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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In a report from the United Nations Environmental Program that addressed climate change, the authors point out that the built environment in both emerging and developed countries accounts for more than forty percent of the global energy usage while also emitting at least one third of the world’s greenhouse gasses. They further assert that the built environment offers an unsurpassed opportunity to supply cost effective, lasting, and meaningful reductions in greenhouse gas emissions. In response to such a call to action, many state and local governments turned to a variety of policies to ensure that the real estate developments within their jurisdiction furthered their green building objectives. However, the availability of mortgages to provide long-term financing for the cost of construction or acquisition of a green building will either support or undermine the policymakers overarching environmental objectives. As a result, many lenders will fail to recognize that a green building differs from a traditional one and will undercut these important environmental policies by denying the loan because the underwriters inadvertently misunderstood the unique risks and opportunities associated with these structures. Accordingly, this article seeks to address the unique issues associated with a mortgage for a green building and provide solutions that can mitigate the exposures presented to acceptable levels so the lending community can also demonstrate its support to furthering a more ecologically friendly built environment.

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INTRODUCTION

Across the country, policymakers at all levels of government are trying to address climate change issues that emanate from the continued release of greenhouse gases into the atmosphere. 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 while also emitting at least one third of the world’s greenhouse gases. From this type of study and others that encourage similar actions, many policymakers began to focus on the built environment as a key component to their strategies to address climate change within their jurisdiction.

In focusing on the built environment within the private sector, policymakers began implementing initiatives to deliver cost effective, lasting, and meaningful reductions in greenhouse gas emissions. Most of these initiatives offer something of value to the developer that meets specific criteria set forth within a given program. These initiatives can occur at the state or local level and may take the form of financial and nonfinancial incentives. In many situations, the incentive programs became highly successful in encouraging developers to build an environmentally friendly structure.

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3 See CHARLES K. KIBERT, SUSTAINABLE CONSTRUCTION: GREEN BUILDING DESIGN AND DELIVERY 47-49 (John Wiley & Sons 2d. ed. 2007). For example, the “Greening of the White House” efforts that began in 1993 showed dramatic energy cost savings of approximately $300,00 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. These achievements paved the way for new 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.
4 See generally Prum Aalberts & Del Percio, supra note 2 at 204-19.
5 Id.
6 Id.
7 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 (Fall 2009) [Hereinafter referred to as Prum 1] In New York, just seven projects exhausted the entire incentive pool; whereas the program passed by the Nevada Legislature was too generous and caused the state to revise and limit
While many policymakers found these types of initiatives as an effective tool to encourage the construction of environmentally friendly buildings, the underlying policy goals maybe undermined if the ultimate owner of the structure cannot get a mortgage to complete the purchase. In some situations, the ultimate owner of a building is the developer and needs to secure permanent financing prior to receiving approval for a construction loan, while at other times, the mortgage will fund the purchase of an existing structure. 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 in order to move forward with the structure’s acquisition.

Given the inevitability that lenders will continue to see increasing numbers of applications for permanent financing and the likelihood that they will not distinguish between traditional and environmentally friendly buildings, the question remains whether adjustments need to occur in the underwriting process and accompanying documents to properly manage and mitigate the risk exposure to acceptable business levels while at the same time providing meaningful support to the efforts of policymakers that address climate change within their jurisdiction in the built environment. This Article seeks to address these issues.

Part I of this Article examines the inherent risks that confront the lenders when extending permanent loans on any type of building regardless of its friendliness towards the environment. These risks may emanate out of the various title theories applied across the country, the environmental issues imposed by the federal government, the nongovernmental sources such as restrictive covenants and equitable servitudes, and those that occur due to the manner in which the borrower acquires the building. It also considers how a lender attempts to mitigate its risk through underwriting measures that carefully consider the suitability of the borrower and the property offered as collateral.

Part II turns to the unique characteristics, attributes, and risks posed by a green building to a lender of permanent financing. Given the complexity associated with providing financing for a green building, some of the risks occur uniformly across the various methods in which the borrower obtains the structure while other times the acquisition manner

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8 Paul V. Franke, A Primer on Construction, Permanent, and Bridge Lending in Financing the Affordable Housing Deal, 7 J. AFFORDABLE HOUS. & COMMUNITY DEV. L. 279, 284 (1998).
generates the concerns. These common risks often originate from a lack of specific knowledge relating to green buildings and translate into misguided estimates and prognostications in the financial models developed by the underwriters to assess risk premium for the loan, the ability of a borrower to adequately insure the collateralized property, and through the various green attributes incorporated into the structure. In situations where the completion of a development project triggers the permanent financing, government requirements along with third party certification issues may create the threat of a loss.

Finally, Part III responds to the unique risks posed toward the permanent lender from a green building by offering solutions that can mitigate risk exposure to acceptable levels. In making this proposal, the subparts divide into recommendations that affect the underwriting process and those that involve the permanent loan documents. The proposals for the underwriting process offers suggestions that assists the lender in capturing pertinent information at the time of the application followed by enhanced methods to better acquire, evaluate, analyze the financial models and pro-forma statements when making the loan decision. Similarly, the recommendations for specific provisions in the loan documents take aim at pre conditions based on the different acquisition methods as well as conditions subsequent that need to address property insurance requirements and strategies for addressing and dissuading noncompliance after funding occurs.

I. MORTGAGE RISKS

When a lender considers making a loan, many factors become relevant in order to ensure a timely repayment as well as to avoid the possibility of a loss. Some of these factors stem from the need to ensure priority over other creditors or from past events on the property that caused the introduction of hazardous substances that now require remediation as well as whether the loan supplies funding for a development project or an existing structure. In response, most lenders attempt to limit their exposure through an underwriting process that carefully considers the suitability of the borrower and the property offered as collateral. Accordingly, a lender’s exposure to potential situations that may cause a loss along with the underwriting process that attempts to screen out applicants that pose such risks from a financial standpoint require consideration first.

A. Loss Exposures/Encumbrances

Across the country, the establishment and maintenance of a system that preserves an official record of land ownership falls upon each state government and serves as important documentation for the courts when recognizing and enforcing rights and encumbrances on real property within its jurisdiction. 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.

However, the recording act of a given jurisdiction will likely yield different results when the same factual scenario for priority order on multiple encumbrances gets applied to the competing approaches. As such, the varied jurisdictional approaches provides a compelling incentive to record an encumbrance due to the emphasis placed upon them by the courts in determining priority positions based on the information contained in the registers even though the statutes do not directly harm a party that affirmatively or inadvertently fails to follow them. This means that a party with a claim against a given parcel of land will risk the diminishment of its rights should it fail to properly record the encumbrance in a timely manner. Thus, a lender that wishes to secure its loan using real property as collateral must understand a jurisdiction’s approach and recognize the potential for numerous encumbrances upon the land before entering into such a transaction.

1. Theories of Title

Varying with each jurisdiction and its adopted mortgage law, 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 along with an intermediate

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13 Id.
14 Ray E. Sweat, Race, Race-Notice and Notice Statutes: The American Recording System, 3 PROB. & PROP. 27 (1989). In considering the various state systems, approximately half of the jurisdictions follow a “notice” approach where a bonafide purchaser for value receives protection regardless of the recording of the encumbrance. (Id.) This makes the recording of an encumbrance irrelevant so long as value occurred for the exchange. (Id.) Nearly all of the remaining states use a “notice-race” system that includes a bonafide purchaser and recording requirement. (Id.) This means that the first to record and receive value for their 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.)
15 See CUNNINGHAM, ET. AL., supra note 13 at § 11.9
16 Id.
method.\(^{17}\) 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.\(^{18}\) Whereas in a Lien Theory jurisdiction, the lender retains a security interest in the real property and receives the right to possess it after a valid foreclosure occurs; so the owner of the land maintains the title.\(^{19}\) In addition, a few states attempted

\(^{17}\) Grant Nelson & Dale Whitman, Real Estate Finance Law § 1.5 (5th Ed. 2007).

\(^{18}\) Id. at § 4.1 Currently, a minority of states follow this approach; and include: Alabama (See e.g., Bailey Mortgage Co. v. Gobble-Fite Lumber, 565 So.2d 138 (Ala. 1990).), Arkansas (See e.g., Bank of Oak Grove v. Wilmot State Bank, 648 S.W.2d 802 (Ark. 1983).), Connecticut (See e.g., Conference Center Ltd. v. TRC The Research Corp. of New England, 455 A.2d 857 (Conn. 1983).), District of Columbia (See e.g., D.C. Code § 45-703), Maine (See e.g., Me. Rev. Stat. tit. 33, § 502), Massachusetts (See e.g., Cooperstein v. Bogas, 58 N.E.2d 131 (Mass.1944); Krikorian v. Grafton Co-op. Bank, 44 N.E.2d 665 (Mass.1942); Magline v. BancBoston Mortg. Corp., 557 N.E.2d 756 (Mass. Ct. App. 1990).), New Hampshire (See e.g., State v. Marion, 440 A.2d 448 (N.H.1982); Brown v. Cram, 1 N.H. 169 (1818).), Rhode Island (See e.g., Houle v. Guilbeault, 40 A.2d 438 (R.I.1944).), and Tennessee (See e.g., Bertha v. Smith, 110 S.W.2d 474 (Tenn.1937).).

to find middle ground through an Intermediate Theory that supplies the lender possession when a default occurs but leaves the title on the real property with the owner.\(^{20}\)

With these different methods in place, the lender 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 upon the real property at the time of the conveyance.\(^{21}\) This approach makes it difficult for a lender to lose its priority status in foreclosing on the property in the event 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.\(^{22}\) Consequently, a sloppy lender could unintentionally surrender it priority position and potentially suffer a loss should another encumbrance against the real property exist and gain superior rights.\(^{23}\)

For these reasons, many of the participants in the real estate community and those involved in lending money recognize these risks and require a proper recording of the appropriate documents without delay.\(^{24}\) Nonetheless, a lender may also face the prospect of losing its priority position in those jurisdictions that draw distinctions between obligatory and

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\(^{20}\) See NELSON & WHITMAN, supra note 18 § 4.3 The main states that follow this approach include Maryland (See e.g., Williams v. Safe Deposit & Trust Co., 167 Md. 499, 175 A. 331 (1934)), Mississippi (See e.g., Meyers v. American Oil Co., 5 So.2d 218 (Miss.1941)), New Jersey (See e.g., Guttenberg Sav. & Loan Ass'N v. Rivera, 428 A.2d 1289 (N.J.1981)), and Vermont (See e.g., Rassman v. American Fidelity Co., 460 A.2d 461 (Vt.1983)); while Georgia (See e.g., Ga. Code Ann. § 44-14-30; Turner Advertising Co. v. Garcia, 311 S.E.2d 466 (Ga.1984)), North Carolina (See e.g., Burhner v. United States, 440 U.S. 48, 52 n.3 (1979); Stevens v. Turlington, 119 S.E. 210 (N.C.1923)), and Ohio (See e.g., Levin v. Carney, 161 Ohio St. 513, 120 N.E.2d 92 (1954)) are arguably intermediate theory states.

\(^{21}\) See NELSON & WHITMAN, supra note 18 § 4.1

\(^{22}\) See Id. at §§ 4.2, 4.3

\(^{23}\) See 3 BRUNER & O’CONNOR, CONSTR. LAW § 8:146

\(^{24}\) See CUNNINGHAM, ET. AL., supra note 13 at § 11.9
optional advances.\textsuperscript{25} 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.\textsuperscript{26} 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.\textsuperscript{27}

Hence, a careless lender on a mortgage may have its 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

Since a building improves a given piece of real property by introducing foreign materials to the land, environmental concerns through the improper disposal of hazardous waste poses serious risks to a lender, which can cause an unexpected loss on the loan. This may occur in situations where the government places a lien on the property that subordinates a mortgage or deed of trust or subsequent litigation occurs and a court attaches liability to the lender as a responsible party. Accordingly, the prudent lender needs to assess the impact of these risks when using a parcel of real property as collateral for a loan it decides to fund.

a. Hazardous Waste

Responding to the increasing problems related to the improper disposal of hazardous and toxic waste, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA),\textsuperscript{28} the Superfund Amendments and Reauthorization Act of 1986 (SARA),\textsuperscript{29} and the Small Business Liability Relief and Brownfields Revitalization Acts in 2002 (Brownfields Act).\textsuperscript{30} Viewed in their totality,
this legislative response by Congress seeks to impose strict liability, jointly and severally on owners, past owners, and operators of facilities for the costs involved in a Superfund cleanup.\textsuperscript{31} The underlying motivations for this policy became predicated on a strategy to pinpoint those that gained from the production and disposal of the hazardous materials on a given parcel of property while requiring them to pay for any remediation costs they may have caused.\textsuperscript{32}

As a result, participants in a real property loan developed into targets for recovery when a U.S. Court of Appeals attached liability to a lender if it attempts to influence the borrower’s hazardous waste disposal.\textsuperscript{33} Adopting and building upon the same analysis, another circuit court of appeals expanded the liability by placing lenders that received title at a foreclosure sale in the identical position as any other purchaser.\textsuperscript{34}

Reacting to the courts’ decisions, Congress decided to establish a safe harbor for lenders when it created the “security interest exemption.”\textsuperscript{35} This exemption prevents the government from holding a lender that merely retains a mortgage or lien on a property as a security interest for the underlying promise to repay the loan as a responsible party for the environmental cleanup costs while also providing a mechanism in which a lender may lose its protections.\textsuperscript{36} 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 exemption may cease to exist.\textsuperscript{37}

Consequently, Congress’ first foray into hazardous waste that permitted the government to recoup its costs for cleaning up environmental pollution created a potential liability for lenders when using an underlying parcel of real estate as collateral; but after amending the law to eliminate the expansive court decisions, some type of actual ownership or participation in the real property in question by those claiming a “security interest exemption” must occur in order to gain an exposure. Thus, a lender faced

\textsuperscript{31}ROBERT J. AALBERTS, REAL ESTATE LAW 584 (8th Ed. Cengage 2009).
\textsuperscript{32}See CLAURETIE & SIRMANS, supra note 11 at 484.
\textsuperscript{33}U.S. v. Fleet Factors, 901 F. 2d 1550 (11th Cir. 1990).
\textsuperscript{36}See CLAURETIE & SIRMANS, supra note 11 at 485.
\textsuperscript{37}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, 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, or the innocent purchaser or landowner defense applies. (\textit{id.})
with a troubled loan from an existing borrower must conduct a more thorough analysis on its environmental risks in regards to 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.

b. Environmental Liens

Besides imposing strict liability upon prior and past owners as well as operators of facilities for the costs involved in a Superfund cleanup, the federal government possesses the ability to place a lien on real property where a party is responsible under § 107(a) of CERCLA using the SARA legislation.\textsuperscript{38} Under the Brownfields Act, the Environmental Protection Agency (EPA) received expanded powers to use the “windfall lien” provisions in those situations where a bona fide prospective purchaser takes title to property that received the benefit of public cleanup funds.\textsuperscript{39} The EPA calculates the lien amount by considering the difference in fair market value attributable to the remediation efforts and includes those 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.\textsuperscript{40}

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.\textsuperscript{41} In these jurisdictions, a state’s hazardous waste lien can subordinate other deeds, mortgages, and

\textsuperscript{38} 42 U.S.C. § 9607(l).

\textsuperscript{39} 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 assessment based on its condition at the time. (42 U.S.C. § 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. (“Guidance on Federal Superfund Liens,” Memorandum from Thomas L. Adams, Jr., Assistant Administrator, Office of Enforcement and Compliance Monitoring, U.S. EPA, September 22, 1987; “Supplemental Guidance on Federal Superfund Liens,” Memorandum from William A. White, Enforcement Counsel, Office of Enforcement/Superfund, and Bruce M. Diamond, Director, Office of Waste Programs Enforcement, July 29, 1993.)

\textsuperscript{40} 42 U.S.C. § 9607(r)(4).

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

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. 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.

While the full force of the statutes conveys 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; so it also developed a policy to address potential issues raised by interested parties. 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.

Consequently, a lender needs to 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 assessments must occur prior to funding the loan or it may unwittingly lose priority on its security interest to the government and other aspects need to occur on an ongoing basis in order to avoid later litigation. Therefore, environmental issues pose significant risks to a lender involved with a loan that uses real property as collateral and requires a plan for minimization.


43 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.)


45 See Interim Windfall Lien Policy, supra note 97; Windfall Lien Admin. Procedures, supra note 45.

46 See Interim Windfall Lien Policy, supra note 97; Windfall Lien Admin. Procedures, supra note 45.

47 See Interim Windfall Lien Policy, supra note 97; Windfall Lien Admin. Procedures, supra note 45.
3. Nongovernmental Issues

Outside of the traditional sources of loss, a lender may face potential issues from nongovernmental parties through restrictive covenants placed on the land by prior owners and those that emanate out of contractual relationships such as a lease. The strength of these private regulations upon the attached structure may influence the value or legal status of the mortgaged property and pose risk to any lending activity that uses real property as collateral.

a. Land Use Restrictions

Following common law principles, a property owner may exercise different legal approaches to privately compel and regulate land use. The applicable traditional methods for commercial structures include real covenants and equitable servitudes that run with the land along with the more modern approach that creates Architectural Review Boards (ARB), which must interpret a set of Covenants, Conditions & Regulations (CC&Rs) that attach to the deeds of trust.

48 See Britell, supra note 10 at § 8.01
49 Id.
50 See Cunningham, ET. AL., supra note 13.
51 Id. Of course, other methods exist such as Defeasible Fees and Negative Easements also exist. Defeasible Fees are present estates that maintain the capacity to last in perpetuity like a fee simple absolute; but they may terminate should a specified, uncertain event occur as provided in the instrument that created it like in a deed. (See Id. at § 2.4) A defeasible fee may come in three different varieties: fee simple determinable, fee simple subject to a condition subsequent, and a fee simple subject to an executory limitation. (See Id.) Generally, none of the defeasible fees occur in a commercial land use context. Both the fee simple determinable and the fee subject to a condition subsequent see applications in “charitable, educational, or other eleemosynary institutions.” (See Id.)

A Negative Easement also places a burden on one set of property owners by dictating how they can or cannot use their land in relation to the benefit enjoyed by the titleholders of an appurtenant parcel. (See Id. at § 8.1.) This means that the owner of a negative easement may inhibit the burdened titleholder from implementing certain uses on his own property and is commonly called an “easement of light, air, and view.”

In an environmental context, a number of jurisdictions are using these types of easements to address solar collection and conservation. For example, a New Mexico statute specifically provides:

A solar right may be claimed by an owner of real property upon which a solar collector has been placed. Once vested, the right shall be enforceable against any person who constructs or plans to construct any structure, in violation of the term of the Solar Rights Act or the Solar Recordation Act. A Solar right shall be considered an easement appurtenant, and suit to enforce a solar right may be brought at law or equity. (N.M.S.A § 47-3-8 (2000).)
Providing one of the alternatives for the private regulation of a commercial development, real covenants offer mutually enforceable promises that limit the use of land for specific purposes in a manner that requires every successive grantee to abide by it. The real covenant runs with the land, which means that the real property and the agreement terms must transfer together and will remain united when conveyed to a subsequent grantee.

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. 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. 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.

Likewise, a conservation easement may “limit uses and development of a property that would be inconsistent with its agricultural, scenic, natural, or open character.” (See ROBERT J. AALBERTS, REAL ESTATE LAW 98 (9th ed. 2012).) This variety of an easement tends to apply to situations where the end goal is to conserve land in its present state rather than shaping how a titleholder structures and uses the property.

Moreover, these approaches may seem like a good opportunity to privately regulate a subsequent landowner; but the courts tend to treat Negative Easements in a different manner than Restrictive Covenants. (See CUNNINGHAM, ET. AL., supra note 13, at § 8.13.) Historically, the courts very narrowly construe and apply the language creating a negative easement whereas a Restrictive Covenants finds a more liberal interpretation. (Id.) Thus, a Negative Easement approach would require close monitoring and enforcement through a complex array of reciprocal burdens and benefits on property owners that would become too unworkable for complex land uses such as a green building.

In his treatise, Professor Cunningham expands in detail on each of the five requirements: (1) the form of the covenants; (2) whether the covenantee parties intended the covenant to run; (3) whether the covenant touches and concerns; (4) whether there is privity between one or both of the covenantee parties and the remote parties or parties sought to be benefited or burdened (“vertical privity”); and (5) whether there is privity between the original covenantee parties (called “horizontal privity”). (See CHARLES CLARK, REAL COVENANT AND OTHER INTERESTS WHICH “RUN WITH THE LAND” (1947).)

In his treatise, Professor Cunningham expands in detail on each of the five requirements. (See CUNNINGHAM, ET. AL., supra note 13, at §§ 8.13-18) However, the issues surrounding the validity of a real covenant is better left to another discussion; since the scope of this article is to only demonstrate potential sources of loss for a lender.
Using a parallel approach to achieve comparable outcomes, equitable servitudes call upon historically equitable principles developed outside of the common law courts in England to create benefits and burdens that run with the land.\textsuperscript{57} As such, an equitable servitude is a nonpossessory interest in real property that limits the use of the land for specific purposes.\textsuperscript{58} The promise that places it upon the land usually benefits and burdens the original parties to the agreement and their successors so long as the subsequent owners receive notification of the original arrangement.\textsuperscript{59}

As this approach has evolved to become the primary choice for developers that subdivide larger parcels of land, the relaxed requirements of the equitable theories has 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.\textsuperscript{60} 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.\textsuperscript{61}

\textsuperscript{57} Id. at §8.22  The theoretical distinction between a real covenant and an equitable servitude has to do with the placement of the burden. (Id.) Under a real covenant, the burden is placed upon the estate that holds the land, which carries forward with each conveyance. (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 any earlier infringements. (Id. at §8.21)

\textsuperscript{58} Id.

\textsuperscript{59} Id. In order for an equitable servitude to run with the land, Professor Cunningham explains that there are six requirements:

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

\textsuperscript{60} Susan F. French, Toward a Modern Law of Servitudes: Reweaving the Ancient Strands, 55 S. Cal. L. Rev. 1261, 1279 (1982).

\textsuperscript{61} See Cunningham, et. al., supra note 13, at § 8.32-3  In extending the equitable theories, some courts allowed “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. at § 8.32) This approach starts with the courts establishing a real covenant but then mixing and blending equitable theories pertaining to easements into its reasoning in order to create a cocktail of precedent for upholding the developer’s uniform covenants. (Id.)
Finally, the use of ARBs offers another method for a master planner or developer to privately regulate a parcel. In these situations, 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 when conveying the land. The developer drafts the CC&Rs, which are mutually binding and enforceable agreements against all owners within the CID. However, the enforcement, maintenance, and interpretations of the CC&Rs gets delegated to the CID’s association or its designee like an ARB.

Pursuant to the applicable CC&Rs, the CID’s association or ARB then possess 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. Because the CC&Rs run with the land along with burdening and benefiting current and

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. (Id.)

Finally, Professor Cunningham calls a series of decisions that uphold the running of covenants upon the land without relying upon any legal theory to uphold them the “Second-Generation” Cases. (Id. at § 8.33) The first group of these types of cases makes a conclusory statement regarding the existence of a common plan of development and 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.) The last group removes the notice requirement of the restrictions by treating the covenants like easements. (Id.)

62 See e.g., CAL. CIV. CODE § 6580 In some jurisdictions like California, the government imposes additional requirements that need to be recorded such as 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 and must pay fees for the upkeep of the common areas, as well as abide by the rule for maintaining the desired environment declared in the CC&Rs that are attached to the deeds.

63 See e.g., CAL. CIV. CODE § 6614
64 See e.g., CAL. CIV. CODE § 6858
future property owners, the CID’s association maintains the ability to legally enforce its decisions through the courts.\textsuperscript{66}

Thus, a lender needs to conduct its 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 may occur on a general level but may also include some very specific standards for the type and level of an environmentally friendly building as well as on the occupant’s operational side, which can negatively affect a property’s value or the ability of a mortgagor to keep its business open and make payments.\textsuperscript{67} Accordingly, a lender needs to complete its due diligence with regard to land use restrictions or risk an unforeseen loss.

\textit{b. Leasehold Estates}

In another instance where private regulations may create an unexpected risk to a lender, a mortgage upon a leasehold estate may pose an opportunity for an unforeseen loss as well.\textsuperscript{68} In these situations, the lender will fund a loan for a building where the mortgagor does not own the land upon which the structure is located but uses it as collateral for the loan.\textsuperscript{69}

\textsuperscript{66} See e.g., CAL. CIV. CODE §§ 6614, 6858
\textsuperscript{67} See Slone, \textit{supra} note 66 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 in order 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 in order to qualify for occupancy and to remain there. (Id.)

\textsuperscript{68} While this type of situation might seem unlikely, it actually occurs more frequently than expected. Many participants in franchising ventures often fit into this situation because they lack the financial capacity to construct and own their facility outright as well as a typical requirement from the franchisor that each location under its master agreement portray a common look and feel and feel in addition to meeting specific building requirements. (JEFFRY A. TIMMONS & STEPHEN SPINELLI, NEW VENTURE CREATION: ENTREPRENEURSHIP FOR THE 21\textsuperscript{ST} CENTURY, 227 (6\textsuperscript{th} Ed. McGraw-Hill/Irwin 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 185-6. (John Wiley & Sons 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 185-6.)

\textsuperscript{69} A leasehold estate allows for a tenant’s possession of land or premises. (See CUNNINGHAM, ET. AL., \textit{supra} note 13, at § 6.11) This may occur as a tenancy for years, as periodic tenancy, as a tenancy at will, or as a tenancy at sufferance. (See Id. at §§ 6.13-20) 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. at § 6.14) This means that the lessee holds an interest in real property and the owner retains only a
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 based upon how the landlord and tenant classify the improvements upon the land.

When considering the risk posed by a landlord terminating a lease agreement with a tenant, common law begins with the premise that stops 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. This means that the leasehold estate may only terminate when one of the parties specifically violates one of the covenants within the lease that provides such a power. Furthermore, the lease will not terminate until the party with the power elects to exercise it in some unequivocal manner.

Of course, the doctrines of waiver and estoppel may impose a limitation on a party’s ability to terminate a lease. Under the doctrine of waiver, one party will voluntarily relinquish the legal right to terminate the lease either explicitly or impliedly. This waiver only shields against past breaches and subsequent reoccurrences of the same infringement. Nonetheless, some courts hold that a party may trigger this limitation when choosing not to pursue the termination remedy as well.

When applying estoppel, a nonbreaching 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. The courts will consider the nonbreaching party to have sanctioned the violation by virtue of its actions.

reversionary interest in the land, which vests only when the lease ends. (See Id. at § 6.12) 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. at § 6.2) 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. (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. (Bankruptcy, 11 U.S.C. § 365(e)) (2006.)

See CUNNINGHAM, ET AL., supra note 13, at § 6.78 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.
By extension of these limitations, some may also argue that a parallel defense may spring up from a contractual discharge like “frustration of purpose,” which provides for excusable nonperformance.\(^{79}\) In considering this option as a means for termination, Professor Cunningham explains that “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.”\(^{80}\)

In turning to the issues posed by an underlying mortgage on the land, several different scenarios will play out in conjunction with many of the principles discussed earlier that pertain to the recording statutes.\(^{81}\) The main exposure under these circumstances emanates from the possibility of another mortgage occurring with the owner of the land. 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, then the lender may be precluded from proceeding unless a subordination occurs.\(^{82}\) 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.\(^{83}\) 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.\(^{84}\)

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 a new lease is begun by the leasehold mortgagee or a purchaser at foreclosure.\(^{85}\) 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.\(^{86}\) Nevertheless, a fee mortgage recorded after the execution of the ground lease but occurs before putting into place an amendment or new lease could result in a subordination situation.\(^{87}\)

Finally, the manner in which the landlord and tenant classify the

\(^{79}\) See CUNNINGHAM, ET. AL., supra note 13, at § 6.87
\(^{80}\) Id.
\(^{81}\) See supra text accompanying notes 13-28.
\(^{82}\) MICHAEL T. MADISON ET AL, LEASEHOLD VS. FEE MORTGAGE FINANCING, 1 LAW OF REAL ESTATE FINANCING §7:12 (July 2015), available at WestlawNext
\(^{83}\) See generally Id. at §3.12.
\(^{84}\) See generally Id. at §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.
\(^{85}\) Id. at §7:12
\(^{86}\) See CUNNINGHAM, ET. AL., supra note 13, at § 3.3
\(^{87}\) See MADISON ET AL, supra note 83, at § 7.12
improvements upon the land may create a loss situation for the lender. Historically, the courts recognize that the lender of a leasehold mortgage keeps a security interest for the loan in the possessory estate along with the improvements made upon the real property. The courts follow this approach notwithstanding the manner in which the tenant acquired its rights including those situations like a new lease or from a sale and leaseback arrangement with the underlying real property. In spite of the longstanding precedent to recognize the security interest in the improvements under real property law, one outlying decision by an Arizona appellate court centered its opinion on Article 9 of the Uniform Commercial Code but was subsequently ordered depublished by the Arizona Supreme Court, which disqualified it for use as precedent.

Hence, the leasehold estate situation poses some very real and difficult loss scenarios for a lender. These scenarios reinforce the need for a lender to complete its due diligence and carefully craft a plan to handle the potential pitfalls for a loss in order to complete the mortgage. Sometimes a risk may not be present such as the occurrence of a Fee Mortgage after the existence of a Leasehold Mortgage; but other times, the decision by a court to apply the Uniform Commercial Code in lieu of the tried and true property law may come as a surprise. Consequently, a savvy lender must weigh all potential risks and determine whether the return adequately justifies participation.

Therefore, a loan that uses a building as collateral poses some very real loss exposures to a lender from a variety of sources. A lender must recognize that the potential for a loss may come from sources such as titling, the government, or from private regulation. Each presents its own particular risk while at the same time offering a solution for minimization. In most cases, the preferred solution may not solve all of the concerns for every participant. As such, a lender choosing to participate in a mortgage on a building must take precautions through various means in order to avoid or manage the wide range of risks.

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

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88 Id. at §7:1
89 Id.
a new development or for the purchase of an existing building. 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 need consideration as well.

a. A Development Project

Under the new development situation, 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. 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. 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 plans and specifications as well as compel the usage of a single set of documents for the transaction.

In essence, the tri-party agreement attempts to deliver in advance the types of documentation and other conditions the permanent financer will require when called to perform in order to avoid a second underwriting process when the building is completed. 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. As such, the permanent lender will need to address the risks inherent in a construction project when it negotiates the tri-party agreement.

To this end, the permanent lender will need to ensure that the completed building will comply with all of the local ordinances and zoning

91 See Britell, supra note 10 at § 8.02
93 See Livingston, supra note 93 at 800.
94 See Franke, supra note 9 at 284. 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 93 at 797.)
95 See Livingston, supra note 93 at 797.
96 See Franke, supra note 9 at 284-5.
requirements, receive a permanent Certificate of Occupancy from the appropriate authorities, and qualify for property tax abatements as well as any other governmental or private financial benefits considered applicable in the original underwriting process prior to paying off the construction loan. 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, 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.

In response to any of these shortcomings, a lender may receive the right to self-help through the executed tri-party agreement to remedy any deficiencies in the collateralized property. Nevertheless, a lender may avoid this type of approach unless it faces no other way to resolve the deficiency because this option may expose a lender to additional liabilities from a sympathetic court who finds that its actions constituted participation in the construction project. Hence, a lender choosing to supply permanent financing for a building under construction must take a proactive approach to limits its potential risk of loss before accepting the terms of the

97 See Britell, supra note 10 at § 8.02
98 Id.
99 Id. The inability to claim tax credits under Maryland’s green building incentive program became the basis of Shaw Developers v. Southern 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 Prum & Del Percio 1, infra note 135 at 244.) 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 posses a risk to the lender. (Id. at 261.)
100 Id.
tri-party agreement that require it to fund a shaky mortgage that may never get repaid.

b. An Existing Building

While not as risky as providing permanent financing to a development project, the funding of a mortgage on an existing building also presents loss exposure issues. In these situations, many of the requirements that emanate out of the construction process like complying with local ordinances and zoning requirements and the issuance of a Certificate of Occupancy by the appropriate authorities should already be satisfied. Moreover, the issues relating to property tax abatements or other financial incentives should be resolved and pose minimal risk.

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

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 others benefits like tax abatements or other financial incentives. Therefore, a lender faces a minefield of risk exposures that can cause it to lose priority as an encumbrance to other lienholders, to facing governmental liability for environmental cleanup costs, to diminishment in value of the collateralized property through nongovernmental sources or through the underlying method in 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

\[102\] See Britell, supra note 10 at § 8.02

\[103\] Id.

\[104\] See infra Section III.B.1

\[105\] See Britell, supra note 10 at § 8.02

\[106\] Id.
these types of occurrences from becoming a reality.\textsuperscript{107} In approaching this essential role that advises the lender on a given mortgage’s risk, the main areas of emphasis by the underwriting process turn to the borrower and the proposed collateral property.\textsuperscript{108} If the proposed property and borrower meet the lender’s standards, then the loan documents can provide the necessary legal support to help deal with and overcome the many risks previously outlined while memorializing each party’s responsibilities.\textsuperscript{109}

1. Borrower

Distinctly different from the standard residential mortgage, most loans for commercial properties are nonrecourse or end up in a situation where the lender can only recover very little from the borrower other than the collateralized property.\textsuperscript{110} While this may seem like a risky proposition, 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.\textsuperscript{111} As such, a lender risks future business opportunities with the borrower if they decline to participate in a transaction and the project ultimately becomes a success.\textsuperscript{112}

Conversely, the lender must also weigh the prospects that some borrowers who maintain multiple business lines may divert funds or attention from an otherwise healthy collateral property to assist troubled endeavors.\textsuperscript{113} This could lead to a borrower filing for bankruptcy under Chapter 11 and a forced renegotiation of the lending terms.\textsuperscript{114} Hence, the unique circumstances surrounding a commercial real estate loan creates a business climate whereby the lender needs to give special consideration to the reputation and future business prospects of the borrower while balancing the risks for the given loan.\textsuperscript{115}

\textsuperscript{107} See GELTNER, ET. AL., supra note 12 at 442. Beyond a tool that attempts to minimize or eliminate defaults, underwriting also maintains the practical goal that attempts to ensure that the lender receives the proper reward for the amount of risk undertaken with the loan. (Id.)
\textsuperscript{108} Id. at 443.
\textsuperscript{109} See supra text accompanying notes 12-105.
\textsuperscript{110} See supra text accompanying notes 12-105.
\textsuperscript{111} Id.
\textsuperscript{112} Id.
\textsuperscript{113} Id.
\textsuperscript{114} Id.
\textsuperscript{115} Id.
2. Property

While the borrower and the client-lender relationship creates some level of influence in the underwriting decision, the main source that will persuade a lender to participate will come from its internal analysis on the property subject to the collateralized loan. This analysis conducted by the lender’s underwriters generally concentrates on the asset value and income flow of the subject property as well as several other metrics.

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. Because the lending community maintains models that link the LTV to default probabilities and can offer predictions on a borrower’s ability to repay the loan, this ratio becomes a crucial factor in determining whether to provide funding.

At first, the underwriters will use the LTV at the time the loan commences to consider the most stringent situation. However, many underwriters will also evaluate the LTV over the loan’s duration using projected net operating income on the property and direct capitalization.

When evaluating the income flow, the underwriters will turn to the debt service coverage ratio as an indicator. In making this 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 will usually need to meet or exceed 120 percent. 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 during the life of the loan.

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116 Id. at 443.
117 Id.
118 Id. at 444.
119 Id. When linking the LTV ratio to a model that corresponds it with default probability, a nonlinear relationship appears. (Id.) It shows a low probability of default and virtually constant in an extensive range of low values of the LTV, but the risk rises quickly at the higher ratios. (Id.)
120 Id. at 445.
121 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.)
122 Id.
123 Id.
124 Id. During times of rapid inflation or when major competition in the lending
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. 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. Most recently, underwriters began to look at the Loan Yield in order to determine a recoverable rate or return that shows the lender what it needs to see should a foreclosure become necessary and has to rely on the property’s Net Operating Income as part of its calculated value in a liquidation sale.

Accordingly, the lender’s underwriters will follow a process that employs a broad set 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. Thus, a lender must consider many factors when considering an application for a long-term loan on a building while guarding against the possibility that a loss may arise from a variety of different sources.

II. LENDER EXPOSURE TO RISKS INHERENT WITH A GREEN BUILDING

When the lender’s underwriters begin to evaluate the qualifications of an applicant in determining whether to provide a long-term loan for an environmentally friendly building, they also need to recognize that differences from a traditional structure will occur based upon the nature of the acquisition. In many cases, the same underwriting issues will arise in both a newly constructed building and an existing structure but differences can occur as well. These differences with a traditional structure 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. As such, this section identifies some of the unique types of risks a lender involved with a long-term loan on an environmentally friendly building must take into account during the underwriting process.

125 Id. at 445-447.

126 Id. Normally, a building’s BER falls below 100 percent; but depending on a particular market, the lower limit will customarily occur around 85 percent. (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 in need of improvement, the underwriters may emphasize this metric. (Id.)

127 Id. at 446.
A. All Types of Buildings/Projects

No matter the method of acquisition, some of the green building specific risks occur uniformly and require consideration in a broad sense by the lender. The underwriting process will need to address green building specific issues from a financial perspective when developing its ratios and models as well as ensuring that the borrower purchases the proper coverages of property insurance to protect against a loss at the collateralized structure. In addition, some of the features that comprise a green building may require additional investigation due to the high performance and cutting edge nature of the completed structure that may jeopardize a borrower’s ability to repay its obligation. Accordingly, this subsection will address the risks a lender needs to address and that occur across all methods of acquisition.

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 sufficient value to the collateralized property such that the lender has appropriate sources to recapture any loan balance in the event that the borrower suffers a major loss and cannot fulfill its obligations. Since the financial aspects weigh so heavily on whether to fund a loan, the pitfalls that can lead the underwriters analysis astray require consideration.

a. Underwriting Models

Because the underwriters place so much emphasis on the financial analysis in determining whether to recommend participation, the underlying assumptions and calculations for the models and ratios require special considerations in order to provide an accurate picture of the collateralized building and the borrower’s qualifications. As previously discussed and part of their financial analysis, the underwriters will need to obtain an appraisal for the building based on its current or expected value depending on the type of acquisition as well as develop a set of pro forma

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128 See supra text accompanying notes 115-126.
financial statements based on the borrower’s application.

In making many of the calculations such as the LTV, an underwriter needs to recognize that appraisers face many difficulties in setting a valuation on a green building. 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.” As a result, the financial ratios that rely on the appraisal will probably contain significant margins of error and by implication 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 model also needs to account for a myriad of other issues and assumptions unique to a green building’s price and associated revenue. For example, many studies evaluated the cause and effect relating to the premiums associated with certified green buildings. A later comprehensive evaluation of these studies found that the buildings that possessed green certifications attained noticeably higher rates for occupancy and leases as well as superior sales prices. Consequently, a loan applicant’s higher occupancy and lease rates may seem overly optimistic to a cautious underwriter when in reality the projections falls right on the mark or offers a slightly conservative point of

130 Grant W. Austin, Sustainability and Income-Producing Property Valuation: North American Status and Recommended Procedures, 4 JOURNAL OF SUSTAINABLE REAL ESTATE 78 (2012).
view.

Similarly, many of the financial incentives to build an environmentally friendly building pose their own set of pitfalls to the underwriter’s models because some jurisdictions do not provide them at all while others allow for direct benefits such as property tax abatements over a limited periods of time or permit for the credits to be transferred to third parties. In general, the direct financial incentives for green buildings should pose the least number of obstacles for an underwriter’s models; but the depth and variation of the different approaches taken by those jurisdictions offering such inducements may provide a materially significant variation that needs special attention.

On the other hand, an underwriter also needs to proceed cautiously with some of the green assertions made by borrowers for increased rents and possibly inflated prices. In some instances, a borrower may try to justify pricing premiums for a green building due to health and productivity savings of the buyer or tenant.

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 develop an accurate tool that assists in assessing the risk and exposure for the loan receiving consideration.

b. Property Insurance

When addressing the insurability of the green building and protecting against a loss due to the destruction of the potential collateral, the underwriter needs to begin with developing an understanding of the various jurisdictional requirements across the country. In some jurisdictions, the state and local governments adopted green construction standards, which incorporate the unique features of these high performance structures into the

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133 See Prum 1, supra note 8 at 188-98; Prum Aalberts & Del Percio. supra note 2 at 212. The type of incentive as well as the means for claiming it from the state and local government occurs in varying methods. See Prum 1, supra note 8 at 188-98; Prum Aalberts & Del Percio. supra note 2 at 208-13.) Many states provide tax credits to the developer of a green building. (See Prum 1, supra note 8 at 188-98; Prum Aalberts & Del Percio. supra note 2 at 208-13.) However, some jurisdictions like Nevada that do not have a state income offer sales and property tax abatements. (See Prum 1, supra note 8; Prum Aalberts & Del Percio. supra note 2 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. 330-090-110(48)-(49) (2015).)

building code.\textsuperscript{135} For example, the International Code Council unveiled the IgCC for adoption by governments looking to add a sustainability component to its existing building codes\textsuperscript{136} and the State of California developed and implemented CALGreen as part of its statutes.\textsuperscript{137}

In these situations, the current underwriting requirement to insure the building should not materially change. An underwriter still needs to make sure that the owner of the collateralized building chooses suitable coverage from a reputable carrier that also protects the lender’s interest. This extends to include a rider for ordinance or law coverage,\textsuperscript{138} since many cause-of-loss forms exclude costs associated with changes in building codes or regulations.\textsuperscript{139}

Furthermore, the building code will most likely receive environmentally friendly updates that will apply to all applicants. In turn, these building code updates will eventually become part of the current ordinances or regulations and will require that the typical commercial insurance policy adjust correspondingly to provide coverage.\textsuperscript{140} Accordingly, the lender will face no different risk than a traditional building in these jurisdictions and the underwriter will not need to adjust its current practices.

In other jurisdictions, the state and local governments do not incorporate any green construction standards into their building code because the programs are voluntary or induced through incentives.\textsuperscript{141} These jurisdictions normally set a standard for compliance and then offer some type of perceived benefit to the private developer or the project for furthering the established green building goals.\textsuperscript{142} Depending on a

\textsuperscript{135} See Darren A. Prum, The Next Green Issue: Considering Property Insurance For The Green Building, 7 VA. L. & BUS.REV. 421, 441-450 (2013) [Hereinafter referred to as Prum 4].


\textsuperscript{138} See Prum 4, supra note 136 at 455.

\textsuperscript{139} JAMES S. TRIESCHMANN, ET. AL., COMMERCIAL PROPERTY INSURANCE AND RISK MANAGEMENT 190(4th Ed. Am. Inst. for CPCU 1994).

\textsuperscript{140} See Prum 4, supra note 136 at 450.

\textsuperscript{141} Id. at 441-2.

\textsuperscript{142} See Prum Aalberts & Del Percio, supra note 2 at 209-19; Prum 1, supra note 8 at 177-99; A. Paige Reber, Taking the “LEED”: Determining the Appropriate Amount of
jurisdiction’s approach, most government programs require a third party organization’s certification in order to receive the proffered benefit; and in other localities, a developer only needs to intend to obtain the recognition but not necessarily complete their green building obligations to get the incentive.

As a result, an underwriter needs to pay special attention to any sustainable features or certifications attained by the building, the coverages associated 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. In addition, the different third party verification organizations routinely update and upgrade their programs to make their standards better reflect advances in building technology. 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 and now 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. Coupled with the previously explained difficulties in trying to assign an accurate value to a green building and its

143 See e.g. Prum Aalberts & Del Percio, supra note 2 at 209-19; Prum 1, supra note 8 at 177-99; Reber, supra note 143 at 585.
144 See e.g., Prum Aalberts & Del Percio, supra note 2 at 209-19; Prum 1, supra note 8 at 177-99; Reber, supra note 143 at 585.
145 See Prum Aalberts & Del Percio, supra note 2 at 194-199; Prum 4, supra note 136 at 445-7.
146 See Prum 4, supra note 136 at 445-7.
147 Id. at 425-30. Today’s commercial property insurance policies usually identify a method for valuing the building in order to determine the amount of loss should a claim occur. (See TRIESCHMANN, supra note 139 at 132.) 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 4, supra note 136 at 456.)
sustainability features, these meaningful differences create many uncertainties in coverage that need to be evaluated on a case by case basis.

To remedy the concerns of policyholders and to offer additional features, several insurers offer supplemental endorsements specifically targeted to provide a more complete coverage for a green building. While each of the supplemental endorsements is dependent on the underlying language contained in the property policy, 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 with an endorsement to cover changes in building codes or regulations will suffice.

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, the underwriters need to recognize that the financial models and requirements applied to the process for evaluating a traditional structure need modification in order to avoid false indicators of risk or situations of contentment when a hazard is actually present when making a recommendation on whether to fund a loan on a green building.

2. Green Attributes

In addition to the financial issues, many of the key features that make the building environmentally friendly may also offer a reason for potential concern due to the fact that a certification does not necessarily translate into a permanent structure that incorporated the best design and construction practices. The prevailing method for designing and constructing an environmentally friendly building originates out of its “holistic” approach.

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148 See supra text accompanying notes 128-129.
149 See Prum 4, supra note 136 at 456.
150 See e.g., INS. SERV. ORG., COM. PROP. CP 04 02 09 09, INCREASED COST OF LOSS AND RELATED EXPENSES FOR GREEN UPGRADES (2009); FIREMAN’S FUND INS. CO., PROPERTY-GARD GREEN COVERAGE ENDORSEMENT (2010); THE TRAVELERS CO. INC., GREEN BLDG. COVERAGE ENHANCEMENT ENDORSEMENT (2008); LEXINGTON INS. CO., UPGRADE TO GREEN – COMMERCIAL ENDORSEMENT (2008); LIBERTY MUTUAL GROUP OF COS., GREEN SELECT (2008).
151 See Prum 4, supra note 136 at 451-5.
152 Id. at 458.
During this process, the development and construction team pair common sense solutions such as optimal siting and using local resources with cutting edge technology to essentially produce a high performance building. 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 its obligation.

For instance, some of the requirements associated with a third party certification may pose significant risks for creating moisture and mold problems in a building. These may occur due to a variety of inducements or requirements in a program that seeks to advance ecologically responsible solutions such as a reduction or minimization in energy performance, diminishment of the heat island effect, reuse or cutback in construction waste, improving indoor air quality, or offering an innovative design or product.

A typical tradeoff occurs when considering how to optimize energy performance in a building, but it may also compromise moisture controls. This type of situation may inadvertently happen when a designer or builder decides to increase the thermal insulation within a wall system, which will change the dew point locations along with the places where condensation will occur around the structure. 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.

Similarly, some third party certification programs offer credits for installing a vegetated roof for a significant portion of the building. As expected, moisture and mold issues emanate out of the development of condensation under the roofing membrane and other types of water

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26 (2010) [Hereinafter referred to as Prum 2]

154 Id.

155 J. David Odom, et al., The Hidden Risks of Green Buildings: Avoiding Moisture & Mold Problems, NCARB MINIMONOGRAPH (2009). Many commercial property insurance policies now contain exclusions for moisture and mold problems because the risk of loss is so great. (See Prum 2, supra note 154 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. (Id. at 453.)

156 Id. at 4-5.

157 Id.

158 Id.

159 Id.

160 See e.g., U.S. GREEN BLDG. COUNCIL, LEED V4 FOR BUILDING DESIGN AND CONSTRUCTION 34-40 (July 1, 2015); GREEN BLDG. INITIATIVE, GREEN GLOBES FOR NEW CONSTRUCTION: TECHNICAL REFERENCE MANUAL 43-5, 46-8 (Feb. 19, 2014).
intrusion. However, a risk may also occur due to a poor design that could allow for mold spores to penetrate a building from an air intake for the heating, ventilation, and air conditioning system near a vegetated roof and are repeatedly delivered throughout the structure.

Furthermore, many of the third party certification programs promote the reduction of construction management waste through the reuse of materials. Often times, these types of programs will create situations where undetectable mold contaminated materials find their way into the new structure. As such, mold issues 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.

Finally, the implementation of new products or designs that have not demonstrated their durability and reliability over the years poses an increased risk. 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 these changes in building performance result in dramatic failures, especially in hot, humid climates.” Consequently, the incentives to implement new

161 Michael J. Bauer, Potential Legal Implications of “Green” Roofs, CONSTR. BR., Jan 2011.
162 Id.
163 See e.g., U.S. GREEN BLDG. COUNCIL, LEED V4 FOR BUILDING DESIGN AND CONSTRUCTION 95-6 (July 1, 2015); GREEN BLDG. INITIATIVE, GREEN GLOBES FOR NEW CONSTRUCTION: TECHNICAL REFERENCE MANUAL 138-41 (Feb. 19, 2014).
164 See J. David Odom, et al., supra note 156 at 4-5.
165 Id.
167 Id. 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 as well as their insurers for all of the problems they caused. (Scott Wyman, Courthouse mold fight has played out before in Florida, SUNSENTINEL, Apr. 1, 2009, available at: http://articles.sun-sentinel.com/2009-04-01/news/0904010171_1_courthouse-sick-building-mold (last visited Sept. 4, 2015.).) 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 (Spring 1996.).) The county ultimately recovered $7 million from the contractors and construction professionals. (Polk County v. Reliance Ins. Co., No. 94-7135 (Fla. 10th Cir. Ct. 1995.).)

Across the state, Martin County also constructed a courthouse and
products or designs in order 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.”  

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 like the moisture and mold problems discussed due to a variety of causes. Therefore, the underwriters must evaluate a building’s unique characteristics and give consideration to the likelihood that some issues may emanate out of the environmentally friendly features incorporated into the structure, which may provide a basis for the borrower to walk away from the collateralized property and leave the lender in a situation that requires more investment beyond the loan principle in order to terminate its involvement.

B. A Development Project

For the permanent lender, the development project poses several risks beyond those of a traditional structure due to the environmentally friendly features of the building. As previously discussed, the issues surrounding the satisfaction of 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.

In situations where the government adopted sustainability components into its existing building code, the risk remains the same as with a traditional development project. A lender is somewhat protected under this scenario because the appropriate governmental agency will not issue the Certificate of Occupancy or other documents that allow for the borrower to use the structure without satisfying the building code of the jurisdiction, which will most likely fail to trigger the permanent financing adjoining office complex for $11 million. (Robert E. Geisler, *The Fungusamongus: Sick Building Survival Guide*, 8 ST. THOMAS L. REV. 511 (Spring 1996).) 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*, THE GROWING HAZARD OF MOLD LITIGATION 1, 15 (July 17, 2003).) The county pursued an action in court against the contractor and its insurers and won a verdict of $14.2 million followed by an affirmation when appealed. (*See* Centex – Rooney Constr. Co. v. Martin County, 706 So.2d 20 (Fla. Ct. App. 1997).)


See supra text accompanying notes 93-100.
Nonetheless, Mr. Britell 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. This might include situations where a government agency adds unforeseen new requirements like a physical inspection when the applicable provision only makes third party certification the standard or the decision by those interpreting the code or ordinance to reevaluate their analysis and direct new measures for compliance.

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. Absent a provision in the take-out agreement to the contrary, the lender’s obligations may compel it 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.

Posing the same risk but originating in a different manner, those structures seeking a third party certification offers another situation that requires the lender’s attention. In these scenarios, the recognition usually occurs after the triggering event calls for the permanent loan to be funded by the lender. In a perfect world, the recognition would occur upon the completion of the structure, which would precede the funding of the permanent loan. However, the reality of the situation is that the recognition occurs at a much later date, which may place the lender in a position fraught with risk and allows for few credible options for a resolution.

To this end, the most likely risk would be that the building fails to receive recognition by a third party certification organization; yet the lender funds the permanent loan while the borrower makes use of the structure. Consequently, the lender performs but the borrower breaches its obligations to attain a third party certification and possibly fails to attain the increased valuation of the collateralized property 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.

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170 See BRITELL, supra note 10 at § 8.02[1]
171 Id. at § 8.02[1][b].
172 Id.
173 Id. at § 8.02[1]
174 Id.
175 Id.
176 Id.
Because this type of a predicament appears to be a likely scenario, the lender must weigh its credible options in the green building context as well. Hence, a more proactive position in the take-out agreement along with the possibility of other remedies that does not invite additional liabilities offers a pathway to mitigating a possible loss scenario in an environmentally friendly new development.

C. *Existing Building*

Given that many of the issues associated with developing a property have already been resolved, there are very few differences that exist between a traditional and a green building loan 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.\(^{177}\)

Moreover, some of the other valuation issues may also be resolved due to the existence of the building. For instance, the valuation associated with the building could be less contestable. An established building will most likely have a market history for the structure as well as for comparable properties in the surrounding neighborhoods. This will provide less variation and opportunity for an appraiser to make judgment calls when suggesting a valuation of the proposed property for collateralization. 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 as well as the operating expenses. The building’s seller should also maintain specifics on any tenants and the remaining time associated with their lease. This additional data specific to the proposed collateralized building will limit the judgment decisions by the underwriters to create a more precise model for the underwriting decision that takes into account the market value for the structure’s environmentally friendly features.

Thus, the existing building poses very few if any new risks to the lender beyond those applicable to every type of transaction. Accordingly, a lender and its underwriters need to consider a variety of green building specific issues along with the nature of the acquisition when evaluating an environmentally friendly structure for a permanent loan or risk missing an opportunity or losing a client due to a misinformed or flawed underwriting process.

\(^{177}\) *Id.* at § 8.02[2]
III. Proposal for Managing Risk on a Green Building Mortgage

As a consequence of this diverse set of exposures a lender faces when providing permanent financing to an environmentally friendly building, the decision to fund or turn down the borrower’s application will require knowledge of the unique traits linked to these structures, a prudent evaluation of the property to be collateralized, and an understanding of the real estate market. This knowledge should turn into more prudent decision making at all levels while providing much needed capital to green building projects while at the same time showing the lending community’s commitment toward public policies that favor a more ecologically built environment.

When selecting the underwriting criteria, a lender tries to navigate through the arduous process of avoiding risky applications that maintain an increased chance of default without rejecting a strong borrower that may chose to take his business elsewhere. Borrowers need to recognize that the unique characteristics of a green building will pose difficulties to the permanent financers and the underwriting process that may lead to flawed decision-making. In responding to the additional risk exposure, a lender 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, which will further illustrate the lending community’s unwillingness to support the policymaker’s environmentally friendly objectives.

To deal with the various exposures to a possible loss when providing the permanent financing for a green building, a lender may choose to follow a strategy that implements an assorted number of mitigation measures along with specific conditions that will allow for an acceptable level of risk within its underwriting standards. These responses by a lender will allow for the funding of the mortgage within their existing underwriting process or becomes incorporated into the covenants of the loan. Based on these types of actions, the added risk created by collateralizing a green building for a mortgage makes the ability to fund it more manageable.

A. Underwriting Process Driven Adjustments

Bearing in mind the previously discussed issues that arise out of the underwriting process along with the unique challenges introduced by a green building, a lender needs to consider altering its practices in order to better capture and comprehend such structures. A simple solution could include the creation of a distinct process for those applications that fit into

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178 See supra Part I.B
179 See supra Part II
the green building category. A lender’s application ought to 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 may proceed with a process that can properly evaluate the risk associated with funding a loan for a green building in a different manner than a traditional structure.

1. Supplemental Application for Green Buildings

When developing a distinct process for determining the lending exposure on a green building, the underwriters need to design a supplemental application that requests information, documentation, and answers related to the sustainable features of the structure over and above those normally requested, which will help address the quantification and other issues previously discussed. This supplemental application should request documentation pertaining to any third party certification received, any acknowledgments of compliance for required government regulations or private obligations relating to environmental construction standards, and any tax certificates or the like that convey incentives or other special financial benefits upon the completed structure.

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 that the borrower supply the name of the third party organization supplying certification, the version pertaining to the proposed building, and the expected level upon completion.\(^{180}\) 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 these pieces of

\(^{180}\) Several organizations provide identifiable systems that endeavor to measure and substantiate the sustainable features within a building. (See Prum Aalberts Del Percio, supra note 4 at 194-200.) The Leadership in Energy and Environmental Design (LEED) program was created by the United States Green Building Council (USGBC) in 1998 and provides an array of approaches for compliance depending on the construction type as well as the 4 different levels of certification: silver, gold, and platinum to denote higher levels of achievement. (GREEN BLDG. CERTIFICATION INST., LEED CERTIFICATION POLICY MANUAL (2012), available at https://www.leedonline.com/irj/go/km/docs/documents/usgbc/leed/config/terms/Legal_Documents_Download/rating_system_doc_nov_2011/Jan2012_Cert_Policy_Manual.pdf) The Green Building Initiative operates the Green Globes program in the United States and awards one to four green globes based on a project’s level of achievement. (Green Globes Overview, GREEN BLDG. INITIATIVE, http://www.thegbi.org/green-globes/ (last visited Jan. 17, 2013).)
information alongside the regular submission for either an existing building or one under construction, the underwriters may now 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 its evaluation, the underwriters will need to address data accuracy issues. Specialized consultants and expert research will provide a good solution. As the appraisal community continues to refine its approach to quantifying sustainable features on a given piece of property, the underwriters will need to find those professionals with more experience assessing a green building in order to get a better evaluation and to avoid issues with those unfamiliar with these types of structures. This will help ensure that the financial models and pro-forma statements present the most accurate data available while supplying a certain level of confidence in the captured and quantified data along with any governmental assistance received in the building’s construction.

In conjunction with the use of experienced professionals, cutting edge research in this emerging field will 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 while attempting to develop explanations and models for predicting outcomes to the same questions asked by the underwriters.\(^{181}\) For example, several published studies considered the income part of the financial statements and evaluated the occupancy rates and premiums for leases and sales of green buildings,\(^ {182}\) while others analyzed the cost side through utility usage and other operating costs.\(^ {183}\) As such, the applied aspects of this research could provide an underwriter useful insight through formulas, models, and multipliers that could 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

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\(^{181}\) See e.g., FUERST & McALLISTER 1, supra note 131; Miller 1, supra note 131; EICHHOLTZ 1, supra note 131; Wiley, supra note 131; EICHHOLTZ 2, supra note 131; FUERST & McALLISTER 2, supra note 131; Norman G. Miller, et. al., *The Operations and Management of Green Buildings in the United States*, 2 JOURNAL OF SUSTAINABLE REAL ESTATE 51 (2010) [Hereinafter referred to as Miller Pogue Saville Tu].

\(^{182}\) See e.g., FUERST & McALLISTER 1, supra note 131; Miller 1, supra note 131; EICHHOLTZ 1, supra note 131; Wiley, supra note 131; EICHHOLTZ 2, supra note 131; FUERST & McALLISTER 2, supra note 131.

\(^{183}\) See e.g., Miller Pogue Saville Tu, infra note 181.
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 the underwriter and lender to develop more reliable and accurate financial models and pro-forma statements in order to make a better decision on whether to fund an application for long-term financing on a green building.

B. Document Driven Adjustments

Following a comparable approach to the tweaking of the underwriting process, a lender can protect against much of its exposure to a risk of loss through the loan documents too. The lender needs to 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, the lender can make allowances for the differences in exposures that are not present in a traditional building and will on occasion force the parties to alter their standard practices when performing.

1. Pre-closing Conditions

Given that the lender maintains a superior position to the borrower and possibly the short-term financer prior to facing its obligation to fund the mortgage, the insertion of conditions precedent provides one of the most useful tools to minimizing 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 needs to consider the unique exposures of the green building along with the methods of acquisition to strategically address the different risks.

a. Development Projects

In those situations where the lender decides to proceed as the provider of long-term financing through a take-out agreement of the construction loan, the pre-closing conditions must consider and attempt to mitigate some of the unique risks previously discussed.\textsuperscript{184} The long-term lender needs to 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 into the take-out agreement that does not obligate the long-term lender to fund its loan until

\textsuperscript{184} See supra Section II.B
issuance of the final green certifications. Often times, this is not usually possible or becomes impracticable.\textsuperscript{185}

To remedy this major issue in those situations, one commentator recommends that the long-term lender should 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 development’s project meeting the third party certification goal.\textsuperscript{186} Mr. Britell suggests an incremental approach that includes language at the development’s initial, middle, and final stages.\textsuperscript{187} He 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.\textsuperscript{188}

Next, Mr. Britell addresses the building’s ongoing construction by conditioning any subsequent draws on the construction loan.\textsuperscript{189} He offers language that requires the consultant to review any and all approved change orders along 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.\textsuperscript{190}

Finally, Mr. Britell 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.\textsuperscript{191} He puts forward language that requires the borrower to: 1) supply 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 enhance commissioning of the building is underway pursuant to the third party verification organization’s initial response to the original submission for certification; and 4) a confirmation from the green building consultant that they examined the submission sent to the third party verification organization and that they maintain the opinion that nothing material will effect the structure’s ability to attain certification.\textsuperscript{192}

Taking a different approach, a long-term lender 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

\begin{itemize}
\item\textsuperscript{185} Id.
\item\textsuperscript{186} See Britell, \textit{supra} note 10 at § 8.02[1][a]
\item\textsuperscript{187} Id.
\item\textsuperscript{188} Id.
\item\textsuperscript{189} Id.
\item\textsuperscript{190} Id.
\item\textsuperscript{191} Id.
\item\textsuperscript{192} Id.
sources like defective workmanship, improperly substituted products, poor design, or a mistake in the documentation, a lender would need to consider a combination of insurance products in order to transfer the risk.

In attempting to mitigate the risks in defective workmanship, improperly substituted products, or a mistake in the documentation, the lender could include covenants in the take-out and loan agreements that requires a performance bond on the building’s construction and that the surety must extend coverage to include the attainment of the desired third party certification. 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.

Similarly, a lender could try to mitigate some of the design risks by requiring the borrower to submit evidence of insurance coverage for its design team and policy limits for prior approval as a condition for agreeing to its participation in the building’s development. This type of requirement would allow the lender to ensure that coverage exists for all of the 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 due to a failure to attain the promised third party certification.

Hence, these different solutions offer several credible options to a lender that genuinely looks to mitigate the unique risks posed by a green building. If a lender is not comfortable with the risk associated with the green building process, it could require a performance bond on the building’s construction and that the surety must extend coverage to include the attainment of the desired third party certification. 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.

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Hence, these different solutions offer several credible options to a lender that genuinely looks to mitigate the unique risks posed by a green building.

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193 Currently, there is no clear industry standard as to whether a performance bond will cover the completion all the way to attaining the desired third party certification or just the building by itself. (See Prum & Medders, infra note 195 at 25-37.) The coverage issue remains with the performance specification of the construction project and the language used in the contract that forms the bond. (Id.)


195 See generally Prum & Del Percio 1, supra note 133 at 257-9. 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) [Hereinafter referred to as Prum 3].) Because participants in a green building will most likely avoid the professional standard, a prudent lender will need to investigate further in order to ensure that those responsible did not contractually lower their standard below that of a reasonable person or did not bifurcate their services to avoid it either. (Id.)
building prior to a loan’s funding and presents approaches that offer similar results utilizing different mechanism to achieve comparable goals.

b. Existing Building

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. However, the underwriters still need to confirm that the borrower’s assertions regarding the green building features are true. Consequently, the underwriters need to receive supporting documentation that the building received certification from a third party verification organization and that any tax certificates or the like that convey incentives or other special financial benefits upon the completed structure occurred.

To eliminate the possibility of a risk occurring from an untruthful applicant, Mr. Britell suggests two different closing conditions that the borrower must fulfill prior to funding the loan above its normal requirements for items such as Certificates of Occupancy and the like. 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. He also advises that the lenders incorporate another preceding condition for the borrower to provide the supporting documentation that may exist for property tax abatements or the like that convey incentives or other special financial benefits upon the completed structure as well.

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, it can made 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 as to whether it should 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 lender for a means of relief should

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196 See supra Section II.C
197 See BRITELL, supra note 10 at § 8.02[2]
198 Id.
199 Id.
the borrower fail to live up to his obligations.

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 will need to take a more proactive approach at the onset to ensure that the policy provides adequate coverage for the myriad of features and the patchwork of regulatory framework that applies to the structure in order to prevent the borrower from ending up in an underwater type of situation 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 some of the areas of concern and stipulate changes in coverage.

As a starting point, the underwriter needs to 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 being insured. When taking into account the ordinance or law exclusion, the underwriters need to consider the existing and prospective attitudes of the jurisdiction where the property is located with respect to green buildings.

If the jurisdiction already adopted a green building code like the IgCC or CALGreen, then the lender needs to 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 as a normal structure for those jurisdictions that do not adopt a more environmentally friendly building code because many of the green requirements already surpass the standard practice.

In weighing the valuation issues, the underwriter will need to insist upon replacement coverage because of the unique features associated with a green building and its high performance characteristics. While quantifying the intangible features of a green building and the process of determining a value appears to be evolving, the lender will maintain historical data within its underwriting process that may make the attachment of a value much smoother and deter an insurer from simply trying to offer policy limits as a solution should a policy call for other methods of coverage. Because the risk of obtaining suitable replacements in the future shifts to the insurer and its experience and tolerance for identifying the possibility of a casualty, the underwriter needs to require that the property owner transfer any exposure
to the property becoming less than the loan balance through the appropriate valuation method.

Finally, the lender must instruct the underwriter to pay special attention to the policy coverages for the collateralized property. Given that many of the 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 in order to gain additional credit towards a specific certification. If the proposed collateralized building contains one of these features, then the underwriter needs to create a list of coverage concerns and require that the borrower obtain endorsements to make sure these aspects receive inclusion in the policy similar to the approach used for vegetative roofs.

Moreover, the underwriter needs to confirm that the underlying property policy does not contain language that excludes the documentation associated with delivering and recertifying the building up 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, a lender needs to instruct its underwriters that the property insurance requirement with a green building poses significant coverage gaps if the loan is funded; so it must extensively review the borrower’s policy for these types of issues and insist on endorsements with applicable in order to prevent a future loss.

b. Consequences and Remedies for Noncompliance

In the event that a borrower fails to live up to its obligations and a lender is required to take action, the loan documents should address the consequences for noncompliance after the funding of the loan occurs. This type of situation may occur because a triggering event obligates the lender to fund the mortgage on the collateralized property, but the borrower fails to achieve the green building certification or other benefits such as property tax abatements in a timely manner.

When anticipating this type of situation, a lender needs to consider the various options it may take such as foreclosure, self-help, and other approaches that 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. 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. 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. Documentation issues such as amended filings with the third party verification organization or updates to the drawings and specifications can be resolved easily. Similarly, a building might require corrective construction in order to attain the third party verification organization’s certification. This might include removing and replacing noncompliant equipment, work, or finishes on the building to meet the required standard.

In both cases, Mr. Britell suggests that a lender can insert post-closing conditions into the lending agreement that require the borrower to accept personal and financial responsibility to complete all necessary tasks required to achieve the agreed upon certification. He proposes that the language make the borrower bear the costs for the necessary green building, construction, and legal consultants. Alternatively or in conjunction with Mr. Britell’s proposal, the lender 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 place

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200 See BRITELL, supra note 10 at § 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.

201 See supra text accompanying notes 101-2.

202 See BRITELL, supra note 10 at § 8.02[2][b]

203 Id.

204 Id.

205 Id.

206 Id.

207 Id.
sufficient funds to cover any costs remaining with attaining the third party certification in such an escrow account. Upon the receipt of certification, the borrower would receive their funds back; but in the meantime, it will remain as additional collateral to cover any extra cost necessary to achieve the agreed upon certification that the lender might bear.

Finally, the situation where neither documentation nor construction offers a solution to the building’s ills provides the most difficult scenario.208 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 that satisfies specific credits.209

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. Depending on how the jurisdiction created and implemented its green building requirements, some governments adopted fines and penalties for noncompliance while others remained silent.210

Given the better than average possibility of this scenario becoming a reality, a lender needs to insert language to cover this option too. Should the jurisdiction levy fines and penalties for any noncompliance, then the lender needs to include a provision that makes the borrower responsible for such assessments along with any costs incurred to gain a Certificate of Occupancy.211 In other jurisdiction that do not address such a situation, the language inserted by the lender needs to place responsibility on the borrower to seek and pay for the costs associated with gaining a variance from the appropriate authorities for the building.212

Moreover, the lender needs to also add sufficient language to the loan documents to ensure that a borrower keeps all responsible parties for delivering a certified green building on task. Mr. 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.213

Consequently, a lender may face a situation where the completed building fails to receive certification by a third party verification organization and will become unusable or less valuable. Hence, the unique

208 Id.
209 For instance, an oversight might occur whereby the commissioning occurs improperly or the contractors use an impermissible approach when handling the waste, disposal, or recycling during the construction of the building. (See Britell, supra note 10 at § 8.02[2][b])
210 See generally Prum 1, supra note 8; Prum Aalberts & Del Percio, supra note 2.
211 See Britell, supra note 2 at § 8.02[2][b]
212 Id.
213 Id.
characteristics of a green building present risks to the lender but most, if not all, of the extra exposure becomes manageable through better underwriting processes and loan documents that anticipate potential quagmires.

CONCLUSION

Overall, a lender that provides long-term financing for a green building confronts a great deal of exposure to a loss from a variety of different sources. The lender is required to take preventive measures in order to guarantee that its mortgage on the real property remains first in line with respect to priority for an action in foreclosure, that it does not turn into a responsible party for an environmental clean up, and that the collateralized structure maintains or attains the necessary approvals from the government for occupancy. However, the addition of sustainable features to the structure coupled with either government or third party requirements bring 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 and will unwittingly go against the desires of the policymakers to advance ecologically friendly buildings.

As such, the current practices for analyzing and mitigating an exposure to a traditional structure will not adequately address the unique issues presented by a green building; so a prudent lender must adjust their strategies for identifying, explaining, and quantifying the exposures for these types of loans in order to better support the agenda put forth by policymakers. After grasping the issues and unique characteristics associated with a green building, a lender can develop practical and uncomplicated solutions to the risks posed by an environmentally friendly structure. These solutions include making adjustments and better identifying the approach and methods that evaluate and address the various exposures while protecting the lender’s interest.

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

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