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Foiled by the Banks? How a Lender's Decision May Support or Undermine a Jurisdiction's Environmental Policies that Promote Green Buildings

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FOILED BY THE BANKS? HOW A LENDER'S DECISION MAY SUPPORT OR UNDERMINE A JURISDICTION'S ENVIRONMENTAL POLICIES THAT PROMOTE GREEN BUILDINGS

*Darren A. Prum**

A United Nations Environmental Programme report addressing climate change states that the built environment in both emerging and developed countries accounts for more than forty percent of global energy usage and at least one third of the world's greenhouse gas emissions. The report further asserts that the built environment offers an unsurpassed opportunity to supply cost effective, lasting, and meaningful reductions in greenhouse gas emissions. In response to this call to action, state and local governments in the U.S. have turned to a variety of policies to ensure that real estate developments within their jurisdictions further green building objectives. However, the availability of mortgage financing for the construction or acquisition of green buildings can undermine policymakers' overarching environmental objectives. Lenders who misunderstand the unique risks and opportunities associated with green buildings may undercut these important environmental policies by denying real estate financing for worthy construction projects or acquisitions. Accordingly, this Article builds upon my previous work that addressed some of the financial aspects relating to green buildings such as performance bonds, insurance, and construction loans while now turning to the unique issues associated with mortgages and provides solutions that can mitigate risk exposure to acceptable levels so the lending community can further a more ecologically-friendly built environment.

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Introduction

Across the country, policymakers at all levels of government are working to address climate change issues that emanate from the continued release of greenhouse gases into the atmosphere.[1] In considering the various sources and their respective contributions, a United Nations study explained that the built environment accounts for forty percent of the global energy usage and at least one third of the world's greenhouse gas emissions.[2] Given

1. *See generally* Darren A. Prum, Robert J. Aalberts & Stephen Del Percio, *In Third Parties We Trust? The Growing Antitrust Impact of Third-Party Green Building Certification Systems for State and Local Governments*, 27 J. Envtl. L. & Litig. 191, 204–19 (2012).

2. U.N. Env't Programme [UNEP], *Buildings and Climate Change: Summary for Decision-Makers*, U.N. Doc. DTI/1240/PA, at 9 (2009).

this opportunity for significant emissions reductions, many policymakers have turned to the built environment as a key component in their strategies to address climate change within their jurisdictions.[3]

In focusing on private sector buildings, policymakers have an opportunity to deliver cost-effective, lasting, and meaningful reductions in greenhouse gas emissions.[4] Most of these buildings programs offer something of value to developers in exchange for specified design changes or existing building upgrades.[5] These initiatives can occur at the state or local level, and they may take the form of financial or nonfinancial incentives.[6] In many situations, the incentive programs have become highly successful in encouraging developers to build an environmentally-friendly structure.[7]

While many policymakers have found these types of initiatives an effective tool to encourage the construction of environmentally friendly buildings, the underlying policy goals may be undermined if the ultimate owner of the structure cannot get a mortgage to complete the purchase. In some situations, the developer is the ultimate owner of a building and must secure permanent financing prior to receiving approval for a construction loan;[8] while at other times, the mortgage will fund the purchase of an existing structure.[9] In both of these circumstances, the ultimate owner of the building will frequently need the assistance of the lending community to provide a long-term and permanent mortgage for the bulk of the real property's value to move forward with the structure's acquisition.[10]

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3. *See* CHARLES K. KIBERT, SUSTAINABLE CONSTRUCTION: GREEN BUILDING DESIGN AND DELIVERY 47–49 (2d ed. 2007). For example, the "Greening of the White House" efforts that began in 1993 showed dramatic energy cost savings of approximately $300,000 per year, reductions in emissions of approximately 767 metric tons of carbon per year, and substantial decreases in the related costs for water and solid waste. *Id.* at 48. These achievements paved the way for new efforts in other parts of the executive branch of the government like the U.S. Post Office, the Department of Defense, the Department of Energy, and the General Services Administration. *Id.* at 49.

4. *See* Prum, Aalberts & Del Percio, *supra* note 1.

5. *Id.*

6. *Id.*

7. *See* Darren A. Prum, *Creating State Incentives for Commercial Green Buildings: Did the Nevada Experience Set an Example or Alter the Approach of Other Jurisdictions?*, 34 WM. & MARY ENVTL. L. & POL'Y REV. 171, 188–99 (2009) [hereinafter Prum, *State Incentives*]. In New York, just seven projects exhausted the entire incentive pool, compared to the program passed by the Nevada Legislature, which was too generous and caused the state to revise and limit the benefits associated with compliance at its next scheduled meeting. *Id.* at 192.

8. *See* Paul V. Franke, *A Primer on Construction, Permanent, and Bridge Lending in Financing the Affordable Housing Deal*, 7 J. AFFORDABLE HOUS. & CMTY. DEV. L. 279, 284 (1998).

9. *See* PETER S. BRITELL, GREEN BUILDINGS: LAW, CONTRACT AND REGULATION § 8.01 (1st ed. 2010).

10. *See generally* TERRENCE M. CLAURETIE & G. STACY SIRMANS, REAL ESTATE FINANCE: THEORY & PRACTICE 415 (Cengage Learning 6th ed. 2010).

In building upon my previous work that tackled some of the financial aspects relating to green buildings such as performance bonds,[11] insurance,[12] and construction loans,[13] this Article seeks to address the adjustments necessary in the underwriting process and accompanying documents to properly manage and mitigate the risk exposure and support climate change action within the built environment. Part I examines the inherent risks that confront lenders when extending permanent loans on any type of building regardless of its green features. These risks may emanate out of various title theories applied across the country, federal environmental regulations, restrictive covenants and equitable servitudes, and issues stemming from the manner in which the borrower acquires the building. It also considers how lenders attempt to mitigate risks through underwriting measures that carefully consider the suitability of the borrower and the property offered as collateral.

Part II turns to the unique attributes and risks green buildings pose to lenders of permanent financing. Some of these risks occur uniformly, no matter the method used to obtain the structure, while other risks originate from the acquisition method. These common risks often stem from a lack of knowledge about green buildings and translate into misguided estimates and prognostications in the financial models developed by underwriters to assess risk premiums for loans, the ability of a borrower to adequately insure the collateralized property, and the various green attributes incorporated into the structure. In situations where a development project triggers permanent financing, government requirements and third-party certification issues may create risk.

Finally, Part III offers solutions that can mitigate the unique risks green buildings pose to permanent lenders. The subparts provide recommendations specific to the underwriting process and to permanent loan documents. The proposals for the underwriting process offer suggestions to assist lenders in capturing pertinent information at the time of the application and evaluating the financial models and pro-forma statements when making the loan decision. Similarly, the recommendations for loan docu-

11. Darren A. Prum & Lorilee A. Medders, *The Bonds That Tie: Will a Performance Bond Require that a Surety Deliver a Certified Green Building?*, 9 HASTINGS BUS. L.J. 1 (2012).

12. Darren A. Prum, *The Next Green Issue: Considering Property Insurance for the Green Building*, 7 VA. L. & BUS. REV. 421 (2013) [hereinafter Prum, *Next Green Issue*].

13. Darren A. Prum, *Greenbacks for Building Green: Does a Lender for Sustainable Construction Projects Need to Make Adjustments to Its Current Practices?*, 43 ENVTL. L. 415 (2013) [hereinafter Prum, *Greenbacks*]. This Article seeks to expand upon the issues initially addressed with construction loans in *Greenbacks for Building Green* by turning to the unique concerns that emanate out of permanent financing instruments on both newly constructed and existing structures.

ments take aim at preconditions and conditions subsequent that can mitigate the unique exposures of the green building.

I. Mortgage Risks

Lenders consider many factors when evaluating a potential loan to ensure timely repayment and avoid losses.[14] Some of these factors include the priority over other creditors, the presence of hazardous substances requiring remediation, and whether the loan supplies funding for a development project or an existing structure. Most lenders attempt to limit their exposure to such risks through an underwriting process that carefully considers the suitability of the borrower and the property offered as collateral.

Accordingly, this Part examines the risks inherent to all mortgage finance and how the underwriting process screens applicants for such risks. Through this careful examination of the proposed collateralized property and applicant, the underwriters will determine the creditworthiness of an application along with a corresponding risk for funding the loan. This risk assessment and possible remediation solutions, such as higher interest rates or more stringent covenants, will give critical input to lenders as to whether funding the loan is appropriate. On a more macro level, it will determine the availability of funding for all buildings, including those considered green.

A. *Loss Exposures/Encumbrances*

Across the country, state governments establish and maintain the systems that preserve the official records of land ownership. These property records systems serve as important documentation for the courts when recognizing and enforcing rights and encumbrances on real property.[15] When resolving these types of real property disputes, many courts must follow the legally recognized recording system of a given jurisdiction to establish the priority order for an encumbrance on a specific parcel of land.[16] Because courts follow local recording systems when determining priority positions, the same factual scenario may lead to different results for priority order based on the recording system involved.[17] For example, a party with a claim

14. *See* David M. Geltner et al., Commercial Real Estate Analysis and Investments 442–43 (OnCourse Learning 3d ed. 2014).

15. Roger A. Cunningham et al., The Law of Property § 11.9, at 823 (2d ed. 1993).

16. *Id.* § 11.9, at 825–26.

17. Ray E. Sweat, *Race, Race-Notice and Notice Statutes: The American Recording System*, 3 Prob. & Prop. 27, 28 (1989). Approximately half of all jurisdictions follow a "notice" approach where a bona fide purchaser for value receives protection regardless of the recording of the encumbrance. *Id.* This makes the recording of an encumbrance irrelevant, so long as the parties exchanged something of value. *Id.* Nearly all of the remaining states use a

against a given parcel of land could risk the diminishment of its rights should it fail to properly record the encumbrance in a timely manner.[18] Thus, lenders that wish to secure their loans using real property as collateral must understand a jurisdiction's approach and recognize the potential for numerous encumbrances upon the land before entering into a transaction.

1. Theories of Title

The titling and ownership of real property, along with the ability to encumber it, differs across the country. The main approaches in use today include the "title" and "lien" theories of mortgage law and an intermediate method.[19] In jurisdictions following English common law under a Title Theory, the lender holds the legal "title" to the real property until the debt is satisfied or foreclosed, but does not receive possession.[20] In contrast, in lien theory states, the lender retains a security interest in the real property and receives the right to possess it after a valid foreclosure occurs, resulting in the owner of the land maintaining the title.[21] In addition, a few states attempted to find middle ground through an intermediate theory, which gives the lender possession when a default occurs but leaves the title on the real property with the owner.[22]

With these different methods in place, the lender's and property owner's status on the title and standing for obtaining a security interest in the real estate becomes an issue. In those jurisdictions that follow a title theory, the lender will automatically obtain legal "title," along with a security interest, at the time of the conveyance.[23] This approach makes it difficult for a lender to lose its priority status in foreclosing on the property if the owner fails to repay the loan.

In comparison, the owner retains the "title" to the real property with the lender's interest becoming that of a lienholder in the lien and intermediate theory jurisdictions.[24] Consequently, a sloppy lender could unintentionally surrender its priority position and potentially suffer a loss if another

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"race-notice" system that includes a bona fide purchaser and recording requirement. *Id.* This means that the first to record and receive value for the encumbrance will receive priority over all others claiming an encumbrance. *Id.* Finally, some states award priority based on the order in which the encumbrances record and are called pure "race" jurisdictions. *Id.*

18. *Id.*

19. 1 GRANT NELSON & DALE WHITMAN, REAL ESTATE FINANCE LAW § 1.5, at 12 (6th ed. 2014).

20. *Id.* § 4.1, at 201. Currently, a minority of states follow this approach. *Id.*

21. *See id.* § 4.2, at 202–03. Currently, thirty-two states follow this approach. *Id.* § 4.2, at 202 n.1.

22. *Id.* § 4.3, at 208.

23. *See id.* § 4.1, at 199–201.

24. *See id.* §§ 4.2–4.3, at 202–03, 208–10.

encumbrance exists against the real property and then gains superior rights.[25]

For these reasons, many of the participants in the real estate community and lenders recognize these risks and require a proper recording of the appropriate documents without delay.[26] Nonetheless, a lender may also face the prospect of losing its priority position in those jurisdictions that draw distinctions between obligatory and optional advances.[27] When the covenants of the loan agreement provide for the disbursement of funds at a later date, an obligatory advance occurs; but if the lender uses its own discretion, the situation becomes an optional advance.[28] In some jurisdictions that set the priority date based on the disbursement of funds, a subordination of the mortgage to other lien claims will occur because the loan agreement does not compel the optional advance.[29]

Hence, careless mortgage lenders may have their security interest subordinated to other encumbrances in situations where the lending agreement fails to compel any applicable subsequent disbursements in a lien theory jurisdiction.

2. Environmental Issues

Improper disposal of hazardous waste on a property can pose serious risks to lenders. This is especially true when the government places a lien on the property effectively subordinating a mortgage or deed of trust, or when subsequent litigation occurs and a court attaches liability to the lender as a responsible party. Accordingly, prudent lenders must properly assess these risks.

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) imposes strict joint and several liability for hazardous waste cleanup costs on "Potentially Responsible Parties" (PRPs), including owners, past owners, and operators of facilities.[30] The "security interest ex-

25. *See* 3 PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER AND O'CONNOR ON CONSTRUCTION LAW § 8:146, at 334–39 (2002).

26. *See generally* CUNNINGHAM ET AL., *supra* note 15.

27. *See* 3 BRUNER & O'CONNOR, JR., *supra* note 25, § 8:146, at 337.

28. *Id.*

29. *Id.* One of the earliest cases to set a preferential order of repayment between two different loans secured by a parcel of real property was *Gordon v. Graham*, where the initial lender made subsequent discretionary advances after a second mortgage occurred. (1714) 22 Eng. Rep. 502 (Ch), *overruled by* Hopkinson v. Rolt, (1861) 11 Eng. Rep. 829 (HL). The *Gordon* court decided the case based on its belief that "it was the Folly of the second Mortgagee, with Notice, to take such Security." *Id.*

30. Comprehensive Environmental Response, Compensation, and Liability Act of 1980, Pub. L. No. 96-510, 94 Stat. 2767 (codified as amended at 42 U.S.C. §§ 9601–9675

emption" provides a safe harbor for most securitized lenders.[31] This exemption prevents the government from holding a lender as a responsible party that merely retains a mortgage or lien on a property.[32] However, should a lender foreclose on a contaminated parcel of real estate or become too involved in the operation of the property owner's business through its influence or through an outright takeover, the lender may void the exemption.[33] Thus, a lender faced with a troubled loan from an existing borrower must conduct a thorough analysis on its environmental risks, focusing on how to recover its investment and whether it should foreclose and sell the collateralized property or accept a loss by relinquishing its security interest rights against the land.

Besides facing potential liability for cleanup costs, a lender may unwittingly lose priority on its security interest to a CERCLA lien that attaches to property where the U.S. government has incurred cleanup costs. The Superfund Amendments and Reauthorization Act of 1986 (SARA) authorizes the federal government to place a lien on real property of a PRP.[34] Under the Small Business Liability Relief and Brownfields Revitalization Acts in 2002 (Brownfields Act), the U.S. Environmental Protection Agency (EPA) received expanded powers to use the "windfall lien" provisions in situations where a bona fide prospective purchaser[35] takes title to property that received the benefit of public cleanup funds.[36] The EPA calculates the

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(2013)); ROBERT J. AALBERTS & GEORGE J SIEDEL, REAL ESTATE LAW 603 (Cengage Learning 7th ed. 2009).

31. Omnibus Consolidated Appropriations Act of 1997, Pub. L. No. 104-208, § 2502(b), 110 Stat. 3009, 3009-464 (1996).

32. *See* CLAURETIE & SIRMANS, *supra* note 10, at 485.

33. 42 U.S.C. § 9601(20)(a)(iii). Several statutory defenses become available in those situations where a lender gets drawn into a claim that originates out of foreclosure or by significantly influencing the business operations. 42 U.S.C. § 9607(b). These defenses include assertions that the lender does not fit within the meaning of a "responsible party"; that the contamination occurred solely due to an act of God, an act of war, or the act or omission of a third party having no relationship with the lender; and that the innocent purchaser or landowner defense applies. *Id.*

34. Superfund Amendments and Reauthorization Act of 1986 (SARA), Pub. L. No. 99-499, § 107(f), 100 Stat. 1613, 1630 (codified as amended at 42 U.S.C. § 9607(l)).

35. As an incentive to spur the redevelopment of brownfields, Congress provided a CERCLA defense to those landowners that knowingly acquire or lease contaminated property after January 11, 2002. *See* 42 U.S.C. § 9601(40). Those asserting the bona fide prospective purchaser defense must prove by the preponderance of the evidence that they satisfy the conditions set forth in the statute. *Id.*

36. Small Business Liability Relief and Brownfields Revitalization Acts in 2002, Pub. L. 107-118, § 102(a), 115 Stat 2356 (codified as amended at 42 U.S.C. § 9607(r)(2)). Pursuant to the applicable "windfall lien" statutes, the EPA must prove that: (1) the government carried out a response action, (2) the government failed to recoup its costs to respond, and (3) the cleanup activity increased the fair market value of the property over a prior assess-

lien amount by considering the difference in fair market value attributable to the remediation efforts and includes costs from the moment the agency spends money on the cleanup until the disposition of the property or when another source pays for the response costs.[37]

Remarkably, the EPA may incur costs associated with remediation and clean-up efforts at one point in time but may elect to perfect and record the lien at a later date.[38] This unique provision in the law allows for a "secret lien" to occur due to the fact that the statutes stipulate that the lien "will arise" at the moment when the EPA incurs expenses to remediate the pollution.[39]

Because neither the SARA legislation nor the Brownfields Act addresses the issue on the level of priority for this type of lien with respect to other encumbrances, several state and local governments passed statutes and ordinances to provide some level of direction.[40] In these jurisdictions, a state's hazardous waste lien can subordinate other deeds, mortgages, and

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ment based on its condition at the time. *Id.* § 9607(r)(3). Given the expansive authority conveyed by these provisions, the EPA provided initial guidance through several policy statements that clarified the process and requirements for giving notice, filing, and perfecting this type of lien. Memorandum from Thomas L. Adams, Jr., Assistant Adm'r, Office of Enf't & Compliance Monitoring, U.S. Envtl. Prot. Agency, on Guidance on Federal Superfund Liens to Reg'l Adm'rs, Regions I–X, Reg'l Counsels, Regions I–X, Dirs., Waste Mgmt. Div., Regions I–X (Sept. 22, 1987), http://www.epa.gov/enforcement/guidance-federal-superfund-liens-supplemental-guidance; Memorandum from William A. White, Enf't Counsel, Office of Enf't/Superfund, and Bruce M. Diamond, Dir., Office of Waste Programs Enf't on Supplemental Guidance on Federal Superfund Liens to Reg'l Counsels, Regions I–X, Dirs., Waste Mgmt. Divs., Regions I–X (July 29, 1993), http://www.epa.gov/enforcement/guidance-federal-superfund-liens-supplemental-guidance.

37. 42 U.S.C. § 9607(r)(4).

38. *See* Memorandum from Susan E. Bromm, Office of Site Remediation Enf't, U.S. Envtl. Prot. Agency & Bruce S. Gelber, Envtl. Enf't Section, U.S. Dep't of Justice on Interim Enforcement Discretion Policy Concerning "Windfall Liens" Under Section 107(r) of CERCLA to Dir., Office of Site Remediation and Restoration, Region I et al. (July 16, 2003) [hereinafter Interim Windfall Lien Policy], http://www.epa.gov/enforcement/interim-guidance-enforcement-discretion-concerning-windfall-liens-cercla-section-107r; Memorandum from Susan E. Bromm, Office of Site Remediation Enforcement, U.S. EPA on Windfall Lien Admin. Procedures to Superfund Division Directors, Regions I–X, Regional Counsel, Regions I–X (Jan. 8, 2008) [hereinafter Windfall Lien Admin. Procedures], http://www.epa.gov/enforcement/guidance-windfall-lien-administrative-procedures-107r-lien-and-model-letter-providing.

39. *See* Interim Windfall Lien Policy, *supra* note 38; Windfall Lien Admin. Procedures, *supra* note 38.

40. *See, e.g.*, CONN. GEN. STAT. § 22a-452a (2013); 65 ILL. COMP. STAT. 5/11-31-1(e), (f) (2014); ME. REV. STAT. ANN. tit. 38 § 1371 (2001); MASS. GEN. LAWS ch. 21E, § 13 (2014); N.H. REV. STAT. ANN. § 147-B:10-b (West Supp. 2015); N.J. STAT. ANN. §§ 58:10-23.11f(f) (West Supp. 2015), 58:10B-25.2 (West 2006). Some counties also maintain these types of provisions. *See, e.g.*, MIAMI DADE COUNTY, FLA., ENVIRONMENTAL PROTECTION ORDINANCES § 24-31(8).

encumbrances.[41] However, the federal statute still requires perfection of the windfall lien and only allows for priority status once recorded.[42]

While the full force of the statutes convey unique powers to the EPA, the agency also recognizes that this authority may create consternation and reluctance on the part of lenders to accept this type of risk or even limit participation in brownfield redevelopment altogether. As a result, the EPA also developed a policy to address potential issues raised by interested parties.[43] At the request of an interested party, the EPA may issue a letter that explains the agency's intentions with regard to pursuing a windfall lien on a particular piece of real property.[44]

Consequently, a lender must evaluate each building and the associated real property for any loss exposure it may have from an environmental perspective before providing its permanent financing. Some of these environmental assessments must occur prior to funding the loan, while others must occur on an ongoing basis to avoid later litigation. Therefore, environmental issues pose significant risks to lenders, who must develop a plan to minimize these risks in real property transactions.

3. Nongovernmental Issues

In addition to traditional sources of loss, a lender may face issues from nongovernmental parties through restrictive covenants placed on the land by prior owners or contractual relationships.[45] The strength of these private regulations on the attached structure can influence the value or legal status of the mortgaged property and pose risk to any lending activity that uses real property as collateral.[46]

a. Land Use Restrictions

Following common law principles, a property owner may exercise different legal approaches to privately compel and regulate land use.[47] The traditional methods for commercial structures include real covenants and

41. *See, e.g.*, sources cited *supra* note 40.

42. 42 U.S.C. § 9607(l)(3). This provision guarantees the recordation of the lien by stating, "If the State has not by law designated one office for the receipt of such notices of liens, the notice shall be filed in the office of the clerk of the United States district court for the district in which the real property is located." *Id.*

43. *See* Interim Windfall Lien Policy, *supra* note 38; Windfall Lien Admin. Procedures, *supra* note 38.

44. *Id.*

45. *See* BRIELL, *supra* note 9.

46. *Id.*

47. *See* Donald J. Kochan, *A Framework for Understanding Property Regulation and Land Use Control from a Dynamic Perspective*, 4 MICH. J. ENVTL. & ADMIN. L. 303, 303 (2015).

equitable servitudes that run with the land. A more modern approach entails creation of architectural review boards (ARBs), which must interpret a set of covenants, conditions, and regulations (CC&Rs) that attach to the deeds of trust.[48]

Real covenants offer mutually enforceable promises that limit the use of land for specific purposes in a manner that binds every successive grantee.[49] Real covenants run with the land, which means that the real property and terms of the agreement must transfer together when conveyed to a subsequent grantee.[50] While traditional common law maintains a bias towards narrowly construing covenants that impose restrictions upon the use and enjoyment of the burdened land, today's reality reveals a more liberal approach.[51] Often, the goal of the covenant is to achieve a greater good and create a benefit for the land, which allows for the selective application of the traditional approach.[52] Accordingly, the vast majority of courts now liberally construe uniform real covenants that apply to nearly all of the lots in a subdivision that also create both a burden and benefit.[53]

Using a parallel approach to achieve comparable outcomes, equitable servitudes call upon historically equitable principles to create benefits and burdens that run with the land and bind successive owners, so long as they receive notification of the original arrangement.[54] As this approach has

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48. *See id.* at 328. Of course, other methods exist such as Defeasible Fees and Negative Easements. Defeasible fees are present estates that maintain the capacity to last in perpetuity like a fee simple absolute. However, these are outside the scope of this Article.

49. *See Covenant Running with the Land*, BLACK'S LAW DICTIONARY 445 (10th ed. 2014).

50. *Id.* There are five requirements for a real covenant to run with the land, as Judge Charles E. Clark explains:

> (1) the form of the covenants;
> (2) whether the covenanting parties intended the covenant to run;
> (3) whether the covenant touches and concerns;
> (4) whether there is privity between one or both of the covenanting parties and the remote parties or parties sought to be benefited or burdened ("vertical privity"); and
> (5) whether there is privity between the original covenanting parties (called "horizontal privity").

See CHARLES E. CLARK, REAL COVENANTS AND OTHER INTERESTS WHICH "RUN WITH THE LAND" 94 (2d ed. 1947); *see also* CUNNINGHAM ET AL., *supra* note 15, §§ 8.13–8.18, at 466–80.

51. *See* CUNNINGHAM ET AL., *supra* note 15, § 8.13, at 467.

52. *Id.*

53. *Id.* Roger Cunningham explains that many homebuyers place a premium on homes where a tight system of real covenants protects a community's value over those without such burdens. *Id.* By extension, this same logic extends to master planned developments or industrial parks where the construction of commercial green buildings occurs frequently.

54. *Id.* § 8.22, at 485. For an equitable servitude to run with the land, Professor Cunningham explains, there are six requirements:

> (1) form of the covenant;

evolved to become the primary choice for developers that subdivide larger parcels of land, the relaxed requirements of the equitable theories have allowed for more liberal interpretations. Sometimes these expansive approaches occur when interpreting the essential requirements for an equitable servitude. For instance, the "existence of a general development plan to determine whether the successors were intended to benefit from servitudes, and have inferred lack of intent where no general plan exists" can determine whether intent exists.[55] Other times, the courts chose to extend the equitable theories into real covenants, apply a contractual approach to create third-party beneficiaries, or even eschew the philosophies from either common law or equity.[56]

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(2) intent of the covenanting parties that the covenant shall run;
(3) the requirement of touch and concern;
(4) (horizontal) privity between the covenanting parties;
(5) benefit or burden to successors of the covenanting parties; and
(6) notice.

Id. § 8.22, at 486. The theoretical distinction between a real covenant and an equitable servitude has to do with the placement of the burden. *See id.* § 8.22, at 485. Under a real covenant, the burden is placed upon the estate that holds the land, which carries forward with each conveyance. *See id.* In contrast, an equitable servitude places a burden directly upon the land just like an easement, which leads to the saying "the servitude 'sinks its tentacles into the soil.'" *Id.* Hence, the party entitled to enforce a real covenant tends to seek damages whereas the beneficiary of an equitable servitude tends to favor an injunction against future breaches along with any damages for earlier infringements. *Id.* §§ 8.21, 8.31, at 483–84, 495–96.

55. Susan F. French, *Toward a Modern Law of Servitudes: Reweaving the Ancient Strands*, 55 S. CAL. L. REV. 1261, 1279 (1982).

56. *See* CUNNINGHAM ET AL., *supra* note 15, §§ 8.32–8.33, at 501–04. In extending the equitable theories, some courts allow "implied reciprocal servitudes" when a developer creates multiple lots and then sells some or all of the parcels to buyers who are both benefited and burdened by the uniform covenants and receive them both explicitly and impliedly. *Id.* § 8.32, at 496–501. Under this approach, courts generally start by establishing a real covenant but then mix and blend equitable theories pertaining to easements into their reasoning to create a cocktail of precedent for upholding the developer's uniform covenants. *Id.* § 8.32, at 501.

In applying a third-party beneficiary theory, those courts take the approach that the rights to enforcement originated in contract rather than the more accepted interests in land and apply to all parcels regardless of whether their deed actually contained the restrictions in question. *Id.*; *see also* Robert Kratovil, *The Declarations of Restrictions, Easements, Liens, and Covenants: An Overview of an Important Document*, 22 J. MARSHALL L. REV. 69, 70–71 (1988). These courts look toward the existence of a common plan for development, that some deeds within the covered land include the restriction in question, and that some of the landowners actually follow the covenants on the ground. CUNNINGHAM ET AL., *supra* note 15, § 8.32, at 502.

Finally, Professor Cunningham categorizes "Second-Generation" cases as those from a series of decisions that uphold the running of covenants upon the land without relying upon any legal theory to uphold them. *Id.* § 8.33, at 503. The first group of these types of cases makes a conclusory statement regarding the existence of a common plan of development and

Finally, the use of ARBs offers another method for a master planner or developer to privately regulate a parcel. In these situations, when conveying the land, the master planner or developer creates a common interest development (CID) by creating separate property ownerships, coupled with an interest in the common area or association of the entire parcel.[57] The developer drafts the CC&Rs, which are mutually binding and enforceable agreements against all owners within the CID.[58] However, the enforcement, maintenance, and interpretation of the CC&Rs is delegated to the CID's association or its designee, like an ARB.[59] Pursuant to the applicable CC&Rs, the CID's association or ARB then possesses the authority to approve and enforce all construction plans according to the master planner or developer's design as well as any subsequent changes to the structures within the development.[60] Because the CC&Rs run with the land, along with burdening and benefiting current and future property owners, the CID's association maintains the ability to legally enforce its decisions through the courts.[61]

Thus, lenders must conduct their own research as to whether the real property and building proposed as collateral for the loan includes any underlying or problematic land use restrictions for the mortgagor. These restrictions may occur on a general level but may also include some very specific standards for the type and level of green building measures required. There may also be operational requirements for occupants, which can negatively affect a property's value or the ability of a mortgagor to keep

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covenants by the grantors and grantees and then holds for their enforcement. *Id.* The second group allows for the enforcement on behalf of the fellow lot owners by a third-party beneficiary or trustee such as a homeowner's association that may own its own land instead of attributing its authority to the vindication of its own rights. *Id.* § 8.33, at 503–04. The last group removes the notice requirement of the restrictions by treating the covenants like easements. *Id.* § 8.33, at 504.

57. *See, e.g.*, CAL. CIV. CODE § 6580 (West Supp. 2016). In some jurisdictions, such as California, the government imposes additional requirements that must be recorded, for example a declaration and parcel map. *Id.* The association generally owns and manages the common areas including the parking lots, non-dedicated streets, and various amenities. All landowners become members of the association once they receive title to their properties, must pay fees for the upkeep of the common areas, and must abide by the rules for maintaining the desired environment declared in the CC&Rs that are attached to the deeds.

58. *See, e.g.*, *id.* § 6614.

59. *See, e.g.*, *id.* § 6858.

60. *See generally*, Daniel K. Slone, *Legal Aspects of Eco-Industrial Development*, *in* ECO-INDUSTRIAL STRATEGIES: UNLEASHING SYNERGY BETWEEN ECONOMIC DEVELOPMENT AND THE ENVIRONMENT 139–40 (Edward Cohen-Rosenthal & Judy Musnikow eds., 2003). Architectural design, building height, outdoor storage limitations, maintenance of common areas, and use limits are examples of the various types of rules set forth by CC&Rs in CIDs. *Id.* at 143–44.

61. *See, e.g.*, CAL. CIV. CODE §§ 6614, 6858 (West Supp. 2016).

its business open and make payments.[62] Accordingly, lenders must complete their due diligence with regard to land use restrictions, or risk an unforeseen loss.

b. Leasehold Estates

Another instance of private regulation potentially leading to unforeseen loss is a mortgage upon a leasehold estate.[63] In these situations, the lender funds a loan for a building where the mortgagor does not own the land on which the structure is located but uses the structure as collateral for the loan.[64] These transactions pose distinct risks that may come from a variety of sources, such as the violation of a covenant in an underlying leasing agreement, the foreclosure of an underlying mortgage on the real property, or the classification of the improvements upon the land by the tenant and landlord.

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62. *See* Slone, *supra* note 60, at 143. Mr. Slone points out that some industrial CIDs include adherence to some type of green building standard such as the United States Green Building Council's Leadership in Energy and Environmental Design (LEED) program as part of their CC&Rs to construct or make improvements upon the land located within it. *Id.* In other industrial CIDs, the CC&Rs incorporate other environmental or social sustainability standards within the business' operations to qualify for occupancy and to remain there. *Id.*

63. While this type of situation might seem unlikely, it actually occurs more frequently than expected. Participants in franchising ventures often fit into this situation because they lack the financial capacity to construct and own their facility outright. There are also typically requirements from the franchisor that each location under its master agreement portray a common look and feel in addition to meeting specific building requirements. *See* JEFFRY A. TIMMONS & STEPHEN SPINELLI, JR., NEW VENTURE CREATION: ENTREPRENEURSHIP FOR THE 21ST CENTURY 227 (McGraw-Hill/Irwin 6th ed. 2004). Harry Sonnenborn developed this model for McDonald's in 1956 where a franchisee would pay McDonald's the greater of a minimum rate associated with leasing the property or a percentage of its sales. DANIEL GROSS, FORBES GREATEST BUSINESS STORIES OF ALL TIME 185 (1997). This strategy allowed McDonald's to include its policies as part of the rental agreement, which made them enforceable using real property law doctrines in addition to those in contracts. *See id.* at 185–86.

64. A leasehold estate allows for a tenant's possession of land or premises. *See* CUNNINGHAM ET AL., *supra* note 15, § 6.11, at 260. This may occur as a tenancy for years, periodic tenancy, tenancy at will, or as a tenancy at sufferance. *See id.* §§ 6.13–6.20, at 261–73.

In a tenancy for years situation, the lessee receives possession and control of the land by the owner for a fixed or finite period of time in advance. *See id.* § 6.14, at 264. This means that the lessee holds an interest in real property and the owner retains only a reversionary interest in the land, which only vests when the lease ends. *See id.* § 6.12, at 260–61.

In contrast, a rental contract confers upon one party the right to use and enjoy a specified piece of property in a manner that does not damage or diminish it. *See id.* § 6.2, at 250–51. This usufruct concept closely mirrors that of license and does not create a real property. *Id.* Hence, the holder of a leasehold estate may mortgage his interest because a property right exists, whereas a party to a rental contract cannot.

When considering the risk posed by a landlord terminating a leasehold tenancy with a tenant, the common law begins with a premise that prevents either party from ending a leasehold interest due to the other's breach unless the lease specifically authorizes it or a violation of the law occurs.[65] This means that the leasehold estate may only terminate when one of the parties specifically violates one of the covenants within the lease that allows for ending the leasehold estate.[66] Furthermore, the lease will not terminate until the party with the power elects to exercise it in some unequivocal manner.[67]

Of course, the doctrines of waiver and estoppel may impose a limitation on a party's ability to terminate a lease.[68] Under the doctrine of waiver, one party can voluntarily relinquish the legal right to terminate the lease either explicitly or impliedly.[69] This waiver only shields against past breaches and subsequent reoccurrences of the same infringement.[70] Nonetheless, some courts hold that a party may trigger this limitation when choosing not to pursue the termination remedy as well.[71] When applying estoppel, a non-breaching party may not exercise its powers to terminate the lease in situations where it stood by or assisted the breaching party in its infringing actions.[72] The courts will consider the non-breaching party to have sanctioned the violation by virtue of its actions.[73] By extension of these limitations, a parallel defense may spring from a contractual discharge like "frustration of purpose," which provides for excusable nonperformance.[74] In considering this option as a means for termination, scholars explain, "because there has been frustration on an object of the agreement that certainly was fundamental to the tenant, and even to both parties, the law excuses the tenant's whole performance."[75]

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65. *See id.* § 6.78, at 398–400. Taking this premise to its most fundamental application, the only exception may occur when a landlord breaches his duties under the warranty of habitability. *Id.* With respect to the law, a common situation occurs whereby the lease authorizes termination if one of the parties becomes insolvent or declares bankruptcy—but this violates the applicable code section and is unenforceable. 11 U.S.C. § 365(e) (2006).

66. CUNNINGHAM ET AL., *supra* note 15, § 6.78, at 398–400.

67. *Id.*

68. *See* 10 MEMBERS OF THE FIRM OF MILLER STARR REGALIA, MILLER & STARR CALIFORNIA REAL ESTATE § 34:223 (4th ed. 2015) [hereinafter MILLER & STARR].

69. 49 AM. JUR. 2D *Landlord and Tenant* § 260 (2015).

70. *Id.*

71. MILLER & STARR, *supra* note 68.

72. *Id.*

73. *Id.*

74. *See* CUNNINGHAM ET AL., *supra* note 15, § 6.87, at 412–13.

75. *Id.* § 6.87, at 413.

The second source of risk stems from the underlying mortgage on the land itself. Typically called a fee mortgage, these types of encumbrances may occur prior to or after the execution of the leasehold mortgage. Should a fee mortgage already exist, the lender may be precluded from proceeding unless a subordination occurs.[76] Depending on the jurisdiction's laws for terminating subordinate interests upon foreclosure, a number of policies and regulatory rules will preclude the leasehold mortgage due to the high risk of loss caused by its junior status.[77] However, that does not stop a lender from seeking an agreement with the current fee mortgagee to surrender its priority position to the leasehold mortgage.[78]

In contrast, a fee mortgage that takes place after the existence of a leasehold mortgage will not gain priority unless the ground lease is amended or the leasehold mortgagee or a purchaser at foreclosure begins a new lease.[79] This priority situation occurs because the only title the property's owner can pledge to the lender is the reversionary interest, which is already subordinate to the lease.[80] Nevertheless, a fee mortgage recorded after the execution of the ground lease but before putting into place an amendment or new lease could result in a subordination situation.[81]

Finally, the manner in which the landlord and tenant classify the improvements upon the land may create a situation of loss for the lender. Courts generally recognize that the lender of a leasehold mortgage keeps a security interest for the loan in the possessory estate, along with any improvements made upon the real property.[82] This applies notwithstanding the manner in which the tenant acquired its rights, including those situations such as a new lease or a sale and leaseback arrangement with the underlying real property.[83] In spite of the long-standing precedent recognizing the security interest in improvements under real property law, one outlying decision by an Arizona appellate court centered its opinion on Article 9 of the Uniform Commercial Code, which gave superior rights to a lender that foreclosed upon a ground lessee's building and fixtures placed upon the land over real property owner. However, this opinion was subse-

76. 1 MICHAEL T. MADISON ET AL., LAW OF REAL ESTATE FINANCING § 7:12 (2015).

77. *See generally id.* § 3:12.

78. *See generally id.* § 7:4. While this may sound unlikely, a fee mortgagee may consider taking this action when a leaseholder seeks a construction loan that will have the effect of increasing the total value of the collateralized property.

79. *Id.* § 7:12.

80. *See generally* CUNNINGHAM ET AL., *supra* note 15, § 3.3, at 89–90.

81. *See* MADISON ET AL., *supra* note 76.

82. *Id.* § 7:1.

83. *Id.*

quently ordered depublished by the Arizona Supreme Court, effectively disqualifying it for use as precedent.[84]

Hence, the leasehold estate situation poses some very real and difficult loss scenarios for a lender. Sometimes, these risks may come as a surprise, such as the decision by a court to apply the Uniform Commercial Code in lieu of the tried and true property law. Nonetheless, a savvy lender must weigh these possibilities and carefully craft a plan to handle unexpected losses.

4. Acquisition Attributes

In conjunction with the loss exposures posed by the subordination of title, environmental cleanup, and nongovernmental sources, a lender must also recognize the risks presented by providing the permanent financing for a new development or for the purchase of an existing building.[85] While both situations ultimately end with the lender funding a long-term loan that enables the borrower to purchase a building, each poses very different issues that require consideration.

a. Development Projects

In the new development context, the mortgage lender usually gets involved with the project at an early stage because the construction loan will demand a "take-out" commitment as part of its short term financing requirements.[86] This precondition by the construction lender seeks to facilitate a smooth assignment and sale of the note at the appropriate time, while making it difficult for any of the parties to materially change any of the loan conditions during the many phases of the project.[87] The executed tri-party agreement between the borrower and the two lenders usually provides for the purchase and sale of the promissory note used to finance the construction of the building upon completion and in compliance with the approved

84. *See* Fla. Receivables Trust 2002-A v. Ariz. Mills, LLC, 111 P.3d 430, 432–33 (Ariz. Ct. App. 2005), *depublished by* 127 P.3d 59 (Ariz. 2006).

85. *See* Bruell, *supra* note 9, § 8.02.

86. *See* Nelson & Whitman, *supra* note 19, § 12.3; Colin C. Livingston, *Current Business Approaches – Commercial Construction Lending*, 13 Real Prop. Prob. & Tr. J. 791, 794 (1978).

87. *See* Livingston, *supra* note 86, at 800–01.

plans and specifications.[88] The agreement also compels the use of a single set of documents for the transaction.[89]

In essence, the tri-party agreement attempts, in advance, to deliver the types of documentation and other conditions the permanent financer will require when called to perform to avoid a second underwriting process when the building is completed.[90] This proactive approach allows the borrower and construction lender to obtain approvals from the permanent financer during all phases of the project, and encourages the parties to resolve any issues before they become contentious.[91] As such, the permanent lender must address the risks inherent in a construction project when it negotiates the tri-party agreement.

To this end, the permanent lender must ensure that the completed building will comply with all local ordinances and zoning requirements, receive a permanent certificate of occupancy from the appropriate authorities, and qualify for property tax abatements. This is in addition to any other governmental or private financial benefits considered applicable in the original underwriting process prior to paying off the construction loan.[92] Should the completed building fail to meet local ordinances or zoning requirements, or receive its permanent certificate of occupancy, then the structure may not be occupied at all,[93] which could cause a default on the permanent loan or mortgage. Similarly, but not as harmful, the inability to qualify for property tax abatements or other financial incentives may severely hamper the borrower's ability to repay the loan or diminish the underlying value of the collateralized building.[94]

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88. *See* Franke, *supra* note 8, at 284–85. This distinctive requirement forces a borrower to meet all conditions for the permanent financing before receiving the approval and the closing of the construction loan. *Id.* As a result of this agreement, the underwriting process for the construction loan will separate any issues that develop by determining whether they relate to construction and completion, or if they concern the documentation requirements for the permanent lender. *See* Livingston, *supra* note 86, at 797.

89. *See id.* at 800.

90. *Id.* at 797.

91. *See* Franke, *supra* note 8, at 284–85.

92. *See* BRIELL, *supra* note 9, § 8.02.

93. *Id.*

94. *Id.* The inability to claim tax credits under Maryland's green building incentive program became the basis of *Shaw Developers v. S. Builders*, No. 19-C-07-011405 (Somerset Cty. Cir. Ct. Md. 2007), which was the first case of its kind to confront this type of issue with regard to an environmentally friendly structure. *See* Darren A. Prum & Stephen Del Percio, *Green Building Claims: What Theories Will a Plaintiff Pursue, Who Has Exposure, and a Proposal for Risk Mitigation*, 37 REAL ESTATE L.J. 243, 244 (2009). While the case settled out of court, it demonstrates that the inability to deliver tax abatements or other financial incentives can motivate parties to litigate due to their significance to a transaction and risks to the lender. *Id.* at 261.

In response to any of these shortcomings, a lender may receive through the executed tri-party agreement the right to remedy any deficiencies in the collateralized property.[95] Nevertheless, a lender may avoid this type of approach unless it lacks another way to resolve the deficiency. This option may expose a lender to additional liabilities from a sympathetic court that finds its actions constituted participation in the construction project.[96] Hence, a lender choosing to supply permanent financing for a building under construction must take a proactive approach to limit its potential risk of loss before accepting the terms of the tri-party agreement that require it to fund a shaky mortgage that may never get repaid.

b. Existing Buildings

While not as risky as development projects, funding mortgages on existing buildings also presents loss exposure issues. In these situations, many of the requirements that emanate out of the construction process, such as the issuance of a certificate of occupancy, should already be satisfied.[97] Moreover, the issues relating to property tax abatements or other financial incentives should already be resolved and pose minimal risk.[98]

However, a risk averse lender may decide to further reduce any exposure through the imposition of preconditions on the borrower during the underwriting process.[99] A lender may require the applicant borrower to provide documentation that the property meets all local ordinance and zoning requirements, that the appropriate authorities issued a certificate of occupancy for the building, and of the receipt of all tax abatements or other financial incentives for the structure.[100] With these assurances in hand, a lender can confirm that little to no risk exists from these

95. *See* Britell, *supra* note 9, § 8.02.

96. *See* Prum, *Greenbacks*, *supra* note 13, at 432–33 (2013). Typically, the courts extended liability to the lender in those cases where the claims originated out of a construction defect. *Id.* The cases tended to focus on three issues: whether (1) the lender entangled itself too much with the development, *e.g.*, Connor v. Great W. Sav. & Loan Ass'n, 447 P.2d 609 (Cal. 1968); Cent. Bank v. Baldwin, 583 P.2d 1087 (Nev. 1978); (2) the lender failed to fulfill its obligations, *e.g.*, Rudolph v. First S. Sav. & Loan Ass'n, 414 So. 2d 64 (Ala. 1982), Davis v. Nev. Nat'l Bank, 737 P.2d 503 (Nev. 1987), Daniels v. Army Nat'l Bank, 822 P.2d 39 (Kan. 1991), Lomax v. Hadley Homes, No. 02A01-9607-CH-00163, 1997 WL 269432 (Tenn. Ct. App. 1997); or (3) the lender turned into a responsible party upon its decision to seize control and finish the project, *e.g.*, Port Sewall Harbor & Tennis Club Owner's Ass'n v. First Fed. Sav. & Loan Ass'n, 463 So. 2d 530 (Fla. Dist. Ct. App. 1985); Chotka v. Fidelco Growth Inv'rs, 383 So. 2d 1169 (Fla. Dist. Ct. App. 1980); Dunson v. Stockton, Whatley, Davin, & Co., 346 So. 2d 603 (Fla. Dist. Ct. App. 1977).

97. *See* Britell, *supra* note 9, § 8.02.

98. *Id.*

99. *See infra* Subsection III.B.1.

100. *See* Britell, *supra* note 9, § 8.02.

sources.[101]Consequently, an existing building poses few risks to a lender because the borrower may provide documentation for many of the unknowns, such as the certificate of occupancy, and any other benefits like tax abatements or other financial incentives. Therefore, a lender faces a minefield of risk exposures, such as the loss of priority over other lienholders, governmental liability for environmental cleanup costs, and diminution in value of the collateralized property through nongovernmental sources or through the underlying method by which the borrower acquired the building.

B. *Underwriting as a Risk Management Tool*

Given that one in six long-term commercial mortgages in the United States defaulted during the last quarter of the twentieth century, the underwriting process now plays a critical role in preventing and minimizing defaults.[102] Underwriters focus on the risk associated with a particular borrower and proposed collateral property.[103] Depending on the risk, a lender may add extra requirements to the loan documents, such as the right to conduct an audit, to minimize a perceived risk, and to memorialize each party's responsibilities.[104]

1. Borrower

Distinctly different from the standard residential mortgage, most loans for commercial properties are nonrecourse or permit the lender to recover very little from the borrower other than the collateralized property.[105] While this may seem risky, a lender for commercial real property cannot ignore these types of borrowers because they are typically wealthy individuals, businesses, or institutions that routinely participate in these types of transactions.[106] As such, a lender risks future business opportunities with the borrower if she declines to participate in a transaction and the project ultimately becomes a success.[107]

Conversely, lenders must also weigh the prospects that some borrowers who maintain multiple business lines may divert funds or attention from an

101. *Id.*

102. *See* GELTNER ET AL., *supra* note 14, at 442. Beyond serving as a tool for minimizing or eliminating defaults, underwriting also helps ensure that the lender receives the proper reward for the amount of risk undertaken with the loan. *Id.*

103. *Id.* at 443.

104. *See infra* Section III.B.

105. *See* GELTNER ET AL., *supra* note 14, at 443.

106. *Id.*

107. *Id.*

otherwise healthy collateral property to assist troubled endeavors.[108] This could lead to a borrower filing for bankruptcy under Chapter 11 and a forced renegotiation of the lending terms.[109] Hence, the unique circumstances surrounding commercial real estate loans creates a business climate whereby the lender must give special consideration to the reputation and future business prospects of the borrower, while balancing the risks for a given loan.[110]

2. Property

Although the borrower and the client-lender relationship influence the loan determination, the lender will primarily rely on the internal underwriting analysis of the collateralized property to predict the borrower's ability to pay the debt.[111] This analysis generally concentrates on the appraised asset value and income flow of the subject property, as well as several other metrics.[112]

In the asset value analysis, the lender's underwriters will calculate the loan-to-value (LTV) ratio because it provides a single indicator that takes into account an asset's value, along with its income coverage.[113] Because the lending community maintains models that link the LTV ratio to default probabilities and predict a borrower's ability to repay the loan, this ratio becomes a crucial factor in determining whether to provide funding.[114] At first, the underwriters will use the LTV at the time the loan commences to consider the most stringent situation.[115] However, many underwriters will also evaluate the LTV over the loan's duration by using projected net operating income on the property and direct capitalization.[116]

When evaluating the income flow for the property, the underwriters will turn to the debt service coverage ratio as an indicator.[117] In making this

108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.* at 444.
114. *Id.* When linking the LTV ratio to a model that corresponds with default probability, a nonlinear relationship appears. *Id.* It shows a low probability of default and is virtually constant in an extensive range of low values of the LTV, but the risk rises quickly at the higher ratios. *Id.*
115. *Id.* at 445.
116. *Id.* When making this calculation, the underwriters must pay attention to the LTV when the loan matures because sometimes the financing agreement will not call for full amortization. *Id.* In these cases, the lender must make sure that the property's value greatly surpasses the outstanding loan balance at maturity. *Id.*
117. *Id.*

calculation, the underwriters will compare the collateral property's annual net operating income to the annual debt service required by the loan. Typically, the underwriters will want to minimize the likelihood that the borrower will find itself pressed for cash flow, so the ratio must usually meet or exceed 1.2.[118] Nevertheless, a lender may adjust this hurdle depending on their current risk sentiment, as well as allowing for lower ratios in the beginning years, so long as a solid projection occurs during the remaining years of the loan.[119]

Supplementing these two indicators, underwriters sometimes turn to calculating the Break-Even Ratio (BER), the Equity-Before-Tax Cash Flow (EBTCF), and the loan yield as other methods to predict the borrower's ability to repay the debt.[120] The underwriters use the BER as a proxy to determine the occupancy ratio of the building, while they employ the EBTCF to get a feel for the borrower's ability to overcome any needed capital improvement expenditures.[121] Most recently, underwriters began to look at the loan yield to determine a recoverable rate of return that shows the lender what it must see in the case that a foreclosure becomes necessary, and the lender has to rely on the property's net operating income as part of its calculated value in a liquidation sale.[122]

Accordingly, the lender's underwriters will follow a process that employs a broad set of indicators coupled with conservative yet flexible standards to adapt to current market conditions, while screening for situations that indicate the likelihood a borrower will fail to repay the loan.

II. Lender Exposure to Risks Inherent to a Green Building

In addition to the risks inherent in any mortgage transaction, the unique characteristics of green buildings pose additional risks to lenders. These differences may cause an underwriter to make an adverse recommendation or require the lender to seek unnecessary or inappropriate solutions solely due to lack of understanding of the characteristics associated with an environmentally friendly building. Some of these risks occur uniformly in

118. *Id.*

119. *Id.* During times of rapid inflation or when major competition in the lending market occurs, the ratios tend to get adjusted below the 120% threshold. *Id.*

120. *Id.* at 445–47.

121. *Id.* Normally, a building's BER falls below 100%; but depending on a particular market, the lower limit will customarily occur around 85%. *Id.* at 446. In considering the EBTCF, these expenditures tend to occur on a more discretionary basis and may not have relevance because financing is frequently available. *Id.* In situations where the property is subject to a long-term lease or is in need of improvement, the underwriters may emphasize this metric. *Id.*

122. *Id.*

both newly constructed buildings and existing structures. However, for the permanent lender, the incorporation of green design features into development projects poses several risks beyond those of an existing structure. Accordingly, this Part addresses the risks common to all green building mortgages and those specific to the construction context.

A. *All Types of Buildings/Projects*

Some of the risks specific to green buildings occur uniformly, no matter the method of acquisition, and require consideration in every mortgage transaction. First, the underwriting process must address issues specific to green buildings in the financial ratios and models. Second, lenders must require borrowers to purchase adequate property insurance to protect against a loss at the collateralized structure. Finally, some of the features that comprise a green building must undergo additional investigation where the high-performance and cutting-edge nature of the completed structure may jeopardize a borrower's ability to repay its obligation.

1. Financial Issues

At the heart of the underwriting process, the financial models and insurability of a collateralized property can make or break a decision to fund a loan application. The financial models play a significant role in determining whether the borrower can afford to repay the loan and whether the collateralized property maintains any value at all. Likewise, the requirement that the borrower maintain a suitable property insurance policy ensures that the collateralized property retains sufficient value, such that the lender has appropriate sources to recapture any loan balance in the event of a default. Since the financial models and ratios weigh so heavily on whether to fund a loan, the possibility that the underwriters' analysis goes astray presents a very real and credible obstacle that requires consideration.

a. Underwriting Models

Because underwriters place so much emphasis on financial models and ratios in determining whether to recommend participation, the underlying assumptions and calculations in these tools merit special consideration.

As previously discussed, a building's appraised value is an integral component of the underwriting process. As part of their financial analysis, underwriters must obtain an appraisal for the building based on its *current* or *expected* value, depending on the type of acquisition.[123] In relying on the appraisal for calculations such as the LTV, underwriters must recognize that

123. *See* Livingston, *supra* note 86, at 801–02.

appraisers face many difficulties in setting a valuation on a green building.[124] One practitioner explained, "there is currently a lack of comprehensive educational material and practical guidance on the integration of sustainability aspects into the educational programs for North American appraisers."[125] Furthermore, appraisers often lack the hard data—regarding comparable sales, absorption trends, rental rates, tenant retention, and operating or maintenance expenses—to assess the impact of green and high performance characteristics on asset value.[126] As a result, the financial ratios that rely on the appraisal will probably contain significant margins of error and, by implication, allow a larger tolerance for variation because the appraisers lack a common approach to calculate a fair and accurate value for sustainability features.

Moreover, the underwriter's financial models must account for a myriad of other assumptions unique to a green building's price and associated revenue. For example, many studies have identified price premiums associated with certified green buildings.[127] A later comprehensive evaluation of these studies found that buildings possessing green certifications attained noticeably higher rates of occupancy and leases, as well as superior sales prices.[128] Consequently, a loan applicant's higher occupancy and lease rates may seem overly optimistic to a cautious underwriter when in reality the projections fall right on the mark, or offer a slightly conservative point of view.

Similarly, many of the financial incentives to construct green buildings pose their own pitfalls to the underwriter's models given their variability across jurisdictions. These financial incentives often include property tax

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124. Timothy P. Runde & Stacey Thoyre, *Integrating Sustainability and Green Building into the Appraisal Process*, 2 J. SUSTAINABLE REAL EST. 221, 222 (2010).

125. Grant W. Austin, *Sustainability and Income-Producing Property Valuation: North American Status and Recommended Procedures*, 4 J. SUSTAINABLE REAL EST. 78, 79 (2012).

126. *See* Jennifer Pitts & Thomas O. Jackson, *Green Buildings: Valuation Issues and Perspectives*, APPRAISAL J., Spring 2008, at 116, http://www.real-analytics.com/Green%20Buildings.pdf; INST. FOR MKT. TRANSFORMATION & APPRAISAL INST., GREEN BUILDING AND PROPERTY VALUE: A PRIMER FOR BUILDING OWNERS AND DEVELOPERS (2013), http://www.imt.org/uploads/resources/files/Green_Building_and_Property_Value.pdf.

127. *See e.g.*, Piet Eichholtz et al., *Doing Well by Doing Good? Green Office Buildings*, 100 AM. ECON. REV. 2494 (2010) [hereinafter Eichholtz et al., *Doing Well*]; Piet Eichholtz et al., *The Economics of Green Building*, 95 REV. ECON. & STAT. 50 (2013) [hereinafter Eichholtz et al., *The Economics of Green Building*]; Franz Fuerst & Patrick M. McAllister, *Green Noise or Green Value? Measuring the Effects of Environmental Certification on Office Values*, 39 REAL EST. ECON. 45 (2011); Norman Miller et al., *Does Green Pay Off?*, 4 J. REAL EST. PORTFOLIO MGMT. 52 (2008); Jonathan Wiley et al., *Green Design and the Market for Commercial Office Space*, 41 J. REAL EST. FIN. & ECON. 228 (2010).

128. David Blumberg, *LEED in the U.S. Commercial Office Market: Market Effects and the Emergence of LEED for Existing Buildings*, 4 J. SUSTAINABLE REAL EST. 24, 32 (2012).

abatements or permission to transfer the tax credits to third parties.[129] The disparities in approaches taken by different jurisdictions offering such inducements may provide a materially significant variation that requires special attention in the underwriting process.

On the other hand, an underwriter must also proceed cautiously with some of the green assertions made by borrowers for increased rents and possibly inflated prices. In some instances, for example, a borrower may try to justify pricing premiums for a green building due to the health and productivity savings of the buyer or tenant, benefits that may not command rent premiums in all markets.[130]

Consequently, the financial models and pro-forma statements used to evaluate an applicant seeking to purchase a green building must navigate these thorny issues with due care to serve as an accurate tool in assessing the risk and exposure for the loan under consideration.

b. Property Insurance

When addressing the insurability of a green building and protecting against a loss due to the destruction of the potential collateral, the underwriter must begin by developing an understanding of the regulatory obligations specific to that property. In some jurisdictions, the state and local governments have adopted green construction standards, which incorporate the unique features of these high-performance structures into the building code.[131] For example, the International Code Council established the International Green Construction Code (IgCC) for adoption by governments looking to add a sustainability component to their existing building codes[132]

129. *See* Prum, *State Incentives*, *supra* note 7, at 188–98; Prum, Aalberts & Del Percio, *supra* note 1, at 212. The type of incentive, as well as the means for claiming it from a state or local government, occurs in varying methods. *See* Prum, *State Incentives*, *supra* note 7, at 188–98; Prum, Aalberts & Del Percio, *supra* note 1, at 208–13. Many states provide tax credits to the developer of a green building. *See* Prum, *State Incentives*, *supra* note 7, at 188–98; Prum, Aalberts & Del Percio, *supra* note 1, at 208–13. However, some jurisdictions that do not have a state income tax, like Nevada, offer sales and property tax abatements. *See* Prum, *State Incentives*, *supra* note 7; Prum, Aalberts & Del Percio, *supra* note 1, at 212. Oregon allows the "pass-through-option," whereby the developer may transfer the credit to a qualified third party in return for a cash payment equivalent to the net present value of the tax credit. OR. ADMIN. R. 330-090-0110(48)–(49) (2015).

130. *See generally* Prum & Del Percio, *supra* note 94, at 248.

131. *See* Prum, *Next Green Issue*, *supra* note 12, at 441–50.

132. Int'l Code Council, *IgCC Code Development*, HISTORY OF THE IGCC, http://www.iccsafe.org/history-of-the-igcc/ (last visited Feb. 10, 2016). Established as a nonprofit organization in 1994, the ICC develops and offers a single set of comprehensive and coordinated model national building codes for adoption by communities and governments. Int'l Code Council, *Overview*, ABOUT THE ICC, http://www.iccsafe.org/AboutICC/Pages/default.aspx (last visited Feb. 10, 2016).

and the State of California has developed and implemented its own green building code, CALGreen.[133]

In these situations, the current insurance requirements should not materially change. An underwriter must still ensure that the owner of the collateralized building chooses suitable coverage from a reputable carrier that also protects the lender's interest. The standard requirements would include a rider for "ordinance or law" coverage,[134] since many cause-of-loss forms exclude costs associated with changes in building codes or regulations.[135]

Green building codes are generally subject to periodic updates that ratchet up the environmental standards for all new or modified structures. These building code updates are eventually incorporated into current ordinances or regulations and therefore require that the typical commercial insurance policy adjust correspondingly to provide coverage.[136] Accordingly, the lender will face no new risk in these jurisdictions, and the underwriter must adjust its current practices.

In other jurisdictions, green construction standards are not mandates under the applicable building code but rather are voluntary or induced through incentives.[137] These jurisdictions normally set a standard for compliance and then offer some type of perceived benefit to the private developer for furthering the established green building goals.[138] Most government programs require a third-party organization's certification to receive the proffered benefit.[139] In other localities, a developer need only demonstrate *intent* to obtain the third-party certification, but not necessarily complete USGBC's LEED obligations specifically, to receive the incentive.[140]

As a result, an underwriter must pay special attention to any sustainable features or certifications attained by the building, the coverage associated

133. CAL. BLDG. STANDARD COMM'N, CALGREEN: THE 2010 CALIFORNIA GREEN BUILDINGS STANDARD CODE, ARE YOU READY? (2011), http://www.documents.dgs.ca.gov/bsc/CALGreen/The-CALGreen-Story.pdf.

134. *See* Prum, *Next Green Issue*, *supra* note 12, at 455.

135. JAMES S. TRIESCHMANN ET AL., COMMERCIAL PROPERTY INSURANCE AND RISK MANAGEMENT 190 (4th ed. 1994).

136. *See* Prum, *Next Green Issue*, *supra* note 12, at 450.

137. *Id.* at 442.

138. *See* Prum, *State Incentives*, *supra* note 7, at 177–99; Prum, Aalberts & Del Percio, *supra* note 1, at 208–19; A. Paige Reber, Note, *Taking the "LEED": Determining the Appropriate Amount of Government Regulation in Projects*, 98 KY. L.J. 573, 577–80 (2009–2010).

139. *See id.*

140. *See, e.g.*, Prum, Aalberts & Del Percio, *supra* note 1, at 209–19 (highlighting that some states allow tax incentives for compliance with green building standards from a different third party's program, not just USGBC's LEED certification program); Prum, *State Incentives*, *supra* note 7, at 189–99 (detailing individual state programs, some of which accept certification from an alternate program to LEED).

with any proposed property insurance policy, and any applicable laws or ordinances. The certifications vary between the private third-party verification organizations and each system maintains different levels with distinct standards.[141] In addition, third-party verification organizations routinely update their programs to reflect advances in building technology.[142] This means that in the event of a loss, the reconstructed collateralized building may not maintain the same attributes, like a LEED or Green Globes certification, bestowed on the prior structure. The reconstructed collateralized building therefore may see a significant decrease in value due to a preceding upgrade by the third-party verifier that the insurer does not feel obligated to attain.

Moreover, property insurers offer different products with varying degrees of coverage that usually exclude costs associated with changes in building codes or regulations.[143] Coupled with the previously explained difficulties in trying to assign an accurate value to a green building and its sustainability features,[144] these meaningful differences create many uncertainties in coverage that must be evaluated on a case-by-case basis.[145]

To remedy the concerns of policyholders and to offer additional features, several insurers offer supplemental endorsements specifically targeted to provide more complete coverage for green buildings.[146] While each of the supplemental endorsements is dependent on the underlying language con-

141. *See* Prum, *Greenbacks*, *supra* note 13, at 446–47; Prum, Aalberts & Del Percio, *supra* note 1, at 194–99.

142. *See* Prum, *Greenbacks*, *supra* note 13, at 446–47.

143. *See id.* at 444–47. Today's commercial property insurance policies usually identify a method for valuing the building to determine the amount of loss should a claim occur. *See* TRIESCHMANN ET AL., *supra* note 135. Typical options that an insured may elect to follow include the actual cash value method, the replacement cost approach, or the functional building. *Id.* at 146. The actual cash value method determines the insurer's obligation by subtracting the depreciated use from the current cost of reconstructing the original structure, whereas the replacement cost approach covers the property without the reduction for depreciation. *Id.* In contrast, the functional building valuation approach allows the insurer to repair or replace the building with one that performs just like the insured property, but may cost less to construct. *Id.* at 150. These valuation methods offer meaningful differences in an insurer's obligations and could affect what and how a borrower receives as compensation in the event of a loss to the collateralized building, especially if the structure includes high performance features. *See* Prum, *Greenbacks*, *supra* note 13, at 451–58.

144. *See supra* Subsection II.A.1.a.

145. *See* Prum, *Greenbacks*, *supra* note 13, at 451–58.

146. *See e.g.*, INS. SERV. OFFICE, INC., POLICY NO. CP 04 02 09 09, INCREASED COST OF LOSS AND RELATED EXPENSES FOR GREEN UPGRADES (2009) (on file with author); FIREMAN'S FUND INS. CO., PROPERTY-GARD GREEN COVERAGE ENDORSEMENT (2010) (on file with author); THE TRAVELERS CO. INC., GREEN BLDG. COVERAGE ENHANCEMENT ENDORSEMENT (2008) (on file with author); LEXINGTON INS. CO., UPGRADE TO GREEN – COMMERCIAL ENDORSEMENT (2008) (on file with author); LIBERTY MUTUAL GROUP OF COS., GREEN SELECT (2008) (on file with author).

tained in the property policy,[147] these insurance industry products appear to offer a one-size-fits-all solution to the risks posed by a green building loss. However, many times a properly valued replacement cost policy, along with an endorsement to cover changes in building codes or regulations, will suffice.[148]

Hence, the complexities of the regulatory framework by state and local governments create a patchwork of legislative approaches that translates into a complicated evaluation for an underwriter to determine if the collateralized property maintains sufficient insurance coverage to protect the lender's interest. Thus, when making a recommendation on whether to fund a loan on a green building, underwriters must recognize that the financial models and requirements applicable to traditional buildings need modification to avoid false indicators of risk or situations of contentment when a hazard is actually present.

2. Green Attributes

In addition to the financial issues, many of the key features that make a building environmentally friendly[149] may also offer a reason for potential concern.

First, the emerging products or techniques employed in green buildings may create risks themselves. Green buildings are often designed as part of a "holistic" approach that pairs common sense solutions, such as optimal siting and use of local resources, with cutting edge technology to produce a high performance building.[150] This combination of innovative design, along with emerging products, creates risks that may diminish the value of the collateralized building or require significant renovations after occupancy and jeopardize a borrower's ability to repay. For instance, some of the requirements associated with a third-party certification may pose significant risks of creating moisture and mold problems in a building.[151] These may occur due to attempts to reduce energy consumption, diminish a building's heat island

147. *See* Prum, *Greenbacks*, *supra* note 13, at 451.

148. *Id.* at 459.

149. *See generally* Darren A. Prum, *Green Buildings, High Performance Buildings, and Sustainable Construction: Does It Really Matter What We Call Them?*, 21 VILL. ENVTL. L.J. 1 (2010).

150. *Id.* at 5–7.

151. *See generally* J. David Odom et al., *The Hidden Risks of Green Buildings: Avoiding Moisture & Mold Problems*, 2009 NCARB MONOGRAPH SERIES 2. Many commercial property insurance policies now contain exclusions for moisture and mold problems because the risk of loss is so great. *See* Prum, *Next Green Issue*, *supra* note 12, at 448. The insurance industry takes a varied approach through its coverage definitions and exclusions, but many carriers appear willing to accept these risks when an insured purchases the green building endorsement in conjunction with an underlying property policy. *See id.* at 452–53.

effect, reuse or cutback construction waste, improve indoor air quality, or offer an innovative design or product.[152]

A typical tradeoff occurs when balancing energy performance and moisture controls.[153] When a designer or builder decides to increase the thermal insulation within a wall system, she may inadvertently change the dew point locations along with the places where condensation will occur around the structure.[154] In addition, any decision that alters the designs associated with heating, ventilation, and air conditioning controls will impact the proper times for operation and may affect any strategies for handling moisture within the structure.[155]

Similarly, installing a vegetated roof can create moisture and mold issues stemming from the development of condensation under the roofing membrane and other types of water intrusion.[156] Additionally, a poorly designed system could allow mold spores to penetrate a building from an air intake for the heating, ventilation, and air conditioning system near a vegetated roof.[157]

Furthermore, many of the third-party certification programs promote the reduction of construction management waste through the reuse of materials, which may allow undetectable mold-contaminated materials to find their way into new structures.[158] When they do, mold issues can become pervasive because the contamination does not usually become visible to the inhabited side of the structure along with the inability for air testing to identify its presence.[159]

Finally, the implementation of new products or designs that have not demonstrated their durability and reliability over the years poses an increased risk.[160] Forensic building specialists J. David Odom and Richard Scott explain, "the history of building failures indicates that when new products are used, or traditional construction processes are significantly altered, the performance of buildings is often adversely affected. Sometimes

152. *See* Odom et al., *supra* note 151, at 4–5.

153. *Id.* at 4.

154. *Id.*

155. *Id.*

156. *Id.*

157. Michael J. Bauer, *Potential Legal Implications of "Green" Roofs*, 2011-01 Construction Briefings 1, 8.

158. *See e.g.*, U.S. Green Bldg. Council, LEED v4 for Building Design and Construction 95–96 (2015); Green Bldg. Initiative, Green Globes for New Construction: Technical Reference Manual 138–41 (2014).

159. *See* Odom et al., *supra* note 151, at 4–5.

160. J. David Odom & Richard Scott, *The Risks of Building Green in the Southeast*, Se. Construction, Feb. 2008, at 37, http://www.epicstructures.net/administrator/imagebuilding/lbfg/articles/completed/The-Risks-of-Building-Green-in-the-Southeast.pdf.

these changes in building performance result in dramatic failures, especially in hot, humid climates."[161] Consequently, the incentives to implement new products or designs to gain a third-party certification, accompanied by its increased amount of documentation, offers the opportunity for more claims in litigation along with the possibility that the borrower may not maintain sufficient resources to repair or salvage a structure suffering from "sick building syndrome."[162]

While a traditional building may develop some of these same issues, the desire to attain a third-party certification may exacerbate many similar areas of concern, such as moisture and mold problems. Therefore, underwriters must evaluate a building's unique characteristics and give consideration to the unintended consequences that environmentally friendly features can have on a structure. Under extreme circumstances, these unanticipated problems may prompt the borrower to walk away from the collateralized property and leave the lender in a situation that requires investment beyond the loan principle to terminate its involvement.

B. *Development Projects*

For the permanent lender, the incorporation of green design features into a development project poses several risks beyond those of a traditional structure. As previously discussed, the issues surrounding the satisfaction of

161. *Id.*

162. T. Sky Woodward & Erin C. Miller, *New Risks for Manufacturers Take Root*, FOR THE DEFENSE, Dec. 2009, at 44, 46, http://www.wcsr.com/resources/pdfs/prodarticle121009.pdf. In two distinct landmark cases involving mold, the courthouses in Polk and Martin Counties in Florida experienced "sick building syndrome," which cost both governments significant amounts of money to remedy, along with litigation against those designing and constructing structures and their insurers for the problems they caused. Scott Wyman, *Courthouse Mold Fight Has Played Out Before in Florida*, SUNSENTINEL (Apr. 1, 2009), http://articles.sun-sentinel.com/2009-04-01/news/0904010171_1_courthouse-sick-building-mold. Polk County paid $37 million in 1987 to construct a new courthouse, but the government spent another $50 million to repair the building after 600 employees were evacuated five years after commissioning due to mold. *Id.* Some people described the situation as "a courthouse of horrors" and "a ten story, 500,000 square foot petri dish." Robert E. Geisler, *The Fungusamongus: Sick Building Survival Guide*, 8 ST. THOMAS L. REV. 511, 512 (1996).

Across the state, Martin County in Florida also constructed a courthouse and adjoining office complex for $11 million. Geisler, *supra*, at 512. Eventually, the county evacuated and virtually rebuilt the courthouse after complaints by employees and visitors. Cliff Hutchinson & Robert Powell, *A New Plague – Mold Litigation: How Junk Science and Hysteria Built an Industry*, *in* U.S. CHAMBER INST. FOR LEGAL REFORM & THE MANHATTAN INST., THE GROWING HAZARD OF MOLD LITIGATION 1, 15 (2003). The county pursued an action in court against the contractor and its insurers and won a verdict of $14.2 million, which was later affirmed on appeal. *See* Centex-Rooney Constr. Co. v. Martin County, 706 So. 2d 20, 23 (Fla. Dist. Ct. App. 1997).

local ordinances and zoning requirements, the receipt of a permanent certificate of occupancy from the appropriate authorities, and the qualification for any financial incentives, such as property tax abatements, remain at the forefront of risk.[163]

In situations where a government adopts sustainability components into its existing building code, the risk remains the same in green buildings. In fact, a lender is somewhat protected under this scenario because the permanent financing obligations are often contingent on the issuance of a certificate of occupancy, which is itself contingent on compliance with the building code of the jurisdiction.[164] Nonetheless, Peter Britell, in his treatise on green building law, points out that specific green issues may develop into a risk for the lender in situations where the permanent funding already occurred but loose ends on the construction side still remain.[165] This might include situations where a government agency adds unforeseen new requirements, such as a physical inspection or other compliance measures.[166]

Moreover, a failure to qualify for any of the expected financial incentives may create some risk within this scenario. Without the financial incentives, the collateralized property may see a reduction in its value.[167] Absent a provision in the take-out agreement to the contrary, the lender may be required to purchase the promissory note used to finance the construction of the building and assume a position where the loan principle may exceed the collateralized property's value.

Structures seeking third-party certification pose the same risk, originating in a different manner. The building certification process generally occurs months after construction is completed and the triggering event calls for the permanent loan to be funded by the lender.[168] Should the building fail to receive recognition by a third-party certification organization, the lender will have few credible options for a resolution. If the lender has funded the permanent loan, it faces the risk that the collateralized property will not attain the increased valuation that predicated the underwriting of the loan. This outcome may also create a situation where the loan's principle exceeds the collateralized property's value and places the lender in a position for a potential loss almost immediately.

Because this type of predicament appears to be a likely scenario, the lender must weigh its credible options should the building fail to obtain the desired third-party certifications. A more proactive position in the take-out

163. *See supra* text accompanying notes 92–101.
164. *See* BRITELL, *supra* note 9, § 8.02[1].
165. *Id.* § 8.02[1][b].
166. *Id.*
167. *See id.* § 8.02[1].
168. *Id.*

agreement, along with the possibility of other remedies that do not invite additional liabilities, offers a pathway to mitigating a possible loss scenario.

C. *Existing Buildings*

Given that many of the issues associated with developing a property will have already been resolved, there are very few differences between traditional and green building loans for an existing structure that have not been previously discussed.

Risks that may occur in a newly developed structure, such as the receipt of a third-party certification, can become a part of the documentation requirements handled in the typical underwriting process.[169] Moreover, some of the other valuation issues may also be resolved due to the existence of the building. The valuation associated with an existing building could be less contestable, given that it will likely have a market history and comparable properties in the surrounding neighborhoods. This will provide less variation and subjectivity in the appraisal.

In addition, the financial models compiled by the underwriters will be able to utilize historical data for the green building. An existing green building will maintain detailed records for any revenue it generates and its operating expenses. The building's seller should also maintain specifics on any tenants and the remaining time associated with their lease agreements. This additional data specific to the proposed collateralized building will limit the subjective judgments by underwriters and create a more precise model for the underwriting decision that takes into account the market value for the structure's environmentally friendly features.

III. Proposal for Managing Risk on a Green Building Mortgage

As a consequence of this diverse set of exposures a lender faces in providing permanent financing to an environmentally friendly building, the decision to fund or turn down the borrower's application requires knowledge of the unique traits linked to these structures, a careful evaluation of the property to be collateralized, and an understanding of the real estate market. This knowledge will translate into more prudent decisionmaking at all levels, greater access to capital for green building projects, and a demonstration of commitment to public policies that favor a more green built environment.

When selecting underwriting criteria, lenders must navigate the arduous process of avoiding applicants with a high risk of default, without un-

169. *Id.* § 8.02[2].

necessarily rejecting strong candidates. Borrowers must recognize that the unique characteristics of a green building create difficulties for the permanent financers and that the underwriting process that may lead to flawed decisionmaking. In responding to the additional risk exposure, lenders today may turn to traditional approaches that attach a higher rate of interest to the loans on a green building or choose to pass on the application all together.

This Part proposes solutions for better managing loss exposures while providing permanent financing for green buildings. These measures may be integrated into existing underwriting processes or incorporated into the loan covenants. Based on these proposed actions, a lender can better manage the added risk created by a green building mortgage while eliminating barriers for the green building community.

A. *Underwriting Process-Driven Adjustments*

Bearing in mind the previously discussed issues that arise out of the underwriting process,[170] along with the unique challenges introduced by a green building,[171] lenders must consider altering such practices. A simple solution could include the creation of a distinct process for those applications that fit into the green building category. A lender's application could require a prospective borrower to make a distinction as to whether the proposed collateralized building fits within traditional or green building standards when the funding of the loan occurs. By requiring such a distinction in the borrower's application, the underwriting process could proceed in a way that properly evaluates the unique risks associated with funding a loan for a green building.

1. Supplemental Application for Green Buildings

When developing a distinct process for determining the lending exposure on a green building, underwriters should design a supplemental application that requests information, documentation, and answers related to the sustainable features of the structure, over and above those normally requested, to help address the quantification and other issues discussed in Part II. This supplemental application should request documentation pertaining to third-party certifications received, acknowledgments of compliance with government regulations or private obligations relating to environmental construction standards, and tax certificates or similar financial benefits conveyed upon the completed structure.

170. *See* discussion *supra* Section I.B.
171. *See* discussion *supra* Part II.

In the event that the loan is part of the take-out agreement from the short-term financing, then the supplemental application should modify the document request to include the name of the third-party organization supplying certification, the version pertaining to the proposed building, and the expected level upon completion.[172] It should also seek information from the applicant with respect to applicable government zoning or ordinances, along with any restrictive covenants placed on the land that may affect the status of a completed structure.

With the requirement that a loan application supply this information alongside the regular submission for either an existing building or one under construction, underwriters can feel assured that they received appropriate guidance from the applicant and direct their attention to the evaluation and data research aspects of the assessment, which entail the completion of the financial models and pro-forma statements.

2. Gathering and Analyzing Green Building Data

When conducting their evaluations, underwriters must address data accuracy issues. Specialized consultants and expert research provide a good solution. As the appraisal community continues to refine its approach to quantifying sustainable property features, underwriters must find those professionals with substantial experience assessing green buildings to obtain better evaluations. This would ensure that financial models and pro-forma statements present the most accurate data available and enhance confidence in the captured and quantified data, along with any anticipated governmental assistance received in the building's construction.

In conjunction with the use of experienced professionals, cutting edge research in this emerging field can help determine market premiums and liabilities more accurately. Researchers from around the world continue to evaluate and assess how the various markets are reacting to green buildings and develop explanations and models for predicting outcomes to the same

172. Several organizations provide identifiable systems that endeavor to measure and substantiate the sustainable features within a building. *See* Prum, Aalberts & Del Percio, *supra* note 1, at 194–200. The Leadership in Energy and Environmental Design (LEED) program was created by the United States Green Building Council (USGBC) in 1998. *Id.* at 195. LEED provides an array of approaches for compliance depending on the construction type, as well as 4 different levels of certification: LEED Certified, LEED Silver, LEED Gold, and LEED Platinum. U.S. Green Bldg. Council, *Rating Systems*, LEED, http://www.usgbc.org/leed#rating (last visited Feb. 14, 2016). Likewise, the Green Building Initiative operates the Green Globes Program and awards one to four "Green Globes" based on a project's level of achievement. Green Bldg. Initiative, *Overview*, GREEN GLOBES CERTIFICATION, http://www.thegbi.org/green-globes/ (last visited Feb. 10, 2016).

questions asked by the underwriters.[173] For example, several published studies consider the income part of the financial statements and evaluate the occupancy rates and premiums for leases and sales of green buildings;[174] others analyze the cost side through utility usage and other operating costs.[175] The applied aspects of this research could provide an underwriter useful insight through formulas, models, and multipliers that reinforce and validate the process used to determine exposure for a given application, based on the collected market data for the location of the green building.

Accordingly, a modified underwriting process that takes advantage of experienced professionals, along with cutting edge research in the field through a specialized evaluation of the proposed loan for a structure with sustainable characteristics, will allow underwriters and lenders to develop more reliable and accurate financial models and pro-forma statements to make better decisions on whether to fund an application for long-term financing on a green building.

B. *Document-Driven Adjustments*

Lenders can also protect against much of their exposure through the loan documents. Lenders must develop a cohesive set of documents that incorporates specific provisions as conditions precedent to funding, along with those that address post-closing situations. Through pre- and post-closing conditions, lenders can make allowances for the exposures that are not present in a traditional building.

1. Pre-Closing Conditions

Given that the lender maintains a superior position to the borrower and possibly the short-term financer prior to funding the mortgage, inserting conditions precedent is one of the most useful tools to minimize exposure before disbursing the loan funds. Because these contingencies can be used to deny funding at a later point in time, the lender of the long-term financing must consider the unique exposures of the green building and the methods of acquisition to strategically address the different risks.

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173. *See e.g.*, Eichholtz et al., *Doing Well*, *supra* note 127; Eichholtz et al., *The Economics of Green Building*, *supra* note 127; Fuerst & McAllister 1, *supra* note 127; Miller et al., *supra* note 127; Norman G. Miller, Dave Pogue, Jeryldine Saville & Charles Tu, *The Operations and Management of Green Buildings in the United States*, 2 J. SUSTAINABLE REAL EST. 51 (2010); Wiley, *supra* note 127.

174. *See e.g.*, Eichholtz et al., *Doing Well*, *supra* note 127; Eichholtz et al., *The Economics of Green Building*, *supra* note 127; Fuerst & McAllister, *supra* note 127; Miller et al., *supra* note 127; Wiley, *supra* note 127.

175. *E.g.*, Miller, Pogue, Saville & Tu, *supra* note 173.

a. Development Projects

When lenders decide to provide long-term financing through a take-out agreement as part of the construction loan, the pre-closing conditions must consider and attempt to mitigate some of the unique risks previously discussed.[176] The long-term lender must address situations that trigger the purchase of the construction loan but where the building has yet to receive its final green certifications. The simple solution is to include language in the take-out agreement that does not obligate the long-term lender to fund its loan until issuance of the final green certifications. Often, this is not possible or becomes impracticable.[177]

To remedy this major issue, Peter Brittell, in his treatise on green building law, recommends that the long-term lender require the developer and those providing the short-term financing to hire an independent consultant to provide assurances at each stage of construction with regard to the third-party certification goal with an incremental approach that includes language at the development's initial, middle, and final stages.[178] He also suggests a condition that requires the borrower to prepare, complete, and file all of the necessary documents towards attaining recognition with a third-party certification organization in conjunction with approval from an external consultant prior to the first draw on the construction loan.[179]

Next, Britell addresses the building's ongoing construction by conditioning any subsequent draws on the construction loan.[180] He offers language that requires the consultant to review any and all approved change orders with all of the bulletins and other documents issued by the architect of record to determine and certify that none of these situations will reduce or prevent the building from attaining the desired third-party certification.[181] Finally, Brittell proposes a condition that occurs prior to the final draw on the construction loan and the issuance of a certificate of occupancy for the building.[182] He puts forward language that would require the borrower to supply: (1) a temporary certificate of occupancy for the structure; (2) a copy of the actual submission for final certification to the desired third-party verification organization; (3) an attestation from the borrower that the enhanced commissioning of the building is underway pursuant to the third-party verification organization's initial response to the original

176. *See supra* Section II.B.
177. *Id.*
178. *See* BRITELL, *supra* note 9, § 8.02[1][a].
179. *Id.*
180. *Id.*
181. *Id.*
182. *Id.*

submission for certification; and (4) a confirmation from the green building consultant that the submission sent to the third-party verification organization was examined and that the consultant maintains the opinion that nothing material will affect the structure's ability to attain certification.[183]

Taking a different approach, long-term lenders could also look at mechanisms to transfer the risk that the building fails to gain the desired third-party certification. Since the exposure may originate from different sources, such as defective workmanship, improperly substituted products, poor design, or a mistake in the documentation, a lender would need to consider a combination of insurance products to transfer the risk.

In attempting to mitigate these risks, lenders could include covenants in the take-out and loan agreements that require a performance bond on the building's construction and a covenant that the surety must extend coverage to include the attainment of the desired third-party certification.[184] This type of requirement would provide additional financial means for issues that may originate from a physical problem in the building along with those concerning documentation. By relying on a performance bond, the lender could reduce its exposure to the possibility that the building fails to attain the desired third-party certification and transfer some of the risk to a surety with large resources to cure any deficiencies.[185]

Similarly, lenders could try to mitigate some of the design risks by requiring borrowers to submit evidence of insurance coverage for their design teams and policy limits for prior approval as a condition for agreeing to participate in the building's development. This type of requirement allows lenders to ensure that coverage exists for all designers, that the carrier maintains satisfactory resources to pay for any errors or omissions on their part, and that sufficient policy limits exist to cover any losses that might occur from failing to attain the promised third-party certification.[186]

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183. *Id.*

184. Currently, there is no clear industry standard as to whether a performance bond will cover completion all the way to attaining the desired third-party certification, or just the building by itself. *See* Prum & Medders, *supra* note 11, at 25–37. The coverage issue remains within the performance specification of the construction project and the language used in the contract that forms the bond. *Id.*

185. *Id.* at 25.

186. *See generally* Prum & Del Percio, *supra* note 94, at 257–59. Beyond reviewing the policy itself, a lender might consider taking a look at any agreements between the borrower and the design professionals to make sure that any contracts call for the appropriate standard of care. *See* Darren A. Prum, *Green Building Liability: Considering the Applicable Standard of Care and Strategies for Establishing a Different Level by Agreement*, 8 HASTINGS BUS. L.J. 33, 59 (2012). Because participants in a green building will most likely avoid the professional standard, a prudent lender must investigate further to ensure that those responsible did not

These different solutions offer several credible options to lenders that genuinely aim to mitigate the unique risks posed by green buildings prior to a loan's funding.

b. Existing Buildings

As previously discussed, the exposure to a lender for providing a loan on an existing green building offers few differences from that of a traditional structure.[187] However, underwriters must still confirm that the borrower's assertions regarding the green building features are true. Consequently, underwriters must request supporting documentation that the building received certification from a third-party verification organization and that any tax certificates or similar instruments, which convey special financial benefits upon the completed structure occurred.

To eliminate the possibility of risk occurring from an untruthful applicant, one commentator suggests two different closing conditions that the borrower must fulfill prior to funding the loan, beyond the normal requirements for items such as certificates of occupancy.[188] He proposes that lenders include a preceding condition that the borrower must deliver a copy of the certification issued by the third-party verification organization as part of its loan obligations.[189] He also advises lenders to incorporate another preceding condition for the borrower to provide the supporting documentation that may exist for property tax abatements or other incentives that convey financial benefits upon the completed structure as well.[190]

Accordingly, a lender can feel confident that its approach to an existing green building poses few differences from that of a traditional one, and that with minimal effort and adjustments, the lender can make a good decision on whether to approve an applicant's loan.

2. Post-Closing Conditions

When considering the exposure a lender faces after funding the mortgage on a green building, the loan documents provide a good opportunity to address issues that may affect the borrower's decision to live up to its obligations at a later point in time. In some instances, the post-closing conditions actually take shape before the loan funds, but the actual performance occurs afterwards. Other times, the conditions subsequent must provide the

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contractually lower their standard below that of a reasonable person or did not bifurcate their services to avoid it either. *Id.*

187. *See supra* Section II.C.

188. *See* BRITELL, *supra* note 9, § 8.02[2].

189. *Id.*

190. *Id.*

lender a means of relief should the borrower fail to live up to his obligations. In drafting these conditions, lenders must keep an eye towards both the present and future to protect their interest and prevent unpalatable consequences should the borrower take actions that are contrary to the loan covenants.

a. Property Insurance

While the need and process to obtain the appropriate type and level of property insurance coverage might start prior to the funding of the permanent financing, the actual requirement will most likely occur as part of a condition subsequent. However, in the case of a green building, the underwriters must take a more proactive approach to ensure that the policy provides adequate coverage for the myriad of features and regulatory frameworks that apply to the structure and prevent the borrower from ending up underwater due to an uncovered claim and loss. As such, the underwriter should provide the applicant with an evaluation of the proposed collateralized property's insurance policy that addresses the areas of concern and stipulates changes in coverage.

As a starting point, the underwriter must closely review and consider the application of the ordinance or law exclusion, the valuation method and amount, and the coverage features as applied to the green building. When taking into account the ordinance or law exclusion, the underwriter must consider the existing and prospective attitudes regarding green building features in the jurisdiction where the property is located.

If a jurisdiction has already adopted a green building code like the IgCC or CALGreen, then the lender must insist that the property owner obtain a higher coverage in the ordinance or law exclusion because a future increase in the standard is highly likely. Conversely, the ordinance or law coverage may not pose as large a risk for normal structures in jurisdictions that are unlikely to adopt a more environmentally friendly building code because many of the green requirements already surpass baseline code requirements.

In weighing the valuation issues, the underwriter must insist upon replacement-cost coverage because of the unique features associated with a green building and its high performance characteristics. Although the process for quantifying the value of intangible green building features is evolving, data collected in the underwriting process may make the attachment of a value much smoother and deter an insurer from trying to avoid paying the higher costs associated with replacement. Historical valuations and other data from the insured and bank can negate the insurer's undervaluation. Additionally, because the insurer drives the process of constructing the re-

placement structure, there is a risk that replacements will fail to maintain the property's green or high performance features. The underwriter must therefore require that the property owner transfer the risk of a property becoming less valuable than the loan balance.

Finally, lenders must instruct underwriters to pay special attention to the policy coverages for the collateralized property. Given that many systems are designed to meet sustainable policy objectives and can be easily replaced with more efficient models during a product's evolutionary cycle, other aspects of a green building may present difficulties. These types of situations occur because many of the third-party verification programs induce designers and developers to include unique architectural and other types of features into the green building to gain additional credit towards a specific certification. If the proposed collateralized building contains one of these features, then the underwriter should create a list of coverage concerns and require the borrower to obtain endorsements to make sure these aspects receive inclusion in the policy, similar to the approach recommended for vegetative roofs.

Moreover, underwriters should confirm that the underlying property policy does not contain language that excludes the documentation associated with delivering and recertifying the building to a third-party verification organization's standards. In the event that the underlying policy fails to exclude such a requirement, then the lender and property owner could insist that the replacement coverage approach will include such documentation, especially when the valuation reflects the significance of this certification and may become a point of contention with an insurer.

Hence, lenders must instruct underwriters that the property insurance requirement with a green building poses significant coverage gaps if the loan is funded. Lenders must extensively review the borrower's policy for these types of issues and insist on endorsements with applicable coverage to prevent a future loss.

b. Consequences and Remedies for Noncompliance

Loan documents should address the consequences of a borrower's failure to comply with the terms of the contract. In the context of a green building, for example, noncompliance may occur when the borrower fails to achieve the green building certification or tax-abatement benefits in a timely manner.

When anticipating non-compliance, lenders must consider the various options they may take, such as foreclosure or self-help, which may be unpalatable to the borrower. Following a traditional approach, the lender may choose to foreclose upon the property for breach of contract and take over

the collateralized building. While this may seem like a viable option, a foreclosure action might be overly harsh for a perfectly functional building that only failed to receive its green building certification or property tax abatement.[191] Furthermore, a lender will eschew remedying any deficiencies in the collateralized property on its own unless absolutely necessary because of the potential risk that a hostile court might attach additional liabilities due to its participation in the construction project.[192] As such, a lender must consider inserting unpalatable conditions subsequent into the loan agreement so that it may make a borrower think twice before going down the path of noncompliance.

In these situations, the lender must prepare for issues that arise out of documentation, corrective construction, or some type of incurable defect.[193] Documentation issues, such as amended filings with the third-party verification organization or updates to the drawings and specifications, can be easily resolved.[194]

Similarly, a building might require corrective construction to attain the third-party verification organization's certification.[195] This might include removing and replacing noncompliant equipment, work, or finishes on the building to meet the required standard.[196] In both cases, Britell suggests that lenders can insert post-closing conditions into lending agreements that require borrowers to accept personal and financial responsibility to complete all necessary tasks required to achieve the agreed upon certification.[197] He proposes that the language make borrowers bear the costs for the necessary green building, construction, and legal consultants.[198]

Alternatively, or in conjunction with Britell's proposal, lenders could insert post-closing conditions that require the borrower to provide temporary financial impounds at the time the long-term financing receives funding. Similar to the current practice that impounds interest or property taxes, a lender could reserve the right to require the borrower to place sufficient funds in an escrow account to cover any costs remaining with attaining the third-party certification. Upon the receipt of certification, the borrower

191. *See id.* § 8.02[1]. In a variation of this situation that only concerns the green building aspects, the government may provide a Certificate of Occupancy, so the building is fully functional. It only fails to receive certification by a third party verification organization, which may decrease its value and cause concern to the lender.

192. *See supra* text accompanying notes 95–96.

193. *See* BRITELL, *supra* note 9, § 8.02[1][b].

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

would receive their funds back, but until that point, the funds would remain as additional collateral to cover any extra cost necessary to achieve the agreed upon certification.

Finally, the most difficult scenario is one in which neither documentation nor construction offers a solution to the building's ills.[199] This may occur due to negligence of the designers or contractors to create a structure that will qualify or a failure to execute the appropriate techniques, practices, or procedures during construction.[200]

In those situations where the government compels a borrower to attain certification from a third-party verification organization, a solution for the building is unclear. But for the lack of certification, the structure would most likely receive its certificate of occupancy and become an operational building. Some jurisdictions impose fines and penalties for noncompliance with green building requirements while others remain silent on the issue.[201] Given the likelihood of this scenario becoming a reality, lenders should insert language to cover this option too. Should the jurisdiction levy fines and penalties for any noncompliance, the lender must include a provision that makes the borrower responsible for such assessments, along with any costs incurred to gain a certificate of occupancy.[202] In jurisdictions that do not address penalties for noncompliance, the language inserted by the lender should place responsibility on the borrower to seek and pay for the costs associated with gaining a variance from the appropriate authorities for the building.[203]

Moreover, lenders should also add sufficient language to the loan documents to ensure that borrowers keep all responsible parties for delivering a certified green building on task. Britell suggests a "default interest rate" that terminates when the issue is cured as a means of dissuading borrowers from heading in the wrong direction.[204]

Consequently, even where a completed building fails to receive certification by a third-party verification organization, most, if not all, of the extra exposure becomes manageable through better underwriting processes and loan documents that anticipate potential quagmires.

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199. *Id.*

200. For instance, an oversight might occur when the commissioning occurs improperly or the contractors use an impermissible approach when handling the waste, disposal, or recycling during building construction. *See id.*

201. *See generally* Prum, *State Incentives*, *supra* note 7; Prum, Aalberts & Del Percio, *supra* note 1.

202. *See* BRITELL, *supra* note 9, § 8.02[2].

203. *Id.*

204. *Id.*

Conclusion

Overall, lenders that provide long-term financing for green buildings confront a great deal of exposure to loss from a variety of different sources. Ordinary preventative measures, such as mortgage underwriting and insurance, help mitigate certain risks: that the real property remains first in line with respect to an action in foreclosure, that the lender does not turn into a responsible party for an environmental cleanup, and that the collateralized structure maintains or attains the necessary governmental approvals for occupancy. However, the addition of sustainable features to the structure brings an extra layer of risk that many lenders will unknowingly reject or accept due to a lack of knowledge on the subject matter, despite the real exposures they present.

In making their decisions to provide funding for green buildings, lenders that solely rely upon customary underwriting tools and analysis will face a unique dilemma. Lenders must balance their tried-and-true business practices that fund loans for the most creditworthy of applicants with the desire to support the overarching goals of policymakers to reduce greenhouse gas emissions attributable to the built environment. Even though the twin aims might seem mutually exclusive, lenders may align their practices with environmental goals by understanding that the current practices for analyzing and mitigating risk exposure from traditional structures will not adequately address the unique issues presented by green buildings.

Therefore, prudent lenders must adjust their strategies for identifying, explaining, and quantifying the exposures for these types of loans to better support the agenda put forth by policymakers. After grasping the issues and unique characteristics associated with green buildings, lenders can develop practical and simple solutions to the risks posed by environmentally friendly structures. These solutions include making adjustments and tweaking methods that evaluate and address the various exposures, while protecting the lender's interests.

Therefore, lenders can successfully and easily modify their procedures and documentation when considering and funding a mortgage for a green building so that they may demonstrate support for policymakers and their ecological goals to reduce greenhouse gas emissions from the built environment.