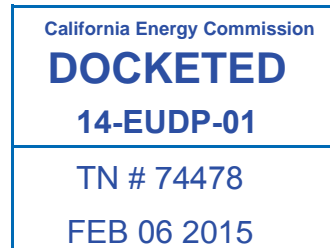


## **AB1103: Insights from the Transactional Perspective**

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### Background

The law intends to provide transparency in a real estate transaction as to the energy costs of real property and the resulting Energy Star Score (ESS) will allow buyers to distinguish between the high and low energy efficient properties for their investments.

It's a law that is not widely recognized nor complied with due to lack of awareness and education among real estate professionals, attorney's, property & asset managers, and the ultimate responsible party – the owners. As such, the law is not being implemented as intended. And more often than not the response I get when I alert a client to the bill is the first question is "what happens if we don't do it". The truth is that there are no "teeth" (aka consequences) in the bill with non-compliance so it is widely being ignored.

Further, no one seems to know "why" it's important nor do they base their investment decisions on utility costs. Savvy investors look at the ROI/NOI of the deal as a whole – and energy costs are not yet a determining factor in whether a buyer will buy or a lender will lend on a specific property. A big reason for that is neither appraisers, or lenders have adopted energy scores or energy upgrades as a measure of value.

An owner is forced by law to disclose their energy star score to a buyer and/or lender – but gets no inherent value from the score upon a sale or loan - a huge disconnect.

The law requires the reporting and compliance certificate be provided by the owner "prior to" a sale, lease or refinance or finance agreement. This is definitely not happening, so first I believe you have to separate all these events and address the issues of the timing of AB1103 disclosure accordingly.

### **SALE TRANSACTION:**

The "standard" process is an owner lists the property for sale, a buyer writes a contract and they open the transaction with an escrow holder/title company who takes in the deposit monies. The escrow holder is not a party to the negotiations or due diligence requirements – merely holds the funds until the buyer/seller instruct us to move forward with the closing terms, finance agreements etc. The escrow holder cannot and will not hold up a transaction for non-compliance issues. Unless it's "of record matter" we don't report or require contractual compliance. Only a buyer/seller dispute would cause an escrow to be held up due to non-compliance with AB1103.

Some due diligence is done by the buyer, some by the seller. Some due diligence is done prior to contract and some is done within a certain due diligence period as specified in the contract (10 days is fairly standard and can be extended). My experience in talking with brokers representing buyers/sellers is that AB1103 is not on any of the seller or buyer "check lists" prior to a listing or sale agreement - nor included as a part of the due diligence process. Perhaps that is where AB1103 could come into play – as part of the due diligence checklist.

The industry perception of AB1103 is that it's a "nuisance bill". It's there, but nobody is policing it so the industry is treating it as optional. But these are the "what if's" and talking points I share with clients to at minimum get them thinking about it for future transactions:

- 1) What if you have a savvy buyer who cares about a green Vs brown property and energy efficiency via the AB1103 certification ESS score can support a higher listing/sale price for the seller you represent?
- 2) Conversely - what if you are in escrow and as an "afterthought" provide the AB1103 compliance and the potential buyer doesn't like the ESS and wants to renegotiate?
- 3) What if you are in escrow, ready to close and attempt to comply with AB1103 and can't get access to some of the tenant utility information in time to complete the disclosure and close on time?
- 4) What if you don't provide AB1103 compliance/ESS and after closing does the AB1103 compliance as a new owner and the building isn't efficient?
- 5) What if new owner solicits a savvy "green" tenant that wants proof of the ESS per the law and owner can't provide and/or the score is low and they lose a prospect?
- 6) What if you the building sells to the new owner you represented and they relist with you and do the compliance and get a low ESS score which might devalue the property?
- 7) If a buyer secures a loan without AB1103 they are technically in "non-compliance" with their loan agreement by NOT being current on all state/federal/local law and or ordinances?
- 8) If owner/seller did not comply before or during a sale transaction – and try to do it after the fact to make the new owner compliant - they would have to contact a seller who is out of the deal and has absolutely no motivation to cooperate and may/may not even have access to 12 months utility history. Further – how would that broker look to a seller or buyer they represented and didn't alert them to the fact they needed to comply and provide that to their buyer?
- 9) I don't have stats on how many commercial deals involve counsel – but most of the deals we've seen with counsel, counsel is a) not aware of AB1103 b) if they represent the buyer they don't care, it's not their issue and consider it a seller liability c) if they represent seller/owner they are charging their hourly rate to secure the utility bills/upload/secure certificate and its driving up owners costs.
- 10) The lenders that have been involved in purchase financing are not requiring their buyer/borrowers to provide AB1103 Certification. In fact, when I've alerted them they say it's a seller issue, their underwriters don't require it, and so it's a non-issue to them /their borrowers. I alert them that their borrowers are in non-compliance with their loan agreement once they take possession and they ask what the consequences are – and I have to respond technically *none*. Another huge disconnect.

### **LEASE TRANSACTIONS:**

The standard process is due diligence is handled up front during negotiations and it usually involves a broker and/or counsel representing the owner and a separate broker/counsel representing the tenant. Unless the tenants counsel or broker asks or requests the AB1103 certificate, consensus among leasing agents I've spoken with is that they aren't initiating or seeing it in their deals. They are relying on disclaimers instead.

If there was widespread understanding and adoption of AB1103, every broker that had a listing would be contacting the owners of the properties they represent and as a "value add" client service, alert them to secure their compliance certificate and provide resources or referrals to help them complete the

process and provide AB1103 Certificate/ESS to all current tenants or future prospects to assure they are in compliance. To my knowledge, that is not happening.

### **REFINANCE/FINANCE TRANSACTIONS:**

I made reference above to the fact that lenders are a) not aware that owners are supposed to provide AB103 Certificates/ESS to lenders providing finance b) not requiring AB1103 certificates in general c) if they are aware, none I've interviewed ask for it prior to the loan application or prior to close and d) it is definitely not on their underwriter checklists once the loan is in process e) have no clue what to do with the certification if they get it, so why ask for it f) there is no penalty to the lender if the owner is not in compliance, so why bother.

All loans have expiration dates and any delays require extensions and can include penalties and interest rate changes. Since they aren't aware they are supposed to have it prior to the application, many lenders have expressed concern that if they require the certificate at any time during the loan it could hold up the loan process if the owner has difficulty obtaining it. They won't risk losing a deal since there aren't any consequences to their loan if underwriting doesn't require they secure AB1103 compliance up front or at any time during the loan process.

### **SUMMARY**

- Without more direct outreach and education, owners and the real estate professionals they deal with will be very slow to adapt
- Without any "value add" for compliance via; higher ESS score = higher value; it will be difficult to get traction
- Without the threat of or actual consequence (aka "teeth") for non-compliance and enforcement of same, there is no motivation for compliance by owners or the parties that represent them in sale, refinance or finance transactions

### **SUGGESTIONS FOR COMPLIANCE:**

- 1) More statewide outreach to the CA Commercial Association of Realtors/Appraisal Institute/Mortgage Bankers Association/State Bar Association to increase awareness of their duty in the process of AB1103 compliance
- 2) A direct mail campaign to every commercial property owner to alert them to the law and their duty to disclose (perhaps an insert with their utility or property tax bills?)
- 3) Mine data from the compliance website that indicates which area has the most compliant owners and reach out to those communities and find out why their numbers are higher and "what's working"
- 4) Advertise the law on the MLS/Zillow/RedFin listing portals