

Solar Basics for the Real Estate Practitioner

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The solar power industry has grown rapidly in recent years. According to data from the Solar Energy Industries Association, the solar energy industry has averaged a 68% annual growth rate over the past decade. As solar has become more prevalent, real estate practitioners are being presented with issues related to solar in real estate transactions with greater frequency.

Solar power systems use photovoltaic (PV) cells to convert sunlight into electricity. Solar projects fall into three categories of scale: (1) residential, (2) commercial, and industrial (whether for on-site consumption by the property owner or tenant, for sale to the local utility, or for some combination of the two), and (3) utility scale. Each of these different types of solar projects presents different concerns for the real estate practitioner, whether your client is the solar project developer or the property owner evaluating solar options.

Residential Solar

Residential solar can involve a system that the homeowner purchases outright or a system that is owned by a third party and installed on the homeowner's property under a lease or power purchase agreement (PPA). In some jurisdictions, the practice of "net metering" has made residential solar particularly attractive. Net metering occurs when a home's solar system produces more electricity than it consumes (for example, during the day when sunlight is at peak levels). When that happens, the unused electricity goes into the grid to serve neighboring properties, and the homeowner's electricity meter runs backwards to provide a credit for the excess electricity produced for the utility by the system. That "credit" on the meter will then be applied to the homeowner's usage (for example, at night, when the solar system is not producing electricity). The credit results in a reduced bill from the utility, or, depending on the efficiency and productivity of the system, the homeowner may not use any electricity from the grid and may not have any bill from the utility.

As a preliminary matter, whether the homeowner can install a solar system may depend on the property's location, what local zoning allows, and what covenants or restrictions of record apply to the use of the property. In particular, if the residence is located in a development subject to covenants and regulations enforced by a homeowners association (HOA), the homeowner may need the approval of the HOA's architectural review board before installing the solar system. Across the country, about half of the states have enacted solar access laws, which prohibit HOAs from refusing to allow rooftop solar installations, regardless of the terms of the written covenants governing the community. In these states, the HOAs may be able to place reasonable restrictions on the placement of the solar installation, but

they cannot outright prohibit a homeowner from installing a solar system. For example, Maryland law provides that “[a] restriction on use regarding land use may not impose or act to impose unreasonable limitations on the installation of a solar collector system on the roof or exterior walls of improvements, provided the property owner owns or has the right to exclusive use of the roof or exterior walls.” Md. Code, Real Prop. § 2-119(b)(1). Similarly, California law provides that “[a]ny covenant, restriction, or condition contained in any deed, contract, security instrument, or other instrument affecting the transfer or sale of, or any interest in, real property, and any provision of a governing document . . . that effectively prohibits or restricts the installation or use of a solar energy system is void and unenforceable.” Cal. Civil Code § 714(a).

For a purchased system (whether purchased with cash or financed), the system will convey with the home unless specified otherwise, like any other appliance or fixture in the home; from a logistical and financial perspective, removal generally does not make sense. The same logistical and financial concerns may apply on the sale of a home with an installed solar system governed by a lease or PPA; however, the terms of the lease or PPA will add a layer of complexity to the analysis of what happens when the homeowner wants to sell.

Generally speaking, with a solar system leased by the homeowner, the homeowner pays a fixed monthly rental payment for the system but has the exclusive right to use all electricity generated by the system. A PPA, on the other hand, obligates the homeowner to purchase all electricity generated by the system at a set price per kilowatt hour. For the lease or PPA residential systems, before listing the property for sale, the homeowner and his counsel should review the terms of the agreement to determine rights to transfer or assign the agreement to a new homeowner. Further, the terms of the agreement should be disclosed to any prospective purchaser, and the purchaser must be willing and able to assume the terms of the agreement at the time of purchase of the home. For the prospective purchaser, rental payments required for a leased solar system may affect mortgage loan qualification calculations.

Commercial and Industrial Solar Projects

In states where net-metering exists, that benefit generally will apply to commercial and industrial (C&I) properties as well as residential properties. C&I solar projects are least complicated when the property is owner-occupied; a property owner has broad discretion regarding the use and improvement of the property, subject to local zoning and any covenants or restrictions that apply to the property.

When the property is occupied by one or more tenants who will benefit from the system, the installation may need to be approved by the landlord, depending on what rights the tenant has to make improvements to the property under the terms of the lease and whether the system is being installed in (or staged on) a common area. For example, if a tenant is leasing an existing office building under a triple net lease (in which all property maintenance costs, including taxes, insurance, and utilities, are passed through to the tenant under the terms of the lease), the tenant may have a strong incentive to install a solar system to reduce utility costs, particularly if the tenant can take advantage of net metering; however, under a long-term triple net lease, the landlord may not have the same incentives regarding utility costs. This split incentive between tenants and landlords may account for the slower growth of C&I solar projects as compared to the residential and utility scale markets.

In addition to potentially requiring the approval of the landlord under the terms of the lease, C&I project viability, like residential solar, also may be affected by local zoning and covenants and restrictions of record attaching to the property. Depending on development density, project viability may also depend on the ability to obtain a solar easement (protecting the property's continued access to sunlight) and the existing utility easements affecting the property. Further, because of the scale of most C&I projects, although these projects are usually larger and more complex than residential projects, there are not currently the same financing or tax credit opportunities that developers can take advantage of in the residential and utility markets. As a result, the margins are often very thin on C&I solar projects, and developers must limit their soft costs, including title review and attorney's fees.

Real property due diligence, including title, zoning, and environmental review, is always prudent for a C&I commercial project. Whether the project is a rooftop installation or a ground mount system, title review is necessary to determine what covenants and restrictions may affect the property, the location of any existing utility easements and infrastructure, and any preexisting rights that may be superior to the solar rights (mineral or air rights, for example). A project developer who opts not to conduct complete due diligence runs the risk that the project may encroach or otherwise violate an existing encumbrance on the property.

Utility Scale Solar Projects

Utility scale solar projects, also known as solar farms, are generally complicated by the scale of the projects, and the different types of property interests involved. Like any large-scale commercial development, construction of a solar farm will require extensive due diligence and management of many moving parts. Unlike many large commercial projects, however, most utility scale solar projects are greenfield developments (constructed on large tracts of undeveloped land, generally in rural areas). The project may be an assemblage, involving acquisition by the developer of some fee, leasehold, and easement interests from many different landowners across hundreds of acres. There may be numerous different uses and property rights already affecting the property, including conventional mortgages, farm and timber leases, mineral rights, hunting leases, farm easements, and rights of first refusal. In addition, depending on the part of the country where the project is located, farm property being developed for solar power may have been owned by the same family for a very long time, without having been surveyed or reviewed by a title examiner in the interim. For these properties with ancient titles and legal descriptions, completing a modern American Land Title Association (ALTA) survey (necessary for any utility scale solar project) can be a challenge, and boundary line agreements may be necessary to complete the ALTA survey with adjoining landowners.

Because of the complexity of utility scale energy projects (including both solar and wind), and in response to investor and lender demand, in 2012 ALTA developed its 36 series of title insurance endorsements specific to energy projects. The seven endorsements in this series modify the definitions and coverage of the standard owner's and loan policies to account for some of the complexities of energy projects.

For utility scale solar projects including fee, leasehold, and easement interests, the 36-06 (Owner's) and 36.1-06 (Loan) endorsements include revised definitions and language regarding valuation. The standard ALTA Owner's Policy (adopted June 17, 2006) defines "Land" as "[t]he land described in Schedule A, and affixed improvements that by law constitute real property." For a solar farm, much of the value of the project relies not on the value of the land itself, but rather on improvements affixed to the property (the solar panels and affiliated infrastructure) that do not constitute real property. Accordingly, the 36 series of endorsements includes coverage for those non-real property improvements. Specifically, the 36 series of endorsements includes additional items of loss, including the cost of removing and relocating the Severable Improvements of the project, including soft costs such as permits, plans, and environmental due diligence. "Severable Improvements" includes:

property affixed to the Land at Date of Policy or to be affixed in the locations according to the Plans, that would constitute an Electricity Facility but for its characterization as personal property, and that by law does not constitute real property because (a) of its character and manner of attachment to the Land and (b) the property can be severed from the Land without causing material damage to the property or to the Land.

ALTA Endorsement 36.1-06(l).

The definition of "Electricity Facility" is very inclusive, including:

a substation; a transmission, distribution or collector line; an interconnection, inverter, transformer, generator, turbine array, solar panel, or module; a circuit breaker, footing, tower, pole, cross-arm, guy lien, anchor, wire, control system, communications or radio relay system, safety protection facility, road, and other building, structure, fixture, machinery, equipment, appliance, and item associated with or incidental to the generation, conversion, storage, switching, metering, step-up, step-down, inversion, transmission, conducting, wheeling, sale or other use or conveyance of electricity, on the Land at Date of Policy or to be built or constructed on the Land in the locations according to the Plans, that by law constitutes real property.

ALTA Endorsement 36.1-06(e).

Further, the 36 series (in the 36-06, 36.1-06, 36.2-06, and 36.3-06) includes coverage for any payment or damages owed to the person ultimately determined to hold title to the property and any contractual payments that the insured may continue to be obligated to pay to the lessor under a lease or grantor of an easement.

In addition to the coverage described above, the 36.4-06 (Owner's) and 36.5-06 (Loan) Land Under Development endorsements provide coverage analogous to the ALTA 9 series but customized for energy projects. Specifically, it provides coverage in the event that an electricity facility or severable improvement (as defined above) (1) violates an enforceable covenant, (2) must be removed because of a setback violation, or (3) violates a recorded environmental protection lien or covenant. The 36.6-06 endorsement provides coverage for encroachment issues and can be used for both owner's and loan policies.

This endorsement insures against loss or damage sustained because of encroachment of the electricity facility or severable improvements onto neighboring land or into a pre-existing easement on the insured land (including, for example, existing utility easements), encroachments from neighboring property onto the insured land, and forced removal of or damage to the electricity facility or severable improvements as a result of the foregoing. To issue the 36.6-06 endorsement, it is crucial to properly locate all easements of record (including utility easements, which can be blanket in nature or not specific to modern surveying standards for the location of the easement) through a thorough review of title and the ALTA survey.

Essentially, the 36 series of endorsements allows a project owner to insure the entire value of the project against a title loss, even though the value of the project will generally far exceed the value of the dirt underneath the project. Because of this increased level of risk for the insurer, the 36 series of endorsements requires a heightened level of underwriting review before issuance. The underwriter will need to review all leases, easements, surveys, and plans for the project, as well as the utility, zoning, and permitting approvals for the project.

In addition to the 36 series of endorsements, solar projects also commonly require use of the 15 series of endorsements (Non-Imputation). The standard ALTA Owner's Policy (adopted June 17, 2006) excludes from coverage:

[d]efects, liens, encumbrances, adverse claims, or other matters (a) created, suffered, assumed, or agreed to by the Insured Claimant; [or] (b) not Known to the Company, not recorded in the Public Records at Date of Policy, but Known to the Insured Claimant and not disclosed in writing to the Company by the Insured Claimant prior to the date the Insured Claimant became an Insured under this policy.

Current tax incentives for solar projects make it attractive for tax equity investors to invest in solar projects, but they often become involved late in the development process. The tax equity investor will not want to assume the risks of knowledge that the original developer may have but which may not have been disclosed to the investor or may not be otherwise known by the investor. Accordingly, the tax equity investor will require a Non-Imputation endorsement to be incorporated into the title policy for the project.

What Can Real Estate Practitioners Expect from Solar in the Future?

Recently, there have been some legal setbacks for the solar industry. Some states have revisited their laws and regulations related to electric utilities, specifically resulting in rollbacks of net metering, which will likely slow growth of residential solar projects in these jurisdictions. Although increased production of cheap solar panels abroad (primarily from China) has caused the cost of solar installations to fall over the last decade, new tariffs on foreign-produced solar panels will likely increase costs across the board for residential, C&I, and utility scale projects. Finally, expiration of tax incentives may reduce investor appetite for large utility scale solar projects and to some extent C&I projects. Notwithstanding uncertainties regarding cost and tax incentives, however, solar panels remain less expensive now than they

were, and solar is increasingly popular with consumers, particularly millennials, who represent the largest growing class of home buyers. Accordingly, real estate practitioners can expect a continued need from their clients for counsel regarding solar projects. n