Power Production Facilities: Lenders Need a UCC Insurance Policy for Full Coverage

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A lender providing financing for power production facilities must be aware of critical differences between power production facilities and traditional commercial real estate developments, and the effect of those differences on the adequacy of the lender's title insurance.

In traditional developments, such as an office building, industrial building or apartment complex, the value of the lender's collateral is based on the inherent value of the real property and the improvements thereon, and on the development's revenue-producing capability. Because an assignment of rents creates an interest in real estate, a traditional lender's title insurance policy (a **"Real Estate Policy"**) covers both bases of value. Any related personal property collateral usually has negligible value compared to the rents and inherent value, so a UCC insurance policy is typically not important.

The value of a lender's collateral in a power production facility is also based on both the inherent value of the facility and the facility's revenue-producing capability. However, the differences in the character of property owned by a power production facility, as compared to that owned by a traditional development, lead to four potential gaps in coverage if only a Real Estate Policy is obtained:

1. A substantial gap in coverage arises because a power production facility's important intangible rights — its right to sell power and the accounts receivable generated from power sales — are personal property and not real property. As a result, a lender's security interests in the revenue-producing value of a power-production facility are not covered by a Real Estate Policy and a UCC insurance policy would be required for coverage.
2. Another gap in coverage arises because many of the critical tangible components of a power production facility included in its inherent value would be categorized as personal property. To the extent they are, a UCC insurance policy would be required for coverage.
3. While certain components of a power production facility will be categorized as real estate or "fixtures" (as defined in UCC9-102: "goods that have become so related to particular real estate that an interest in them arises under real property law"), the case law on such categorization is not consistent and outcomes are difficult to predict in many cases. By definition, a mortgage lien would attach to components characterized as real estate or fixtures, and a real estate policy would provide

coverage, but a lender who relies only on a real estate policy takes the risk that important components might instead be characterized as personal property.

4. Even if a component would certainly be characterized as a fixture (and covered by a Real Estate Policy) once attached to the real estate, (a) a lender who relies only on a Real Estate Policy would lose priority to a competing secured party with a security interest perfected prior to installation where the component is readily removable and not primarily used for the operation of the real estate, and, similarly, (b) a lender who cannot obtain a first priority lien on the relevant real estate will want assurances that it had a perfected security interest in such a component prior to intallation. In both cases, the lender will want assurances, provided only by a UCC insurance policy, with respect to pre-installation security interests.

A Typical Scenario

A **Lender** wants to provide financing to a **Debtor** who wants to construct a solar power production **Facility** located on **Real Estate** owned or leased by the debtor. The Lender requires a "blanket" first lien on all of the assets of the Debtor, including all assets that comprise the Facility. The Real Property will be secured by a mortgage/deed of trust on the Debtor's interest in the Real Estate. Some of the tangible assets comprising the Facility (**"Components"**) are attached directly to the Real Estate, some are attached indirectly, and some are not attached at all. As a result, some assets will become real property, some will become fixtures and some will remain personal property. The Debtor has a power purchase agreement (**"PPA"**) under which it will sell the Facility's output of power to the local electrical utility. The Debtor will have a **Construction Contract** with the contractor for the Facility. The Debtor may have **Other Agreements** for management services, employee sharing and the like.

There are potential gaps in coverage if a Lender relies only on a Real Estate Policy.

The Facility will be assembled in place on the Real Estate and is expected to generate positive cash flow under the terms of the PPA to adequately support debt service on the Lender's loan and all other obligations of the Debtor. Assembly is a significant expense, and removal would also be a significant expense, so the Facility has its greatest value in place as a going concern based on what it can earn under the PPA.

While we will focus on the solar facility example to illustrate these gaps in coverage, the following analysis applies to power production facilities of ***all types***. There will be some differences in the characterization of different types of equipment as personal property, a fixture or real property, but all power production facilities present the same potential collateral risks for a lender who only relies on a Real Estate Policy.

Three Reasons To Insure All Assets Comprising the Power Production Facility

Lenders want assurance that their collateral coverage is adequate to support their loan and their lien on the collateral is a properly perfected first lien. However, as noted above, there are potential gaps in coverage if a Lender relies only on a Real Estate Policy.

Accordingly, a Facility presents three compelling reasons for a Lender to purchase a UCC insurance policy:

1. Critical elements of the Facility's "going-concern" value, including the PPA, the Construction Contract and Other Agreements, are not covered by a Real Estate Policy. This intangible personal property can only be insured by a UCC insurance policy.

2. One cannot be certain that all Components of the Facility will be covered by a Real Estate Policy because some might be characterized as personal property. The Lender will subject itself to the “collateral roulette” risk discussed below and, as will be seen, may be without coverage with respect to critical elements of both “inherent” value and “going-concern” value of the Facility.
3. The Lender can obtain priority over an owner or encumbrancer of the Real Estate with respect to readily removable items not primarily used in the operation of the real estate, but only if the Lender is perfected by filing under the Uniform Commercial Code (“UCC”) before the items become fixtures. It can also protect itself as a Real Estate encumbrancer by being perfected by filing under the UCC before goods become fixtures. These non-fixture filings are not covered by a Real Estate Policy. Note that in these scenarios a bankruptcy trustee would be able to take advantage of a loss of priority under its strong-arm powers.

The lender will subject itself to the “collateral roulette” risk and... may be without coverage with respect to critical elements of both “inherent” value and “going concern” value of the facility.

Collateral Roulette

Title Policies cover goods that are incorporated into real estate and goods that have become fixtures, but do not cover goods that retain their character as personal property. For a Facility, where Components are attached to the Real Estate by various means and degrees, directly or indirectly, and in many cases are readily removable without damage to the Real Estate, careful analysis is required to determine which Components become real property or fixtures as a result of such attachment.

Although a complete discussion of the law of fixtures is beyond the scope of this article, some key aspects of what is typically a fact-specific analysis are apparent. In general, there must be some degree of attachment to real estate for an item to be a fixture, but readily removable items, where removal does not damage the real estate, may not be treated as fixtures. If the item in question is attached for the purpose of enabling the building to achieve its own function, such as a boiler or an air conditioning system, or if the installation is custom fit to the building (a solar water heater for example), it will more likely be a fixture. Courts also look to the intentions of the parties as expressed in their agreements. In many solar power production facilities built on leased real estate, the lease clearly specifies that the solar panels are not part of the real property and will (and may) be removed upon the termination of the lease.

The vagaries and uncertainties of goods and fixtures are expressed well in a 2011 article on fixtures by Brennan Posner at the Sutherland Asbill law firm. Posner concludes his article with this heading: “Belt and Suspenders Protection is Best”. Posner notes that “when collateral consists of goods that might be or become fixtures, ‘belt and suspenders’ protections should be the creditor’s guiding principle. A creditor cannot conclusively determine in many instances whether a good is or is not a fixture and it cannot predict or prevent all circumstances under which that good might become a fixture”.

The following table illustrates, by type of property, whether or not any of our compelling reasons for acquiring a UCC insurance policy apply.

Collateral Roulette Risks

KEY: Yes No

Type of Property	Character	Does UCC insurance add value?	Collateral Roulette?	Potential Priority Loss?
Fee Simple Real Estate	Real	No	No	No
Leasehold Interest	Real	No	No	No
Building and Related Structured Support	Real	No	No	No
Integrated Building-Related Fixtures Attachment equipment — not removable without damage — required for the physical operation of the building (HVAC, elevators, brackets, frames, wiring and jacks)	Real or Fixture[1]	No	No	Yes
Traditional Building-Related Fixtures Attached equipment that relates to building function or essential use (solar water heater, refinery equipment, boilers, elevators, turbine housings, gas or steam generators)	Real, Fixture or Personal	Maybe Complete coverage when coupled with a Real Estate Policy	Yes	Yes
Trade Fixtures Attached equipment — readily removable with no or repairable damage (tooling machines, web presses, casino equipment, medical equipment such as MRI, CAT scanners)	Fixture or Personal	Yes	Yes	Yes
Trade Fixtures (Energy) Attached equipment — readily removable (solar panels on a solar farm, solar panels on a roof top — solar panel assemblies, wind turbines)	Fixture or Personal	Yes	Yes	Yes
Goods Unattached equipment and inventory	Personal	Yes	No	No
Power Purchase Agreement Contract rights and accounts	Personal	Yes	No	No
Construction Contract Contract rights	Personal	Yes	No	No
Other Agreements Employment, management and maintenance contracts	Personal	Yes	No	No
Project Documents Plans and more	Personal	Yes	No	No
Governmental Approvals and Permits	Personal	Yes	No	No
Deposit Accounts and Securities Accounts	Personal	Yes	No	No
Pledged Equity in Debtor	Personal	Yes	No	No

[1] These answers take the uncertainty of the fixture case law into account, but assume a court would not reach a highly unusual outcome.

Practical Impact

A Lender to a traditional commercial real estate development will make a loan only if it obtains a Real Estate Policy that covers all of the real property collateral for the loan, including the rental revenue that arises from the property. A Lender to a Facility should want similar coverage for its collateral. Because the personal property associated with a Facility has substantial value as collateral and includes a Facility's revenues, similar coverage would require both a Real Estate Policy and a UCC insurance policy. The going concern value of a Facility is covered only when both the personal property assets of the Facility are secured and insured under a UCC insurance policy.

To the extent Facility assets include readily removable fixtures not primarily used in the operation of the real estate, the Lender has the ability to obtain priority over a landlord or mortgagee (and bankruptcy trustee), but only if the Lender's security interests in such assets was perfected by filing under the UCC before they become fixtures. Similarly, a lender relying on a mortgage or deed of trust will want to protect its priority in goods that are to become fixtures on the mortgaged property by having a perfected security interest under the UCC prior to installation. UCC perfection and priority are covered only by a UCC insurance policy.

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Even if a Lender believes it has sufficient value in the Real Estate and fixtures covered by a Real Estate Policy, it needs to account for the uncertainty and ambiguity that exists in practice and the related case law regarding fixture status. A competing secured party with priority in a critical component has the right to repossess or disable its collateral when its debtor defaults. Playing "collateral roulette" should not be an acceptable solution if the Lender wants full coverage, especially when a Real Estate Policy and a UCC insurance policy can be purchased as a package.

Contact the Author

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