, NYCEEC will be responsible for billing and collection. Interestingly, the Revised Guidelines require that "repayment of the loan cannot be accelerated upon the occurrence of an event of default or any other event, and the obligation to repay the loan stays with the subject property regardless of a change in the ownership". According to the Energy Improvement Corporation (which administers the New York State C-PACE program), in the event of a default, a program administrator can foreclose on the subject property after satisfying any superior tax liens by paying off the delinquent taxes.

Going Forward

It remains to be seen how prevalent C-PACE financing will become as a source of capital in the New York City real estate market. One major contributor to the success or failure of the program in the market, will be the willingness of traditional mortgage lenders to participate in the program. Whether lenders will grant consent when requested, and whether they will be willing to make loans to properties subject to PACE liens, remain open questions.

Some commentators are anticipating that the competitive forces of the market will force lenders to acquiesce. On the other hand, property owners and developers alike may be hesitant to pursue PACE loans for fear of souring existing relationships with their lenders. Speculation aside, the success of New York City's C-PACE financing program, or the lack of such success, is certain to have a major effect on the implementation of similar programs in the nationwide real estate financing market for years to come.