The Constitutionality of Property Assessed Clean Energy (PACE) Programs Under Federal and California Law

A White Paper

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EXECUTIVE SUMMARY

Property Assessed Clean Energy (PACE) programs enable local governments to finance renewable energy and energy efficiency projects on private property by utilizing the widely adopted mechanism of land-secured financing. Under these increasingly popular programs, local governments finance clean energy improvements and levy special assessments against the property benefitted by the improvements.

Twenty-two states have enacted legislation authorizing local PACE programs, and PACE programs are being developed in hundreds of locations around the country. Participation in a PACE program is purely voluntary. PACE assessments are collected as part of the property owner's regular property tax bill and are secured by a lien on the property. In California, such a lien has the same senior status as other local government tax or assessment liens.

Some opponents of PACE programs have questioned the constitutionality of PACE programs. Specifically, the superiority over private liens that is provided to PACE liens has raised concerns that such liens could impair mortgage lenders' contractual rights to repayment in violation of the Contracts Clause of the U.S. Constitution. Others have expressed concern that PACE assessments in California could violate Article XIII D of the California Constitution. This white paper evaluates these concerns about the constitutionality of PACE programs, and concludes they are unfounded.

The U.S. Supreme Court applies a three-part test to determine whether state and local government actions affecting private contracts violate the Contracts Clause of the U.S. Constitution. PACE programs do not violate the Contracts Clause because (i) they do not substantially impair pre-existing liens, (ii) they serve a legitimate public purpose, and (iii) they are a reasonable and appropriate means for achieving a public purpose. For the same reasons, PACE programs do not violate the Contracts Clause of the California Constitution. In fact, PACE programs fit squarely within the long-standing tradition consistently upheld by courts of using land-secured financing to support municipal programs.

PACE programs in California typically utilize the legal structure authorized by AB 811, enacted in 2008, which enables California municipalities to levy contractual assessments to finance certain clean energy installations. PACE contractual assessments are valid under Article XIII D of the California Constitution because (i) they are consistent with its underlying purpose, (ii) they are not subject to Article XIII D, and (iii) even if PACE contractual assessments are subject to Article XIII D, property owners may waive the procedural requirements of Article XIII D when they voluntarily execute a contractual assessment.

Local governments throughout the country are developing PACE programs to increase investment in clean energy, create green jobs, and reduce emissions of greenhouse gases. None of the issues raised by opponents of PACE programs poses a barrier to implementation of PACE programs under federal or California law.

I. INTRODUCTION

A Property Assessed Clean Energy (PACE) program is a cost-effective tool that enables local governments to finance renewable energy and energy efficiency projects on privately owned residential and commercial property. Under a PACE program[1], property owners elect to have up to 100% of the cost of clean energy improvements added to their property tax bill as an assessment or special tax. The assessment or special tax is secured by a lien on the property and is not an obligation of the individual property owner. Participation in PACE programs is purely voluntary.

PACE programs utilize the longstanding and widely-adopted mechanism of "land-secured financing," pursuant to which local governments finance improvements and levy assessments or special taxes against property benefited by such improvements.[2] Land-secured financing districts (also known as special assessment districts) are used throughout the United States to fund sewers, sidewalks, seismic retrofitting, fire safety improvements, and many other projects that serve a public purpose.[3] Such districts have been a part of municipal finance and the tax lien structure for more than a century.[4] The assessments or special taxes are collected as part of the regular property tax bill and are secured by a lien on the property. Like other local government assessment or tax liens, in California PACE liens are senior to private liens, including those for pre-existing purchase money mortgage loans.

PACE programs typically are established after a state legislature enacts statutory changes to the existing authority for local entities to undertake land-secured financing to expand the types of improvements that may be financed by local governments to include privately-owned renewable energy and energy efficiency projects. Using this authority, local governments can develop PACE programs with detailed features (e.g., types of improvements permitted, limits on financing and assessments, "underwriting" standards, and consumer and lender risk mitigation features). The enabling legislation typically provides that taxes or assessments may be levied only where the property owner has

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[1] Alternative names for similar programs include VEIB (Voluntary Environmental Improvement Bond) programs, ELTAP (Energy Loan Tax Assessment Programs), and E-CAD (Energy Efficiency/Renewable Energy Contractual Assessment District).

[2] While PACE programs have been described as "innovative," they simply are another exercise of the land-secured financing power by municipalities.

[3] *See, e.g.*, The Improvement Act of 1911, Cal. Sts. & High. Code §§ 5000, *et seq.*; the Municipal Improvement Act of 1913; Cal. Pub. Res. Code §§ 26500, *et seq.* (relating to Geologic Hazard Abatement Districts); the Mello-Roos Community Facilities Act of 1982, Cal. Gov't Code §§ 53311, *et seq.*; Colo. Rev. Stat. §§ 30-20-601, *et seq.*; Consolidated Local Improvements Law, Nev. Rev. Stat. Ch. 271; Or. Rev. Stat. Ch. 223.

[4] *See* Ronald H. Rosenberg, *The Changing Culture of American Land Use Regulation: Paying for Growth with Impact Fees*, 59 SMU L. Rev. 177, 217 n.138 (2006) (discussing the "long history" of special assessments in the United States, "reaching back to the seventeenth century," and citing *People ex rel. Griffen v. Mayor of Brooklyn*, 4 N.Y. 419, 438 (1851) and Osborne M. Reynolds, Jr., Local Government Law 349-54 (2d ed. 2001)); *see also German Sav. & Loan Soc'y v. Ramish* (1902) 138 Cal. 120 (upholding priority of assessment lien for street improvements over prior mortgage).

expressly consented to participate in the PACE program. PACE assessments or special taxes are made according to agreed-upon amounts over the useful life of the financed improvement. If the property owner sells the property, the PACE assessment or tax lien remains with the property.

PACE programs address an economic reality that makes it difficult for many property owners to afford clean energy installations: the economic benefits of energy cost savings are distributed over time, but a relatively large upfront cost is required to begin accruing those benefits. PACE programs correct this disconnect and allow the costs of the clean energy installation to be distributed over time just as the benefits are. PACE programs can be used to finance a wide variety of clean energy installations, including rooftop solar photovoltaic systems, solar water heating systems, high-efficiency furnaces and water heaters, energy efficient windows, and insulation. These programs can be a powerful tool for creating green jobs and generating economic activity at the local level, while helping to significantly increase investment in energy efficiency, reduce emissions of greenhouse gases, and achieve national clean energy goals.

Twenty-two states, including California, and the District of Columbia have enacted PACE legislation authorizing local programs, and similar legislation has been introduced in a number of other states. Eight active PACE programs currently are in place: Berkeley, CA; Palm Desert, CA; Placer County, CA; San Francisco, CA; Santa Barbara County, CA; Sonoma County, CA; Yucaipa, CA; Boulder, CO; and Babylon, NY. In addition, a statewide program is being established in California, and PACE programs in Los Angeles and hundreds of other locations around the country also are in the process of development.

PACE programs have received the support and endorsement of numerous stakeholders who have voiced support for strong underwriting standards and other elements of PACE programs designed to protect consumers and lenders.[5] The White House and certain federal agencies collaborated to develop a "Policy Framework for PACE Financing Programs" that was released in October 2009.[6] This Policy Framework, which provides safeguards for mortgage lenders, homeowners and other parties, serves as guidance for the design of PACE programs around the country. In addition, on May 7, 2010, the Department of Energy released PACE program guidelines that apply to any PACE program utilizing federal funds.[7]

[5] Supportive stakeholders include Vice President Joe Biden, federal agencies including the Department of Energy and the Department of Housing and Urban Development, numerous state officials including the California Attorney General, and nongovernmental organizations.

[6] The Policy Framework is available at: http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf.

[7] Because the majority of operating and soon to be launched PACE programs rely at least partially on federal funds to cover initial administration costs, the Department of Energy "best practice" guidelines essentially apply to PACE programs across the board. The guidelines are available at: http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf.

Recently, some opponents of PACE programs have questioned the legality of PACE programs, including whether the programs violate provisions of the U.S. and California Constitutions.[8] Among other things, PACE opponents have argued the superiority provided to PACE liens could interfere with, or impair, mortgage lenders' contractual rights to repayment in violation of the Contracts Clause of the U.S. Constitution.[9] Others have expressed concern that PACE assessments in California could violate Article XIII D of the California Constitution.

This white paper evaluates the constitutionality of PACE programs and concludes that PACE programs do not run afoul of the cited provisions of the U.S. Constitution or the California Constitution. In fact, as explained below, PACE programs fit squarely within the long-standing tradition consistently upheld by courts of land-secured financing for municipal programs.[10]

This analysis was prepared for The Vote Solar Initiative, a non-profit organization working to bring solar energy into the mainstream across the United States.[11]

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[8] For example, Michael Swartz of Hennigan, Bennett & Dorman, LLP prepared a white paper dated February 18, 2010 titled "A White Paper on PACE Loans: Unconstitutional and Damaging to GSE's Such As Fannie Mae and Freddie Mac." ("GSE" means government-sponsored enterprise.)

[9] These concerns are limited to existing lenders; a private mortgage loan made to a property owner after creation of a PACE lien will not raise the same issue.

[10] The California Legislature has authorized the levy of assessments and special taxes to finance privately-owned improvements for public purposes. *See* (i) the Improvement Act of 1911, which authorizes the levy of special assessments to finance, among other things, improvements on private property to prevent, mitigate, abate or control geologic hazards (Cal. Sts. & High. Code § 5105); (ii) the Municipal Improvement Act of 1913, which authorizes the levy of special assessments to finance, among other things, seismic- and fire safety-related improvements on private property (Cal. Sts. & High. Code §§ 10100.2, 10100.3); (iii) the Mello-Roos Community Facilities Act of 1982, which authorizes the levy of special taxes to finance a variety of privately-owned improvements, including work on private property to bring it into compliance with seismic safety standards or regulations or to repair earthquake damage (Cal. Gov't Code § 53313.5(i)), and to repair and abate damage caused to private property by soil deterioration (Cal. Gov't Code § 53313.5(j)); and (iv) California Public Resources Code section 26500, *et seq*., which authorizes a geologic hazard abatement district to make improvements to public or private structures where the legislative body determines that it is in the public interest to do so, and authorizes the levy of special assessments to finance such work.

See also City of Oxnard v. Donlon, Nos. B103714, B107180, slip op. at 18 (Cal. Ct. App. Mar. 31, 1998) (upholding legislation making a Mello-Roos Community Facilities Act of 1982 special tax lien superior to the liens of pre-existing deeds of trust and specifically observing that "[i]t is well established that there is '. . . no constitutional objection to a legislative provision making the county's lien superior to pre-existing mortgages'" (quoting *Guinn v. McReynolds*, 177 Cal. 230, 232 (1918))); *id.* at 14 ("[T]here is no taking here because the lien of the Mello-Roos special taxes on the real property supersedes the Donlon's trust deed as a matter of law." (citing *Fed. Deposit Ins. Corp. v. New Iberia*, 921 F.2d 610, 611 (5th Cir.1991))).

[11] The authors thank Colin Barreno for his contributions to this white paper.

II. ANALYSIS

Concerns have been raised about whether implementation of PACE programs violates the Contracts Clause of the U.S. Constitution or Article XIII D of the California Constitution. As discussed below, these concerns are misplaced.

A. CONSTITUTIONALITY UNDER FEDERAL LAW

PACE programs are constitutional under both the Due Process Clause and the Contracts Clause of the U.S. Constitution.

1. Imposition of a Priority Lien by a Local Government Does Not Violate the U.S. Constitution

In general, state legislatures have power to impose liens for special taxes or assessments that are superior to other liens or claims against property, including mortgage loans and deeds of trust. *See Guinn v. McReynolds* (1918) 177 Cal. 230, 232 ("A lien for unpaid taxes or assessments is generally held to be superior to all contract liens, whether prior or subsequent in time" provided that the law creating the lien has given it priority); *Thompson v. Clark*, 6 Cal. 2d 285, 290-91 (1936); *Zipperer v. City of Fort Meyers*, 41 F.3d 619 (11th Cir. 1995). The imposition of "special assessments and their lien prioritization do[es] not constitutionally impair or deprive a mortgagee of his [pre-existing] interest in mortgaged land." *Zipperer*, 41 F.3d at 624 (citing *Fed. Deposit Ins. Corp. v. New Iberia*, 921 F.2d 610 (5th Cir. 1991) ("*FDIC*")).

In *Zipperer*, a mortgage holder challenged the lien prioritization of special assessments that were levied on the mortgaged property for various public improvements after the mortgage had been recorded. The Eleventh Circuit Court of Appeals noted that those with interests in the property that predated the special assessment (like mortgage lenders) "retain a significant interest in the land even after its subordination to the special assessment." *Id.* at 624. A requirement to pay delinquent special assessment fees out of the proceeds of a foreclosure sale would not "immediately and drastically diminish[]" the mortgagee's interests, which would be significantly larger than the amount owed in overdue fees. *Id.* Accordingly, the court held that Zipperer had not been deprived of his property interest as a mortgagee and thus his constitutional due process rights had not been violated. *Id*. at 625.

Similarly, in *FDIC*, the Fifth Circuit Court of Appeals upheld the priority of assessment liens against a due process challenge. The court reasoned that a mortgagee cannot claim to have been deprived of its property interest where it receives the benefit of the improvement retroactively funded by a special assessment, especially when a government entity undertook the assessment at the land owner's request. 921 F.2d at 615-16. The court determined that the owner who petitioned for the improvements had no takings claim. *Id.* at 615 (discussing *Furey v. City of Sacramento*, 780 F.2d 1448, 1454 (9th Cir. 1986), *partially abrogated in First English Evangelical Lutheran Church*

v. County of Los Angeles, 482 U.S. 304 (1987)).[12] Consequently, the mortgagee, whose "interest in the property is derivative from that of the owner," could not successfully assert an unconstitutional taking. *Id.* at 615-16.

Zipperer and *FDIC* arose in the due process context and did not discuss the Contracts Clause of the U.S. Constitution. This is not surprising because both cases were litigated after the U.S. Supreme Court largely eliminated the grounds for attacking legislation that impairs pre-existing contracts, so long as the legislative body has not abused this power to avoid its own contractual commitments. *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 412 (1983). Despite the limited role of the Contracts Clause in modern legal analysis, some opponents of PACE programs nevertheless have persisted in arguing that the superiority provided to PACE liens could interfere with, or impair, mortgage lenders' contractual rights to repayment in violation of the Contracts Clause. Those concerns are unfounded under existing law.

2. PACE Programs Do Not Violate the Federal Contracts Clause

The Contracts Clause of the U.S. Constitution prohibits laws that "impair[] the Obligations of Contracts." U.S. Const. art. I, § 10. Since the 1930s, the U.S. Supreme Court consistently has held that this provision is necessarily qualified by states' inherent "authority to safeguard the vital interests of [their] people" through statutes and regulations. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 434 (1934); *Energy Reserves Group*, 459 U.S. at 410. In fact, during the past 73 years the U.S. Supreme Court "has only twice found that [state] laws are unconstitutional impairments of rights under existing contracts in violation of the Contracts Clause . . . ." Erwin Chemerinsky, *Expanding the Protections of the Takings Clause*, 37 Trial 70 (Sept. 2001) (citing *U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1977) and *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978),[13] which is the sole modern decision where the U.S. Supreme Court struck down a law because it impaired a private contract).[14]

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[12] In *Furey*, the Ninth Circuit Court of Appeals noted the absurdity of classifying an assessment as a government taking when "the owners not only consented to, but in fact requested the inclusion of their property in the assessment district." 780 F.2d at 1456. This reasoning appears to still apply despite the fact that the underpinnings of the Court's ultimate holding have since been overruled. *Id.* at 1454 (holding that "whether a taking has occurred depends on whether the construction of an improvement, from which no benefit is derived, is action that a landowner has been compelled by government to undertake and pay for or is rather a private investment voluntarily undertaken"). The *Furey* holding relied, in part, on the California Supreme Court's rule at the time that there was no inverse condemnation action for a temporary regulatory taking in California, a proposition that *First English* overruled. *Jama Constr. v. Los Angeles*, 938 F.2d 1045, 1048 n.2 (9th Cir. 1991)

[13] *U.S. Trust Co.* is easily distinguishable because it involved a state's attempt to impair its own contractual obligations, a scenario that receives greater scrutiny. *Allied Structural Steel* involved the impact of a change in the law on pre-existing private contracts, but "[t]he law was not even purportedly enacted to deal with a broad, generalized economic or social problem" and "[i]t did not operate in an area already subject to state regulation at the time the company's contractual obligations were originally undertaken . . . ." 438 U.S. at 250.

[14] *United States v. Winstar Corp.*, 518 U.S. 839 (1996), is the sole decision issued during the same time period holding that a *federal* law impaired rights under existing contracts. Among other reasons, this case

Federal courts apply the following three-part test to determine whether state and local government actions affecting private contracts violate the Contracts Clause:

(i) Does the state law operate as a substantial impairment of a contractual relationship?
(ii) If the state law constitutes a substantial impairment, does the state have a significant and legitimate public purpose behind the regulation?
(iii) Once a legitimate public purpose has been identified, is the adjustment of the rights and responsibilities of the contracting parties based upon reasonable conditions and of a character appropriate to the public purpose justifying the law's adoption?

See, e.g., Energy Reserves Group, 459 U.S. at 411-13.

a. Early Contracts Clause Cases No Longer Apply

Since federal Contracts Clause case law does not support their position, opponents of PACE programs rely on a handful of dated state court decisions they assert stand for the proposition that it is unlawful for a state to supplant a pre-existing lien through a voluntary arrangement with a property owner. However, several of these cases date back to the so-called "*Lochner* Era" of the late 19th and early 20th centuries, a period of constitutional jurisprudence during which the U.S. Supreme Court tended to invalidate state law in its zealous efforts to protect private contract and property rights. *See* Chemerinsky, 37 Trial at 70; *see, e.g.*, *Davis v. County of McLean*, 204 N.W. 459 (N.D. 1925) (priority given to voluntarily-incurred lien for state-provided insurance against crop damage due to hail). To the extent that courts struck down statutes that elevated voluntarily-incurred liens over pre-existing commitments during that period, they did not apply the current test for constitutional impairment. *Compare Davis*, 204 N.W. at 464 ("[I]t is sufficient to condemn a law that it works any impairment, however slight, of the obligations of a contract. To affect a dollar of a prior lien by subsequent legislation is as vicious before the law as to destroy the lien altogether."), *with Blaisdell*, 290 U.S. at 428, *and Energy Reserves Group*, 459 U.S. at 411-13 (laying out the modern test, pursuant to which an impairment is only unconstitutional if it is *substantial* and the allegedly offensive law is not a reasonable means of effectuating a legitimate public purpose); *see also In re Seltzer*, 104 F.3d 234, 236 (9th Cir. 1996) (observing that cases "decided before" the U.S. Supreme Court's decision in "*Energy Reserves* . . . did not give appropriate deference to legislative judgments").

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is distinguishable because, as in *U.S. Trust Co.*, the government was attempting to revise its own contractual obligations. *See also* James W. Ely, Jr., *Whatever Happened to the Contract Clause?*, 4 Charleston L. Rev. 371, 391 (2010) ("By 1940, while the Contract Clause retained some vitality at the state level, the Supreme Court had recognized so many exceptions to its guarantee at the national level as to virtually read the provision out of the Constitution."); Jeffery A. Berger, *The Contracts Clause: Time for a Rebirth?*, 24 WLF Legal Backgrounder No. 29 (Sept. 25, 2009), *available at* http://www.wlf.org/publishing/publication_detail.asp?id=2106 (observing that "since *Blaisdell*, the Supreme Court has . . . struck down a state law on Contracts Clause grounds on only one occasion (where a private contract was involved)" (citing *Allied Structural Steel*)).

PACE opponents also have cited the outmoded decision in *Jeffreys v. Point Richmond Canal & Land Co.* (1927) 202 Cal. 290, for the proposition that the California Supreme Court previously invalidated a statute that sought to improve an assessment's priority over an existing mortgage. This interpretation of *Jeffreys* mischaracterizes the holding of the case, which considered whether a statute could apply retroactively to enable a bondholder to directly sue a delinquent property owner who otherwise was subject only to suit for unpaid assessments by the city or contractor. *Id*. at 292. The status of the bonds was not at issue. In holding that the particular expansion of the bond holders' remedies, vis-à-vis the property owners, violated the California Constitution's Contracts Clause, the court considered only whether the statute impaired existing contracts. Even if the court had considered subject matter remotely analogous to a PACE program (which it did not), the *Jeffreys* court did not apply the modern day test used to identify unconstitutional impairments. Today, legislation that impairs a contract is not necessarily unconstitutional. Even a severe impairment only advances the inquiry to the next stage—"a careful examination of the nature and purpose of the state legislation." *Allied Structural Steel Co.*, 438 U.S. at 245.

In addition to being outdated, the state court decisions cited by PACE opponents are readily distinguishable. For example, *Central Savings Bank in the City of New York v. City of New York*, 18 N.E.2d 151 (N.Y. Ct. App. 1938) involved a New York statute that required property owners to make improvements in order to maintain their buildings as tenements. In holding that the lien priority that resulted from this law impermissibly impaired the contractual rights of the mortgagee, the court's reasoning turned on the involuntary nature of the improvements and the lack of a valid public purpose. The court emphasized that while the city could exercise its police powers to compel property owners to demolish a dangerous building that posed a threat to public health, it could not "compel the owner to keep it for a specific use." *Id*. at 156. Numerous cases have distinguished *Central Savings* on this basis. *In re City of New York ex rel. City of New York Housing Auth.*, 143 N.Y.S. 2d. 346, 349 (1955); *Thornton v. Chase*, 23 N.Y.S. 2d 735, 737 (1940); *State of New York v. Gebhardt*, 151 F.2d 802, 805 & n.2 (2d Cir. 1945). In contrast, PACE programs are entirely voluntary and employ a time-tested mechanism to achieve a valid public purpose.[15]

PACE opponents cite only one decision published after the U.S. Supreme Court established the modern three-part test for contracts clause analysis in *Energy Reserves Group*: a 1995 Illinois state court case, *First of America Bank v. Netsch*, 651 N.E.2d 1105 (Ill. 1995) (statute imposing on purchasers at foreclosure sales the liability for shortfalls in cemetery care trust fund contributions). *First of America* is not a Contracts Clause case, however. *Id*. at 1112 ("Although the parties devote a significant portion of their

[15] Note also that, as a pre-*Energy Reserves Group* case, *Central Savings* did not consider whether the legislature's "'judgment as to the necessity and reasonableness of a particular measure"' deserved deference. *Energy Reserves Group*, 459 U.S. at 412-13 (quoting *U.S. Trust Co.*, 431 U.S. at 22-23). Had *Central Savings* been evaluated under the modern day test, the outcome almost certainly would have been different.

briefs to a discussion of whether section 15b violates the contract clauses of the Federal and State Constitutions, we need not decide that constitutional question.").[16]

b. PACE Programs Satisfy the Modern Contracts Clause Test

As indicated above, the U.S. Supreme Court now applies a three-part test to determine whether state and local government actions affecting private contracts violate the Contracts Clause. To meet the first part of the test, PACE opponents must demonstrate that a PACE program substantially impairs a particular contractual right. *Allied Structural Steel Co.*, 438 U.S. at 244. If opponents can meet this first part of the test by showing a substantial impairment, the second part of the test provides that "the State, in justification, must have a significant and legitimate public purpose behind the regulation." *Energy Reserves Group*, 459 U.S. at 411. If the State can identify a legitimate public purpose, a court then must consider the third part of the test: whether the implementing ordinance is based on reasonable conditions and is appropriate in light of the purposes behind its adoption (in other words, whether it is "reasonably necessary"). *Id.* at 412. When analyzed pursuant to the legal framework currently applied by federal courts, PACE programs do not violate the Contracts Clause.

(i) PACE Programs Do Not Substantially Impair Pre-Existing Contracts

The threshold inquiry of the U.S. Supreme Court's test is "whether the state law 'has operated as a *substantial* impairment of a contractual relationship.'" *Rui One Corp. v. City of Berkeley*, 371 F.3d 1137, 1147 (9th Cir. 2004) (quoting *Gen. Motors Corp. v. Romein*, 503 U.S. 181, 186 (1992)) (emphasis added). A court engaging in this inquiry must assess whether a contractual relationship exists and whether a change in law substantially impairs that relationship. *Id.*

"[T]otal destruction of contractual expectations is not necessary for a finding of substantial impairment." *Energy Reserves Group*, 459 U.S. at 412. Courts instead focus on the practical consequences of the regulatory change and its foreseeability. In particular, a court is more likely to find a substantial impairment when the law represents a foray into an area not previously subject to regulation by the state. *Id.* at 411; *Veix v. Sixth Ward Bldg. & Loan Ass'n*, 310 U.S. 32, 38 (1940). This is so because "[w]hen regulation already exists, it is foreseeable that changes in the law may alter contractual obligations." *Zimmerman v. Bd. of County Comm'rs*, 289 Kan. 926, 969 (2009).

In *Northwestern National Life Insurance Co. v. Tahoe Regional Planning Agency*, 632 F.2d 104 (9th Cir. 1980), the Ninth Circuit Court of Appeals considered whether a

[16] The court noted in passing that "if [the statute at issue] was construed as applying to the Bank's foreclosure sale, it would retroactively impair the Bank's contract . . . ." *First of America*, 651 N.E.2d at 1114. Rather than examining whether the state had selected a rational means of pursuing a legitimate public purpose, the court instead interpreted the statute to apply only prospectively, and thereby rendered plaintiff's claims moot without further examination of the constitutional question. *Id.* at 1114-15. *First of America* is not relevant to a Contracts Clause analysis.

new land use ordinance, which restricted development on a significant portion of property after bonds repayable through future special assessments already had been issued, violated the Contracts Clause. The plaintiff argued that "because the restrictive zoning drastically reduced the value of the assessed lands . . . the landowners [would be] deterred from paying the assessments [and furthermore] any defaults caused by reduced land values could not be adequately remedied by judicial land sales." *Id.* at 106. Observing that "[t]he land use ordinance complained of did not alter the obligation of the landowners to pay the assessments," the court held that plaintiff had "failed to allege an impairment which falls within the prohibition of the contract clause . . . ." *Id.* at 107.

Similarly, the attachment of a PACE lien to a previously mortgaged property does not substantially impair prior arrangements between landowners and mortgage lenders, regardless of their priority. First, the mortgagee may still foreclose on the property in the event of default. *See, e.g.*, *Zipperer*, 41 F.3d at 621; *FDIC*, 921 F.2d at 616. Under such circumstances, PACE taxes and assessments in California do not accelerate and, as a result, only delinquent PACE assessments would be due at time of foreclosure, not the entire assessed amount. In addition, the clean energy improvements financed by PACE programs increase the value of the underlying property and should decrease energy bills, thereby potentially lowering the risk of default and providing a benefit to the mortgagor. The application of senior lien priority for PACE assessments therefore does not drastically reduce the value of the assessed lands or the amount lenders might recover in a foreclosure. Furthermore, the imposition of a subsequent senior lien pursuant to a PACE program does not alter a landowner's obligation to pay its mortgage. As a result, such liens do not constitute a substantial impairment under Ninth Circuit precedent.

The fact that lien priority is an area otherwise regulated by states further supports the conclusion that senior lien priority for PACE assessments does not substantially impair pre-existing mortgage rights. As "[t]he Court long ago observed: 'One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the state by making a contract about them.'" *Energy Reserves Group*, 459 U.S. at 411 (quoting *Hudson Water Co. v. McCarter*, 209 U.S. 349, 357 (1908)). A contract "carr[ies] with it the infirmity of the subject matter." *Hudson Water Co.*, 209 U.S. at 357. Additionally, even if the state has not directly regulated the specific subject matter of a particular contract in the past, extensive regulation of the industry as a whole can justify an expansion of existing regulations. *Energy Reserves Group*, 459 U.S. at 414-16 (impact of changes in Kansas law that directly regulated natural gas prices for the first time did not substantially impair the pricing terms of pre-existing contracts for the sale of natural gas given the state's extensive regulation of the industry).

Land-secured municipal finance districts have existed in the United States for well over a century,[17] and the seniority of assessment liens was a longstanding and well-known element of the statutory law at the time parties contracted for the mortgages. In California, the subordination of purchase-money mortgage liens to tax and assessment liens, although originally derived from common law, is based on statute, and in fact is an exception to the general rule of lien priority being based on the time of recording the lien.

[17] *See* Rosenberg, *supra* note 4 at 217 n.138.

See Cal. Civ. Code § 2898(a); Articles 13 (commencing with section 53930) and 13.5 (commencing with section 53938) of Chapter 4 of Part 1 of Division 2 of Title 5 of the California Government Code (purpose is to "make uniform the priority of special assessment liens" (Cal. Gov't Code § 53930)). In California, mortgage lenders have made loans subject to a regulatory environment in which local agencies' taxes and assessments are secured by a senior lien. Consequently, mortgage lenders cannot credibly argue that the State lacks authority to regulate in this area. Although the specific types of improvements that may be financed by PACE programs may be somewhat novel (see footnote 10), this financing mechanism, and the status of local government special assessment liens, is part of the pre-existing legal structure and thus does not substantially impair the rights of mortgagees.[18] *Cf. Energy Reserves Group*, 459 U.S. at 414-16.

Even if a court was to consider the value of a potential impairment suffered by the mortgage lender as a result of its mortgage being junior to a PACE lien, the amount is typically sufficiently insignificant that lenders are willing to cure the delinquencies to protect their property interest.[19] In the event of a foreclosure, only the past-due assessments pledged to pay back the PACE lien will come due. While actual impairment, if any, would be calculated on a case-by-case basis, this would not appear to be a substantial impairment by commercial lenders' standards.[20]

"Minimal alteration of contractual obligations may end the inquiry at the first stage." *Nw. Nat. Life Ins.*, 632 F.2d at 106 (citation omitted). As noted above, the priority status of PACE liens does not relieve landowners of their obligations to repay their mortgages. *See Blaisdell*, 290 U.S. at 430 ("Without impairing the obligation of the contract, the remedy may certainly be modified as the wisdom of the nation shall direct." (citation omitted)). Moreover, to the extent that the senior priority of a PACE lien *might* reduce the amount recouped by the mortgagor in the event of a foreclosure sale, this amount typically would be insignificant in relation to the size of most mortgages. The impairments, if any, resulting from PACE lien priority therefore reasonably should be expected to be minimal. Furthermore, as this approach to funding private projects with public benefits is not novel, potential plaintiffs could not credibly argue that the expansion of laws to offer funding for clean energy improvement projects constitutes a foray into a new area of government regulation. For these reasons, the senior priority given to PACE liens does not substantially impair pre-existing contracts.

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[18] For example, in California see The Improvement Act of 1911, the Municipal Improvement Act of 1913, as well as the Mello-Roos Community Facilities Act of 1982, which authorizes the formation of "community facilities districts." The liens imposed to repay the community facilities districts for projects they finance are "paramount to all existing liens of a private nature," including mortgages. Cal. Gov't Code § 53340(e); *Chase v. Trout* (1905) 146 Cal. 350, 365.

[19] See the Department of Energy PACE program guidelines, *supra* note 7, which encourage non-acceleration upon property owner default and a property value-to-PACE lien ratio of 10:1.

[20] Moreover, this valuation of the potential "impairment" does not take into account the value added by the improvements financed by the PACE program. It may be difficult to value the premium that might be paid for a home equipped with solar panels, for example, but the energy savings are concrete and calculable.

(ii) PACE Programs Serve a Legitimate Public Purpose

Even if PACE opponents were able to satisfy the first part of the three-part test by demonstrating that a PACE program substantially impairs a particular contractual right, they would be unable to satisfy the second part of the test because PACE programs are enacted in the pursuit of significant and legitimate state interests. As a general rule, "parties by entering into contracts may not estop the legislature from enacting laws intended for the public good." *Manigault v. Springs*, 199 U.S. 473, 480 (1905). The sanctity of contracts must yield to the State's power "to protect the lives, health, morals, comfort, and general welfare of the people . . . ." *Id.* at 481. This legitimate public purpose requirement in turn guarantees that the State is not providing a benefit to special interests at the expense of others. *Id.*; *Energy Reserves Group*, 459 U.S. at 411-12.

Numerous cases have established "that the protection of the environment is a broad societal interest which is well within the authority of the state to protect." *Lefrancois v. Rhode Island*, 669 F. Supp. 1204, 1215 (D.R.I. 1987); s*ee also Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 505 (1987) ("the Commonwealth has a strong public interest in preventing this type of harm [mine cave-ins], the environmental effect of which transcends any private agreement between contracting parties."); *U.S. Trust Co. v. New Jersey*, 431 U.S. 1, 28 (1977) ("Mass transportation, energy conservation and environmental protection are goals that are important and of legitimate public concern.").

PACE programs seek to address the risk of global climate change impacts, accelerate investment in energy efficiency, and increase energy security. *See, e.g.*, Cal. Sts. & High. Code § 5898.14(a). PACE programs therefore serve a significant, legitimate public purpose. *See also Manigault*, 199 U.S. at 480 (reiterating that a State can exercise "such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public, though contracts previously entered into between individuals may thereby be affected").

(iii) PACE Programs Offer a Reasonable Means for Achieving the Public Purpose

To succeed on a claim of contractual impairment, PACE opponents also must demonstrate that the approach taken in the enabling legislation is unreasonable and inappropriate in light of the objectives it seeks to accomplish. However, "[u]nless the State itself is a contracting party, 'as is customary in reviewing economic and social regulation, . . . courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.'" *Energy Reserves Group*, 459 U.S. at 412-13 (quoting *U.S. Trust Co.*, 431 U.S. at 22-23) (footnote omitted). Under such circumstances, there are few, if any, limits on the degree of deference courts have accorded legislative judgments, provided that the legislature makes some effort to explain its rationale. *Keystone*, 480 U.S. at 505-06 (noting that the court has "repeatedly held that unless the State is itself a contracting party, courts should properly defer to legislative judgment as to the necessity and reasonableness of a particular measure" and

"refus[ing] to second-guess the Commonwealth's determinations that [the means chosen were] the most appropriate ways of dealing with the problem" (quotations omitted)); *U.S. Trust Co.*, 431 U.S. at 26-27 (implying that as long as a state is not modifying its own obligations, "*complete deference* to a legislative assessment of reasonableness and necessity is . . . appropriate" (emphasis added)); *El Paso v. Simmons*, 379 U.S. 497, 508-09 (1965) ("The State has the 'sovereign right . . . to protect the . . . general welfare of the people . . . . Once we are in this domain of the reserve power of a State we must respect the "*wide discretion* on the part of the legislature in determining what is and what is not necessary."'" (quoting *E. N.Y. Savings Bank v. Hahn*, 326 U.S. 230, 232-33 (1945)) (emphasis added)); *see also In re Seltzer*, 104 F.3d at 236 (observing that cases "decided before" the U.S. Supreme Court's decision in "*Energy Reserves* . . . did not give appropriate deference to legislative judgments"). In light of these authorities, a court likely would defer to state legislatures enacting PACE legislation.

In enacting AB 811, the California Legislature authorized PACE programs as part of the pre-existing scheme to levy assessments to finance public improvements, some of which would be publicly-owned and some of which would be privately-owned. The Legislature determined that "a voluntary contractual assessment program that provides the legislative body of any public agency with the authority to finance the installation of distributed generation renewable energy sources and energy or water efficiency improvements that are permanently fixed to residential, commercial, industrial, agricultural, or other real property" was an appropriate tool for making such improvements to real property more affordable and to encourage their installation. Cal. Sts. & High. Code § 5898.14(b). Given the U.S. Supreme Court's jurisprudence, courts are unlikely to second-guess this legislative determination. Moreover, the use of assessments and special taxes to finance improvements to private property is not a novel concept under California law. As noted above, California law permits the formation of land-secured financing districts to finance privately-owned projects through assessments and special taxes that enjoy priority lien status. In this regard, California's PACE legislation is not particularly innovative, which is further evidence of the reasonableness and appropriateness of PACE programs.

Even if a court declined to defer to the judgment of a state legislature enacting PACE legislation, it would find that the approach taken in PACE programs is reasonable and appropriate. Among other things, the imposition of PACE assessments is subject to reasonable conditions imposed under PACE programs, such as creditworthiness criteria, equity and assessment amount limitations, and requirements regarding the cost (relative to the benefit) of PACE assessments. In addition, the priority of PACE assessment liens is appropriate to the public purpose, which generally includes environmental, health, and energy independence benefits. *See, e.g.*, Cal. Sts. & High. Code § 5898.14(b) (findings in support of AB 811).

As explained above, PACE programs satisfy the three-part test to determine whether state and local government actions affecting private contracts violate the Contracts Clause. PACE programs do not substantially impair pre-existing liens, serve a legitimate public purpose, and are a reasonable and appropriate means for achieving the public purpose. Therefore, PACE programs do not unconstitutionally impair mortgage

lenders' contractual rights to repayment in violation of the Contracts Clause of the U.S. Constitution.

B. CONSTITUTIONALITY UNDER CALIFORNIA LAW

PACE programs in California utilize several legal structures. The most common structure is authorized by AB 811, enacted in 2008, which added to the existing authority of California municipalities under the California Streets and Highways Code by providing the authority to levy assessments (called "contractual assessments"[21]) to authorize the financing of installations of distributed generation renewable energy sources or energy efficiency improvements that are permanently affixed to real property. Cal. Sts. & High. Code §§ 5898.12, *et seq*. Subsequent legislation, AB 474 (2009), included water efficiency improvements in the types of projects that may be financed through contractual assessment programs in California.[22]

Under AB 811, the legislative body of a California municipality may establish a program to make PACE financing (voluntary contractual assessment financing) available to property owners within its jurisdiction, provided that the municipality gives notice of the proposed program and an opportunity for comment during a public hearing. *Id*. § 5898.20. "Assessments may be levied . . . only with the free and willing consent of the owner." *Id*. § 5898.12(g). Like general taxes owed to a city or county on real property, assessment liens imposed pursuant to a PACE program are senior (i.e., superior in priority) to all other existing and future contractual liens, including for mortgages, attached to the property. *Id*. § 5898.30.[23]

PACE program opponents assert that implementation of AB 811 programs violates the requirements of Articles XIII C and XIII D of the California Constitution, as well as its Contracts Clause. For the reasons discussed below, implementation of PACE programs does not violate these provisions of the California Constitution.

1. PACE Programs Do Not Violate the California Contracts Clause

Article I, section 9 of the California Constitution provides that a "law impairing the obligation of contracts may not be passed." Cal. Const. art. I, § 9. This provision is almost identical to the Contracts Clause of the U.S. Constitution, discussed above.

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[21] The contractual assessment concept provided for in The Improvement Act of 1911 is "an alternative procedure for authorizing assessments to finance" the work at issue. Cal. Sts. & High. Code § 5898.10.

[22] Other local agencies, most notably the City of Berkeley, the City of San Diego and the City and County of San Francisco, are employing a special tax program based on the Mello-Roos Community Facilities Act of 1982 to finance PACE improvements. These special tax programs are not subject to the procedural provisions of Article XIII D of the California Constitution. *See* Cal. Const. art. XIII D, § 3(a)(2) (special taxes are subject to the procedural requirements of section 4 of Article XIII A).

[23] California law expressly provides for the superior nature of tax, special assessment, and special tax liens. *See*, *e.g*. Cal. Gov't Code § 53935.

To determine whether a law impermissibly impairs a contract, "[t]he analysis is substantially the same under the California Constitution" as under the U.S. Constitution. *Hall v. Butte Home Health, Inc.* (1997) 60 Cal.App.4th 308, 319. In fact, "[t]he California Supreme Court uses the federal Contract Clause analysis for determining whether a statute violates the parallel provision of the California Constitution." *Campanelli v. Allstate Life Ins. Co*., 322 F.3d 1086, 1097 (9th Cir. 2003) (citing *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805); *see also Hermosa Beach Stop Oil Coalition v. City of Hermosa Beach* (2001) 86 Cal.App.4th 534, 559 n.15 (California Supreme Court and Courts of Appeal do not differentiate between the federal and California Contracts Clauses in their analysis).

When considering whether a law violates the Contracts Clauses of the federal and California Constitutions, many California courts have simply analyzed the statute at issue solely under federal law. *See, e.g., Torrance v. Workers' Comp. Appeals Bd*. (1982) 32 Cal.3d 371, 376-80 (applying U.S. Supreme Court cases analyzing the federal Contracts Clause to determine whether a statute violated the Contracts Clause of the California Constitution); *Calfarm*, 48 Cal.3d at 826-31 (statute that passed the federal test did not violate either the federal or California Constitutions); *Sonoma County Org. of Pub. Employees v. County of Sonoma* (1979) 23 Cal.3d 296, 307 (same); *Campanelli*, 322 F.3d at 1097 (same).

As explained above, PACE programs do not violate the Contracts Clause of the U.S. Constitution. The analysis is substantially the same, if not identical, under the parallel provision of the California Constitution. Accordingly, PACE programs do not violate the Contracts Clause of the California Constitution.

2. PACE Programs Are Valid Under Article XIII D

Articles XIII C and D of the California Constitution ("Assessment and Property-Related Fee Reform") were adopted by the California voters in November 1996 as part of Proposition 218. In the Statement of Drafters' Intent, the Howard Jarvis Taxpayers Association stated that the "unifying theme" of Proposition 218 is "voter and taxpayer control over local taxes." Article XIII D and its implementing statutes require a local agency, before it may levy assessments, fees, and other charges related to real property ownership, to comply with certain substantive and procedural requirements (i.e., preparation of an engineer's report detailing improvements and assessment amounts; mailed notice to the owners of all properties to be assessed; and a determination of no majority protest based on weighted ballots). Proposition 218 Omnibus Implementation Act, Cal. Gov't Code §§ 53750, *et seq*.; Cal. Const. art. XIII D; *see also Silicon Valley Taxpayers Ass'n v. Santa Clara County Open Space Auth*. (2008) 44 Cal.4th 431, 443 (Proposition 218 restricts government's ability to impose assessments and establishes strict procedural requirements for the imposition of a lawful assessment).

In addition,

> An agency which proposes to levy an assessment shall identify all parcels which will have a special benefit conferred upon them and upon which an

> assessment will be imposed . . . [and] the record owner of each parcel shall be given written notice by mail of the proposed assessment . . .

Cal. Const. art. XIII D, § 4(a)-(c).[24]

AB 811 is consistent with the purpose of public notice of assessments and taxpayer control over local taxes embodied in Article XIII D because: (i) AB 811 requires a local agency to hold a public hearing on the establishment of the program following two publications of a notice of the public hearing and provide all interested persons with an opportunity to be heard, and (ii) AB 811 allows the levy of contractual assessments only with the free and willing consent of the owner of each lot or parcel on which an assessment is levied at the time the assessment is levied.

An important question concerns whether voluntary contractual assessments imposed under AB 811 are invalid under Article XIII D for failing to comply with its procedures. This white paper concludes that contractual assessments levied under a PACE program are not invalid under Article XIII D because they are consistent with the underlying purpose of Article XIII D, they are not subject to Article XIII D, and, even if the contractual assessments were subject to Article XIII D, property owners may waive the procedural requirements of Article XIII D.

a. PACE Programs Are Consistent With the Purpose of Proposition 218

With respect to the underlying purpose of Article XIII D, Section 2 of Proposition 218 states that the initiative "protects taxpayers by limiting the methods by which local governments exact revenue from taxpayers *without their consent*." Public entities in California cannot levy assessments in connection with authorized PACE programs unless and until the property owner willingly and voluntarily *consents* to a levy that would not otherwise apply as a normal incident of property ownership. Cal. Sts. & High. Code § 5898.12(g). Therefore, PACE programs in California do not appear to run afoul of the purpose of Proposition 218. *See* Cal. Const. art. XIII D, § 2.

It has been argued, however, that consent (even consent resulting from a voluntary *request*) does not assure the constitutionality of a PACE assessment under Proposition 218. As explained below, under well-established California Supreme Court authority, PACE programs adopted pursuant to California's enabling legislation are not subject to the requirements of Article XIII D of the California Constitution.

[24] Furthermore, the notice of proposed assessment "shall contain a ballot . . . whereby the owner may indicate . . . his or her support or opposition to the proposed assessment, . . . [and] [t]he agency shall conduct a public hearing . . . [and] shall not impose an assessment if . . . ballots submitted in opposition to the assessment exceed the ballots submitted in favor . . . weighted according to the proportional financial obligation of the affected property." Cal. Const. art. XIII D, § 4.

b. Under *Richmond*, Requirements of Article XIII D Apply Only When Assessments Will Be Imposed on Identifiable Parcels

In *Richmond v. Shasta Community Services District* (2004) 32 Cal.4th 409, the California Supreme Court considered whether a water capacity charge imposed by a local water district only on applicants for new water service connections constituted an "assessment" under Article XIII D. *Id*. at 418. Article XIII D defines "assessment" generally to mean "any levy or charge upon real property by an agency for a special benefit conferred upon the real property." Cal. Const. art. XIII D, § 2(b). The court reasoned, however, that "[t]o determine what constitutes an assessment under article XIII D, it is necessary to consider not only article XIII D's definition of an assessment, but also the requirements and procedures that article XIII D imposes on assessments." *Richmond*, 32 Cal.4th at 418.

The court explained that, as a practical matter, a public entity cannot comply with the requirements and procedures that Article XIII D imposes on assessments unless the public entity applies the assessment to identifiable parcels from the outset. *Id.* at 418-19. The water capacity charge at issue in *Richmond* did not apply to predetermined, identifiable parcels because it was imposed only on individuals who requested the new water service at the time of their request. Under such circumstances, the public entity was not proposing the levy and thus could not give prior notice in the manner required by Article XIII D. In recognition of the fact that it would be impossible to comply with Article XIII D under such circumstances, the court concluded "that an assessment within the meaning of article XIII D must . . . be imposed on identifiable parcels of real property." *Id.* at 419.

The *Richmond* court also held that a charge on property that is "contingent on some voluntary action by the property owner is not an assessment within the meaning of Article XIII D." *Id*. at 424. The taxpayer's voluntary action can satisfy the purpose of Article XIII D: to obtain a taxpayer's consent before imposition of a fee or assessment. *Id.* at 420 ("[c]ustomers who apply for new connections give consent by the act of applying"). Additionally, the court considered Article XIII D's requirements for "fees or charges for property related services" and limited Proposition 218's protections to situations where local authorities seek to burden taxpayers with charges automatically imposed "'as an incident of property ownership' . . . ." *Id.* at 427 (citation omitted); *id.* at 426-27 (specifically holding that a fee for making a new water connection was not an incident of property ownership because such fees "result from the owner's voluntary decision to apply for the connection").

The contractual assessments levied in connection with California PACE programs are not charges on identifiable parcels of real property. Pursuant to the enabling statute, the legislative body of any public agency may "designate an area within the public agency . . . within which authorized public agency officials and property owners may enter into voluntary contractual assessments." Cal. Sts. & High. Code § 5898.20(a)(2). Like the water district imposing a capacity charge on new connections in *Richmond*, a

California local government implementing a PACE program cannot know in advance specifically which parcels will be covered by these arrangements.

PACE contractual assessments are contingent on voluntary consent by the property owner, and such consent occurs *after* the local government's adoption of the contractual assessment program. A local government could estimate the number of energy projects that might be financed through a PACE program, *cf. Richmond*, 32 Cal.4th at 419, but it would be unable to apply the procedures required by Article XIII D, such as collecting ballots to provide the opportunity to protest based on proportional financial obligation, to a speculative list of participants. In short, a California local government implementing a PACE program cannot comply with the procedural requirements of Article XIII D, and thus PACE contractual assessments cannot constitute "assessments" within the meaning of Article XIII D, as interpreted by the California Supreme Court.

In 2009, the California Legislature approved legislation in which it expressly declared that voluntary contractual assessments imposed under the contractual assessment provisions of The Improvement Act of 1911 (*i.e.* AB 811 programs) are not "assessments" for the purpose of Articles XIII C and XIII D of the California Constitution. The bill, AB 474, added the following provision to the California Streets and Highway Code:

> Since contractual assessments on real property under this chapter are voluntary and imposed pursuant to an agreement with an assessed property owner, the Legislature finds and declares that voluntary contractual assessments under this chapter are not assessments for the purposes of Articles XIII C and XIII D of the California Constitution and therefore the provisions of Articles XIII C and XIII D . . . are not applicable to voluntary contractual assessments levied pursuant to this chapter.

Cal. Sts. & High. Code § 5898.31.

This legislation was signed by the Governor years after issuance of the *Richmond* decision and took effect on January 1, 2010. Under *Richmond*, PACE contractual assessments are not subject to the requirements of Articles XIII C and XIII D because they are not charges on identifiable parcels of real property. AB 474 confirms that PACE contractual assessments are not subject to the requirements of Articles XIII C and XIII D.

c. Cases Applying Article XIII D to Rate-Based Water Fees Do Not Alter the *Richmond* Holding

Two decisions issued after the California Supreme Court's *Richmond* decision address whether consumption-based user fees are subject to the requirements of Articles XIII C and XIII D of the California Constitution: *Bighorn-Desert View Water Agency v. Verjil* (2006) 39 Cal.4th 205, and *Pajaro Valley Water Mgmt. Agency v. Amrhein* (2007) 150 Cal.App.4th 1364. In both instances, the courts rejected arguments that consumption-based user fees are beyond the reach of Articles XIII C and XIII D simply

because such fees are "voluntarily" incurred based on consumer behavior. *See, e.g.*, *Bighorn*, 39 Cal.4th at 217.

Opponents of PACE programs assert that *Bighorn* and *Pajaro Valley* have some significance in the analysis of whether Article XIII D applies to assessments levied as a result of PACE programs. But neither decision altered the applicable holding of *Richmond* that the requirements of Articles XIII C and XIII D apply only when assessments are imposed on identifiable parcels. Moreover, neither case altered the additional holding that Article XIII D does not apply to fees "imposed as an incident of the voluntary act of the property owner." *Richmond*, 32 Cal.4th at 426.

Both *Bighorn* and *Pajaro Valley* are inapplicable because they involved *fees* for government services; neither case involved an *assessment*.[25] In *Richmond*, the California Supreme Court implicitly distinguished such fees or charges from assessments when it analyzed the separate components of a "connection fee" as either an assessment or a fee. With regard to the capacity charge component, the court concluded that Article XIII D's restrictions on assessments did not apply because the charge, which was "similar to a contingent assessment" as defined in other contexts, was not an assessment within the overall meaning of Article XIII D. 32 Cal.4th at 424. The court did not hold, however, that the capacity charge was not a "levy or charge upon real property by an agency for a special benefit conferred upon the real property" (Article XIII D's definition of "assessment") or go on to analyze whether, if not an assessment for purposes of imposing Article XIII D's requirements, the charge was a "'[f]ee' or 'charge' "meaning any levy other than . . . an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership." Cal. Const. art. XIII D, § 2(e). *But see Richmond*, 32 Cal.4th at 426 (analyzing whether the "connection fee", which included the capacity charge and a fire suppression charge "imposed for general governmental services", was a fee for purposes of Article XIII D). Thus, as in *Richmond*, an analysis of whether PACE contractual assessments are subject to Article XIII D should end once it has been determined that they are for a special benefit to property, because imposing the requirements of Article XIII D would be impracticable.

Even if PACE contractual assessments fall within the definition of "fee" or "charge" in Article XIII D, *Richmond* controls and PACE obligations are not charges for purposes of Article XIII D. *See also* Cal. Const. art. XIII D, § 2(e) ("'Fee' or 'charge' means any levy other than an . . . assessment, imposed by an agency upon a parcel . . . as an incident of property ownership, including a user fee or charge for a property related service."). To fall within the scope of Article XIII D, a fee or charge must be imposed "as an incident of property ownership." *Richmond*, 32 Cal.4th at 425-26; *Apartment Ass'n of L.A. County, Inc. v. City of L.A.* (2001) 24 Cal. 4th 830, 842 ("The language of

[25] *Silicon Valley Taxpayers Ass'n v. Santa Clara County Open Space Auth.* (2008) 44 Cal.4th 431, another case addressing voluntariness, involved assessments but is not relevant to this analysis. In that case, the California Supreme Court held that voter consent alone could not justify an assessment by an open space authority that did not confer special benefits on the assessed properties and failed to make assessments proportional based on the benefit received, as required by Proposition 218. 44 Cal.4th at 456-57. The authority had diligently fulfilled the procedural requirements of Article XIII D for the imposition of a special assessment, but the assessment nevertheless was deemed to be invalid. *Id.* at 439-440, 455-56.

article XIII D, sections 2, subdivision (e), and 3, shows that it applies to levies imposed on a person or on property strictly as an incident of property ownership."). The California Supreme Court reasoned that a fee or charge is imposed "as an incident of property ownership" when its application "requires nothing other than normal ownership and use of property." 32 Cal.4th at 427. Fees "imposed as an incident of the voluntary act of the property owner in applying for [the program]" do not meet this requirement. *Id*. at 426.

The fees at issue in *Bighorn* and *Pajaro Valley* consisted of payments for ongoing, vital utility services that realistically could not be provided by other means.[26] In contrast, PACE assessments require a voluntary initial decision on the part of the property owner to enroll in a non-essential program. The contractual assessments that follow therefore are not subject to Article XIII D's requirements.

As a final matter, *Richmond* also observed that "[a]s with assessments, article XIII D requires local government agencies to indentify the parcels affected by a property-related fee or charge. Specifically, it requires the agency to identify '[t]he parcels upon which a fee or charge is proposed for imposition.'" 32 Cal.4th at 429 (quoting Cal. Const. art. XIII D, § 6(a)(1)). When a local agency cannot determine in advance which property owners will voluntarily elect to participate in a fee program, it is impossible to comply with such requirements and, "[a]s with assessments, this impossibility of compliance strongly suggests that [fees for new, voluntary participants] are not subject to article XIII D's restrictions on property-related fees." *Id.* For this additional reason, even if PACE program assessments come within the definition of "fees and charges" under Cal. Const. art. XIII D, § 2(e) (which they do not), the procedural requirements of Article XIII D still do not apply. *See also Richmond*, 32 Cal.4th at 426-27 (suggesting that fees and charges must further be for a "property-related service"); Cal. Const. art. XIII D, § 6(b) (same).

In sum, neither *Bighorn* nor *Pajaro Valley* is applicable because those cases involved *fees* for government services, not assessments, and the fees were an incident of property ownership. PACE programs involve assessments, not fees. Moreover, neither decision altered the holding of *Richmond* that the requirements of Articles XIII C and D apply only when assessments are imposed on identifiable parcels. As discussed above, the PACE contractual assessments are not charges on *identifiable* parcels of real property and thus are not subject to the requirements of Articles XIII C and XIII D.

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[26] For example, in connection with its analysis of whether section 3 of Article XIII C empowered voters to use their initiative power to reduce local fees, the *Bighorn* court incidentally held that water delivery fees, which were based on "the voluntary decisions of each water customer as to how much water to use," were "for a property related service." 39 Cal.4th at 216-17. Consequently, the fees fell within the meaning of Article XIII D. *Id.* The *Pajaro Valley* court similarly held that a usage fee charged to groundwater well operators on the basis of presumptive use was incidental to property ownership and thus subject to the provisions of Article XIII D. 150 Cal.App.4th at 1369. Significantly, *Bighorn* relied on the distinction between ongoing delivery charges and charges assessed in response to the property owner's initial decision to participate in a program with attendant fees. 39 Cal.4th at 215. The former are subject to Article XIII D; the latter are not. *Richmond*, 32 Cal.4th at 427.

d. Property Owners May Waive the Protections of Proposition 218

Even if one were to conclude that the requirements of Article XIII D do apply to PACE contractual assessments (which they do not), property owners that voluntarily agree to pay contractual assessments may waive the protections of Article XIII D. As noted above, in the Statement of Drafters' Intent, the Howard Jarvis Taxpayers Association stated that the "unifying theme" of Proposition 218 is "voter and taxpayer control over local taxes." Consistent with the idea of public notice of assessments and taxpayer control over local taxes embodied in Article XIII D, AB 811 requires a public hearing following two publications of a notice of the public hearing at which all interested persons have an opportunity to be heard. AB 811 also allows the levy of contractual assessments only with the free and willing consent of the owner of each lot or parcel on which an assessment is levied at the time the assessment is levied.

Because the primary policy underlying Article XIII D – taxpayer control over assessments – is accomplished as a result of compliance with the requirement for the free and willing consent of participating property owners, compliance with the procedures established by Article XIII D for non-consensual assessment proceedings would not produce any greater notice or consent by property owners. Accordingly, property owners participating in AB 811 PACE Programs may waive the provisions of Article XIII D and the Proposition 218 Omnibus Implementation Act.

The right of property owners to waive constitutional protections established for their protection has been upheld by the California Supreme Court. In *Bickel v. City of Piedmont* (1997) 16 Cal.4th 1040, the court ruled that the advantage of a law intended for the benefit of a person may be waived unless expressly prohibited by law and unless the waiver would compromise the law's public purpose. *Id*. at 1048-50. There is no language in Proposition 218 prohibiting the waiver of its protections, and the provisions of Article XIII D are intended to benefit individual voters and taxpayers. Moreover, voluntary contractual assessments do not compromise the public purpose of Article XIII D. Therefore, even if PACE contractual assessments are subject to the provisions of Article XIII D (which they are not), in voluntarily consenting to a contractual assessment, property owners may validly waive these provisions.

III. CONCLUSION

PACE programs rely on the use of a time-tested method of empowering local governments to finance improvements on private lands to achieve public purposes and to levy taxes or assessments against the benefitted property. The legislative decision to give PACE taxes or assessments senior lien status is likewise supported by ample precedent addressing the constitutionality of government action that affects pre-existing private contracts.

The California PACE program framework established in California Streets and Highway Code section 5898.12, *et seq*., and the voluntary contractual assessments that it authorizes, are fully compliant with the Contracts Clauses of the federal and California Constitutions. Furthermore, PACE contractual assessments are valid under Article XIII D of the California Constitution. In sum, the concerns raised about the constitutionality of PACE programs have no basis in current federal or California law.

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