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Solar Rooftop Generation: A Primer for Real Estate Owners and Developers

The electricity industry's movement toward renewable energy development presents a unique opportunity for owners and developers of large-scale real property (e.g., warehouses and distribution centers). Such owners are exploring the feasibility of reducing energy costs and "going green" through the installation of on-site renewable (solar) generation. One exciting and growing application of renewable electric generation entails the installation of rooftop solar, photovoltaic ("PV") panels to convert the sun's energy directly into electricity. The following is a primer on what real estate owners and developers need to consider before embarking on the installation of a rooftop PV system.

Technical Feasibility/Permitting

Whether a PV rooftop system is feasible depends on a number of factors, including the age and condition of the structure. Generally, roofs that are five years or younger may be sufficiently stable to sustain the PV equipment. As a general rule, approximately 100,000 square feet of roof space is required for a 1 MW solar array. Finally, an owner should review local ordinances to determine if there are any restrictions on, or special permits required for, such rooftop structures.

Economics

If a rooftop solar system is technically feasible, a developer would then need to consider the economics of such a system. In a typical model, the developer would lease its rooftop space to a contractor that would construct, own, generate and maintain the solar system. The contractor would enter into a long-term power purchase agreement ("PPA") with the real property owner under which the contractor would sell electricity to the owner at a rate representing a discount from the otherwise applicable utility tariff. The length of the PPA would depend, in part, on the useful life of the solar system, which could be in excess of 15 years.

The contractor finances the construction of the solar system through the revenue streams represented by the PPA sales to the property owner and the sale of renewable energy certificates ("RECs"), which are tangible rights related to the beneficial environmental attributes associated with generating power from a renewable resource. RECs can be sold separately from the power generated to create them, and there are several markets (both voluntary and compulsory) in which RECs may be traded.

While the chief economic benefit for the owner associated with the rooftop PV system is the stream of energy savings associated with the PPA, an owner may wish to negotiate with the contractor for a share in the revenue attributable to the sale of RECs.

Regulatory

Because a rooftop solar system cannot produce electricity in every hour, an owner needs to consider the rate it will pay for electric service obtained from its local utility (or an alternative supplier) when its rooftop system is not producing power. (Rooftop facilities produce power on average for 6 to 8 hours per day.) Some utilities require a customer with "on-site generation" to take electric service under a "standby" service tariff with rates that may differ from the otherwise applicable tariff rates paid by the owner. This differential needs to be factored into the economic analysis of the solar rooftop generation.

With a contractor assigned the responsibility of owning, generating and maintaining the rooftop system, there are minimal regulatory considerations for the property owner under state and federal laws regulating utilities and the services they provide. While the contractor may be

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subject to limited regulation in certain jurisdictions, the owner, who is a retail purchaser of electricity under the PPA, will be subject to no public utility regulation and will need to consider, as noted above, the terms of service for those hours when its rooftop array is not producing.

If an owner or developer wishes to consider the sale of excess power produced by the rooftop PV system to either the local utility (a wholesale sale of power) or a customer located near the owner's site (a retail sale of power), additional regulatory, technical and economic considerations will need to be examined.[1]

Renewable energy, particularly rooftop solar energy, may offer an attractive opportunity for owners and developers of real property to lower energy costs and establish a market reputation for responsible energy usage. Rooftop solar installations are gaining in applications across the country, particularly in California, Texas and New Jersey. With careful consideration of technical, economic and regulatory factors, a real property owner or developer may find that a rooftop PV installation is a feasible energy solution.

1 A future newsletter article will address these considerations.

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Chinese Go Bargain Shopping for U.S. Real Estate

Americans are witnessing one of the worst corrections in history in the U.S. real estate market as evidenced by steep declines in new home sales and rapidly growing real estate foreclosures. The S&P/Case-Shiller Home Price index reported that 11 of 20 metro areas around the nation showed the highest decline in annual rates ever on record. This huge decline in real estate prices is due to immense oversupply caused by dwindling demand as a result of numerous factors including low consumer confidence, high unemployment rates, high cost of production and difficulty in obtaining mortgage financing. The Center of Responsible Lending projects that foreclosures will reach 2.4 million nationwide in 2009.

During this same time, while not unaffected by the global economic crisis, China continues to be one of the world's fastest growing economies. From 1979 to 2007, China's real GDP grew at an average annual rate of 9.8% and it shows no signs of a long-term slowdown. Even in 2008, its real GDP still grew at 9%. Trade and foreign investment are the major drivers of China's economy. In 2007, China's exports exceeded U.S. exports for the first time and its trade surplus registered a historic high. China is also the world's largest holder of foreign exchange reserves. This is principally a result of large trade surpluses, foreign direct investment and large-scale purchases of foreign currency. International financial statistics compiled by the International Monetary Fund predict if these trends continue, China could become the world's largest economy within the next 10 years. China is now home to the 5th largest number of U.S. dollar millionaires in the world, with many of them owning substantial amounts of liquid assets.

Many analysts believe Chinese companies and individuals will increasingly use their cash reserves to purchase resources across the globe at bargain-basement prices. Key policy decisions have limited how China can spend its case reserves–U.S. real estate, equities and debt. Since 2000, $96 billion was used to purchase stock in U.S. companies, $16 billion was invested in corporate bonds, $474 billion was used to buy debt of government chartered organizations, $439 billion was used to purchase U.S. treasuries, and the balance of $400 million remained in Chinese banks and was invested in U.S. real estate or entered the U.S. through foreign intermediaries. Some Chinese companies have already started purchasing existing international firms to increase the global visibility of Chinese brands. Recent examples include Lenovo Group Limited's purchase of IBM Corporation's personal computer division, Aluminum Corp. of China's investment in Rio Tinto, Tempo Group Inc.'s purchase of certain assets of Delphi's global brake and suspension component business and China's multi-billion dollar investment into the Morgan Stanley Sovereign Wealth Fund. The easing of lending rules by Chinese bank regulators has contributed to the increase of cross-border acquisitions. Individuals have similarly sought attractive overseas investments. Making investments in U.S. real estate is considered both financially sound and prestigious. According to the National Association of Realtors, investors from China are the most likely foreign investors to purchase U.S. properties valued at $1 million or more. Moreover, the median price paid by Chinese real estate investors was $450,000, which was the highest median of any customer segment. Due to rising Chinese income levels, the strength of the Chinese currency against the U.S. dollar and fewer domestic investment options, these trends are expected to continue. According to an annual survey of the Association of Foreign Investors in Real Estate, the U.S. still remains as the most stable and secure country for real estate investment with the best opportunity for appreciation.

With this in mind, U.S. real estate owners, developers and brokers would be wise to embrace the changing global economic landscape and position themselves to take advantage of these historic opportunities.

Blank Rome is currently representing numerous China companies in U.S. real estate and corporate transactions.

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Negotiating with Commercial Lenders in Turbulent Economic Times

Real estate professionals are well aware of the dramatic decline in the origination of commercial real estate loans in these last few months of economic turbulence. Projections for 2009 consistently demonstrate a steep fall in loan volume from the peaks of just a few years ago. However, it is important for real estate professionals to be aware of an emerging trend in real estate lending–some lenders who are willing to fund new commercial loans are assuming an inflexible "take it or leave it" approach, forcing borrowers to assume legal and/or business risks that they previously would have strenuously resisted.

Lenders have never been known to tolerate lengthy negotiation of their loan documents. However, financially solid borrowers with good reputations could reasonably expect some healthy give and take in the negotiation of the loan documents. Particularly in the past few years when the CMBS market was hot and lenders were competing for deals, lenders were much more willing to accommodate borrowers of all reputations.

Now many lenders are simply saying "no." Moreover, to address deficiencies that have been exposed by the CMBS implosion, lenders are revisiting their longstanding loan forms to further limit lender risk and exposure. Experienced and reputable borrowers who are accustomed to using pre-negotiated forms from prior deals are now finding that they are forced to negotiate a set of loan documents from scratch.

As a result of this shift, borrowers and their attorneys face difficult challenges. Facing impending maturity dates or defaults under existing loans, borrowers are so thrilled at the possibility of obtaining new financing, they are willing to accept onerous business terms that they would have never entertained in the past, such as low loan-to-value ratios, hard lockboxes, ongoing financial covenants, significant upfront reserves and expanded recourse liability.

Therefore, when it comes to negotiating the loan documents, borrowers expect their counsel to quickly pinpoint a few hot button issues, and to deemphasize language and other legal issues that counsel would have addressed in the past. However, the bright line between these two categories is not always clear. In the face of pressure from clients, lawyers for borrowers must strive to obtain a clear understanding of their clients' business operations and risk tolerance, and should surgically tailor their comments to only the most meaningful provisions in the loan documents. Below is a primer of some critical issues on which counsel to borrowers should focus:

(1) Economic Terms: Attorneys should never be reluctant to confront lenders if the terms of the proffered loan documents are inconsistent with those in the term sheet.

(2) Financial Covenants: Lenders are, more than ever, seeking ongoing financial covenants (such as ongoing loan to value, debt service coverage and guarantor net worth covenants). Often, there are a lot of grey areas in the definitions of these financial terms which lenders try to exploit to their benefit; it is therefore well worth a lawyer's time to examine these definitions carefully. Attorneys should also consider requesting notice and cure periods as well as the right to cure any non-compliance with cash or other collateral.

(3) Default Remedies: Recognizing the greater likelihood of borrowers being in default, attorneys should review carefully late charges, default rate interest, remedies and prepayment penalties on defaults. They should always try to exclude late charges on the balloon payment due on the maturity date.

(4) Personal Liability: It is, of course, essential to make sure your client understands the scope and full impact of recourse liability. For example, as part of the typical recourse carve-out guaranty, more lenders are looking to guarantors to become responsible for foreclosure costs (including attorneys' fees and transfer taxes). In addition, many lenders are now looking to principals or credit entities to guaranty repayment of all or a portion of the debt.

(5) Transfer Rights: Transfer rights are always crucial for a borrower as they affect a borrower's business strategy. A borrower will likely need some measure of flexibility to admit minority partners, raise capital, exercise buy-sell rights or reorganize. As lenders' underwriting criteria have become more regulated, lenders will want to reserve the right to scrutinize new equity participants. In addition, it is becoming increasingly harder to obtain special rights regarding releases, substitution of collateral or third-party assumption of debt.

(6) MAC Default: To protect against future economic downturns, in addition to strict financial covenants, many lenders are looking to add a "material adverse change in the condition of the borrower, guarantor or the property" to the enumerated list of loan defaults. This should be aggressively resisted, as it essentially gives the lender a call right if economic conditions worsen (including if a tenant defaults or files bankruptcy).

(7) Reserves: Another area where lenders are protecting themselves is by requiring significant up-front and ongoing reserves. Even if borrowers are willing to fund these reserves, borrowers need to make sure the proceeds held in these accounts will be made available when needed without major hurdles. In addition, in light of many lenders' financial instability, it is prudent for a borrower to have the right to offset such reserve amounts against the debt if its lender files bankruptcy, is placed into receivership or refuses to fund. Similarly, if lenders will be making periodic advances of loan proceeds (e.g., construction loans or earn-out advances), borrowers may need to examine the

lenders' balance sheets to determine whether there is any risk that the lender will not be able to perform its obligations and provide for appropriate protections.

(8) Leasing/Operations: Flexibility on leasing parameters is always a concern for borrowers. However, lenders are equally as concerned, especially if there is large rollover risk. Counsel should carefully review the leasing parameters with the client and determine whether any changes based on future leasing are necessary.

(9) Renewal Conditions: With many lenders providing short-term loans with renewal options, focus on the specific conditions for renewal is increasingly important, especially any conditions which are not within the control of the borrower. If a lender imposes a minimum creditworthiness standard on an interest cap provider as a condition of the renewal option, the borrower could simply lose the renewal option because the cap provider's creditworthiness could not be satisfied, most likely due to market conditions.

In these turbulent times, it is incumbent for both borrowers and their counsel to recognize that life has changed. But adapting to the tougher lending climate does not mean that the borrower should rush into any lending transaction. There is still an important role to be played by counsel in identifying key provisions and assuring that the client gets the best deal possible.

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Final Regulations and New Guidance Regarding Loan Modifications for REMICs Holding Commercial Mortgage Loans

On September 15, 2009, the IRS released final regulations and a Revenue Procedure addressing modifications to commercial mortgage loans held by real estate mortgage investment conduits ("REMICs"). The new regulations are designed to "accommodate the evolving practices in the commercial-mortgage industry," while the Revenue Procedure addresses "[t]he current situation in the credit markets … affecting the availability of financing and refinancing for commercial real estate."

Revenue Procedure 2009-45 describes when changes to certain commercial mortgage loans made to prevent a default on the loan will not cause the IRS to challenge the tax status of certain securitization vehicles, including REMICs, or to assert that such modifications constitute prohibited transactions. The provisions of the Revenue Procedure will apply if, based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default on maturity or sooner and that the modification will substantially reduce the risk of default, provided that certain additional requirements are met. Prior to the issuance of this Revenue Procedure, a commercial mortgage loan that was "significantly modified" would fail to be a qualified asset of the REMIC, jeopardizing the REMIC's tax status unless default occurred or was reasonably foreseeable, which was typically viewed as a loan that was not performing or for which default was imminent. The ruling reduces this standard for modification to "significant risk of default," even if the loan is performing. Thus, the ruling creates the potential for special servicers to modify loans before they enter default. Notwithstanding the ruling and the relaxation of the standard from a tax perspective, servicers may continue to be constrained in their ability to modify otherwise performing commercial mortgage loans by the terms of their applicable servicing agreements.

Treasury Decision 9463 amends Treasury Regulations governing REMICs by allowing certain changes to obligations held by REMICs that will not jeopardize the REMIC's tax status. These changes include certain changes in collateral, guarantees, credit enhancement and the recourse nature of an obligation. Additionally, under certain circumstances a real property lien securing a mortgage may be released without causing the mortgage to lose status as a qualified REMIC asset. The regulations require that a mortgage loan continues to be "principally secured by an interest in real property" after the modification or release.

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