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Why Hotels Are Turning to C-PACE Financing to Drive Sustainable Development

By Mary FitzSimons McQuinn and Sean Kiernan*

In this article, the authors discuss the basics and benefits of commercial property assessed clean energy (C-PACE) financing, as well as important considerations for stakeholders in hotel deals.

Over the past few years, environmental, social, and governance (ESG) principles have played a more prominent role than ever in the way real estate investors, property owners, and lenders invest in and develop commercial real estate. In particular, the hotel industry has taken meaningful strides to improve energy efficiency, pursue sustainability missions in branding, and reduce utility bills.

Commercial property assessed clean energy (C-PACE) financing has emerged in recent years as an innovative tool to finance energy efficient projects. First developed in California in the late 2000s, C-PACE financing is now available under programs adopted by legislation in 38 states. According to PACENation, the aggregate monetary value of originated C-PACE loans has increased nearly fivefold since 2018. This is due in large part to hotel owners seeking to bridge gaps in capital sources with respect to property improvement plans (PIPs) and other projects driven by ESG principles, as well as through the funding of new construction.

But what are C-PACE loans? What unique benefits do they offer, and what should hotel owners and operators consider if a C-PACE loan is obtained for a hotel they own or operate?

WHAT ARE C-PACE LOANS?

C-PACE loans are state-policy-enabled financing tools that allow owners of real property to borrow money to fund eligible projects with sustainable design and construction. Projects range from solar panel installations and hurricane preparedness to other less-obvious energy efficient improvement projects, such as updates to elevators, escalators, and heating and cooling systems. C-PACE loans can be obtained for new developments or renovations. In many jurisdictions, they may also be obtained and applied retroactively for eligible projects completed within the past two to three years. C-PACE proceeds applied retroactively can be used for working capital, paydown or payoff of existing loans, payment for PIPs, or other improvements to the property.

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C-PACE loans are provided through private third-party lenders. But unlike traditional financing, they are administered through local municipalities or development authorities as part of such authorities' assessment programs and repaid through supplemental tax assessments to regular property taxes. While program models may vary among jurisdictions, such payments generally take the form of a voluntary tax assessment on real property. Similar to tax liens, if a property becomes delinquent on C-PACE assessment payments, a lienholder may eventually enforce the lien through a tax sale or tax foreclosure and thereby acquire the real property.

BENEFITS OF C-PACE LOANS

C-PACE loans offer unique benefits to property owners, including the following:

- Lower rates than traditional financing;
- A capitalized interest component, allowing the borrower to delay monthly payments for several years;
- Repayment over 15 to 30 years through semiannual assessments;
- Retroactive acquisition and application for recently completed projects;
- Generally no requirement for the detailed covenants or representations required in traditional property financing;
- Generally not subject to acceleration upon default;
- No personal recourse or guaranty requirement; and
- Fully assumable by a buyer of the real property without a formal assumption process.

In the current financing market environment, and with the benefits they offer, C-PACE financings are primed to continue to increase in frequency. What should hotel owners and operators keep in mind if a hotel owner is considering C-PACE financing for its hotel?

CONSIDERATIONS FOR HOTEL OWNERS AND OPERATORS

A hotel owner should anticipate seeking consent to enter C-PACE financing from its existing mortgage lender. C-PACE assessments are prioritized over mortgage and mezzanine loans (similar to tax and assessment liens) and thus often require consent from an existing mortgage lender. An increasing number of mortgage lenders have consented to C-PACE financings in recent years, but some mortgage lenders may remain reluctant, concerned about the potential to be "wiped out" by a tax sale or tax foreclosure. Borrowers seeking to address mortgage lender concerns may agree to establish a reserve (similar to typical reserves for real property taxes and other impositions) to ensure funds will be available to pay C-PACE assessments as and when they become due.

Certain hotel operators, particularly those party to long-term management agreements that provide for robust nondisturbance protections from lenders in the event of a foreclosure, may also find comfort in a senior lender establishing C-PACE assessment reserves to avoid tax foreclosure, because obtaining a subordination and nondisturbance agreement (SNDA) from a C-PACE lender is generally not possible. Typically, a municipal assessing authority controls the enforcement process for unpaid C-PACE assessments pursuant to state statute, which likely cannot be modified by private agreements such as SNDAs. However, C-PACE lenders maintain the position that there is little need for an SNDA (just as there is no SNDA requirement for property taxes), as C-PACE loans are not subject to acceleration.

Moreover, a tax lien foreclosure could take two to four years to process, depending on the jurisdiction, presenting less risk of a C-PACE foreclosure occurring without intervention by the hotel owner or its mortgage lender. If a mortgage loan is included in the capital stack, a hotel operator might want to consider negotiating with a mortgage lender in SNDA discussions to mitigate the risk of a C-PACE foreclosure – for example, through establishing reserves and payment of C-PACE assessments directly from hotel bank accounts in a manner consistent with payment of other taxes.

Hotel owners and operators should also consider the potential impacts of a C-PACE loan on the economics of their hotel management agreement (HMA). For example, if the HMA provides for an incentive fee to be paid to the operator and property taxes are deducted in the calculation of this fee (i.e., if the incentive fee is tied to profitability), parties should consider whether C-PACE assessments should be deducted as well. A hotel owner may take the position that C-PACE assessments should be treated similarly to any other ad valorem or real property taxes and be deducted for purposes of calculating profitability. Furthermore, a hotel owner would maintain that the energy efficient projects funded by such C-PACE loans ultimately reduce the overall operating expenses of the hotel. Conversely, an operator may reason that unlike mandated property taxes, C-PACE assessments are voluntarily imposed because of a hotel owner obtaining the C-PACE financing and therefore should not be deducted when calculating an incentive fee, just as debt service payments are not deducted.

Hotel owners and operators may also consider whether any of the C-PACE tax assessments could (and should) be passed through to hotel guests in the form of a "green fee" charged to guests on top of their hotel bills. If parties take this approach, the hotel operator should maintain that, in any event, such recouped amounts should not be deducted when determining its incentive fee.

CONCLUSION

C-PACE loans offer an attractive option for some property owners to access additional capital to design, develop, and renovate their real estate assets in accordance with certain ESG initiatives. To take full advantage of the benefits of this relatively new lending model, hotel owners should consider involving legal advisers early in the process to understand the specifics of C-PACE programming adopted in the state where its hotel is located, obtain mortgage lender consent, and address any concerns raised by its hotel operator. Likewise, legal counsel can advise hotel operators on the risk profile of the hotel becoming subject to C-PACE assessments and how such assessments affect hotel economics in the HMA.