

Properly Categorizing Commercial-Scale Solar Energy Assets

Whether a solar asset is classified as realty, a fixture or personalty will have important ramifications on project financing issues.

■ Sosi Biricik & Dan Black

A lender that finances the construction of a commercial-scale solar energy project in California will require a perfected security interest in the assets constituting the project. Large-scale photovoltaic installations or concentrated solar power projects must be attached, affixed or in some way fastened to the land.

The methods of affixation are numerous, but they all raise one common question: For the purposes of perfection of the lender's security interest, are these assets realty, fixtures or personalty?

Division nine of the California Commercial Code establishes priorities among creditors based on different filing procedures to be followed for different categories of property. Prior to completion of the project, the physical components of a solar power project - its panels, materials, etc. - may be in any number of stages of assembly, manufacturing or fabrication.

Prior to assembly and installment on the land, such materials would be categorized under the code as a good and would be characterized as personalty. However, once those assets are fully assembled and installed on the land and are subsequently put into use, the question arises as to

whether such assets retain their classification as personalty, or whether they instead become fixtures or realty.

These three characterizations may be thought of as a points on a continuum, where the left end represents assets that are freely moveable and not a permanent part of the realty.

The middle of the continuum represents assets that are affixed to realty but that still retain their separate character as fixtures. The far right end of the continuum represents a point where the assets become so integral and permanent to the realty that they cease to be separate therefrom.

The right end of the spectrum represents assets that are characterized as realty. Under the code, real property "consists of (1) land, (2) that which is affixed to land, (3) that which is incidental or appurtenant to land and (4) that which is immovable by law."

For the purposes of perfection, the code recognizes that ordinary building materials (such as concrete and lumber) that are personalty at the time of sale may later become an integral part of the real estate and, therefore, do not retain their personalty character for the purpose of financing. Instead, these building materials are treated in the same manner as the realty itself.

However, the vast solar photovol-

taic arrays or parabolic-trough concentrating solar power projects that are typically spread out over acres of land in remote locations are distinguishable from materials such as cement that are incorporated into a building and become an integral part of the improved real property.

A solar array that is merely affixed to land or even attached to a structure is distinguishable from the cement, lumber, tile and brick used to construct the structure. Therefore, if a solar array is not realty, the question then becomes whether the array should be classified as personalty or fixture.

An affixed array

The components of a solar project prior to installation would be categorized under the code as goods. For example, components of a photovoltaic array that are not yet in use and that are sitting in a warehouse almost certainly retain their character as personalty. However, when the array is installed on the realty, its characterization as personalty versus fixture is not quite as clear.

Although the code determines the outcome in fixture conflicts between secured creditors, it does so without elaborate definition of the term "fixture." The code simply states, "'Fixtures' means goods that have become so related to particular real property that an interest in them arises under real property law." Therefore, in order to determine whether or not the asset is a fixture, the lender must look outside the code to California's real property law.

In defining "fixture," the California Civil Code states the following: "A thing is deemed to be affixed to land when it is attached to it by roots, as in the case of trees, vines or shrubs; im-

bedded in it, as in the case of walls; permanently resting upon it, as in the case of buildings; or permanently attached to what is thus permanent, as by means of cement, plaster, nails, bolts or screws.”

The California courts have followed the landmark case of *Teaff v. Hewitt* that established a three-part test for the characterization of fixtures. In determining whether or not an article is a fixture, the courts consider three criteria: (1) the manner of its annexation, (2) its adaptability to the use and purpose for which the realty is used, and (3) the intent of the parties making the annexation.

In resolving the question of whether or not an article constitutes a fixture, intent is regarded as the crucial and overriding factor. The other two criteria are considered subsidiary factors relevant to the determination of intent.

In determining whether an article attached to land becomes a fixture, the first test is to determine whether or not the article has been annexed or affixed to the realty, either actually or constructively. As described earlier, actual annexation or affixation occurs when an article is imbedded in, permanently resting upon or permanently attached to the realty.

Of course, personalty may be attached to realty by means other than those enumerated in the Civil Code - for instance, adhesives, moldings, ties and other such fastening may constitute annexation. “The fact that a screw or nail fastens the article to the realty is not determinative of its permanent attachment to the realty,” the code says.

Constructive annexation acknowledges that an article need not be physically attached to the real property by nails, screws or cement. Even if it merely rests on the surface of the land or the building and can be easily removed, the article may be constructively annexed if it is necessary and convenient to the use of the realty.

In determining whether an article

attached to land becomes a fixture, the second test is to determine whether the article is particularly adapted for use on the realty. An article will be characterized as a fixture when it is necessary or helpful in using the realty, if it is an integral and indispensable part of the realty or if it would damage the realty if severed.

The most important criterion in the three-part test for determining whether an article is a fixture is whether the parties intend the article to remain personalty or to become a fixture. Under this test, an article remains personalty if the parties so intend, unless the article has been absorbed into the real property in such a manner that its identity as personal property is lost.

For example, when an article cannot be removed without practically destroying it or the realty, or when it is essential to support the structure to which it is attached, the article is not personal property. This means that, in many cases, the parties may specify the character of an article - whether personalty or fixture - and “the courts will give to the property the character which the parties themselves have fixed upon it.”

Absent an express provision, intention may be inferred by reference to the terms of an agreement between the parties, the language used, the circumstances under which the agreement was made and the purpose for making the agreement.

Even without a written agreement, the courts may infer the parties’ intention in light of (a) the nature of the article; (b) the relationship between the parties involved (for example, whether the debtor is a tenant or owns the underlying realty to which the personalty will be attached); (c) the degree of annexation; and (d) the purpose of annexation.

California test cases

While no California case has addressed the characterization of commercial-scale solar power proj-

ects, a number of courts in California, as well as outside the state, have analyzed the characterization of assets such as solar water heaters, electrical generation equipment and other related devices.

One such case employed the three-element test to characterize a solar water heater. First, the court found that the solar water heater met the criteria for the first element of annexation because the water heater was affixed with bolts and was connected to the structure’s plumbing.

Second, the court found that the water heater met the criteria for the second element because the water heater was specifically manufactured and fabricated for use on and with the specific structure. It found that the solar water heater was “perfectly adaptable to the [structure].”

Finally, the court found that the water heater met the criteria for the third element because the parties intended the solar water heater to become a permanent fixture on the realty. The court reasoned that the parties would have intended that the solar water heater become attached to the structure in such a manner that it would function through its entire useful life.

If “the parties had intended the solar water heater to perform a temporary task, measures would have been taken to assure its easy removal from the [realty].” Instead, the solar water heater was fastened with bolts, connected to the plumbing, and holes were drilled in the structure. The court held that the solar water heater was, therefore, a fixture, because all three elements of the fixture test were established.

Also illustrative are cases involving various types of electrical devices and appliances. For instance, in one case, a turbine generator was held to be a fixture.

As noted previously, the method by which a solar array is affixed to the real property is one of the three tests that lenders should analyze in assess-

ing their security interests in the assets. The more the array is cemented, bolted, buried and/or adhered to the realty, the more likely the array will be characterized as a fixture.

If the affixation is more temporary - such as through the use of weights instead of cemented footings, or fasteners instead of bolts - the more likely the array would be characterized as personalty.

Purchasing intent

Next, if a solar array is customized to fit the certain specifications of an exact piece of realty, it is more likely that such an array would be characterized as a fixture. For example, custom-made and adapted fabrications may include special footings or housings to accommodate the terrain where the array is placed or special manufacturing to meet the specifications of the power lines or power grid to which the array will be connected.

On the other hand, if the array comprises mass-produced photovoltaic panels with no specific tailoring to a specific real property, then its adaptability may be fairly general.

Of the three elements in the fixtures test, the intent element may be the one over which lenders have the most control. As is clear from most California cases, this element is significant in the characterization of fixtures.

If the credit, security and other loan agreements unambiguously express that both the lender and the borrower intend for the solar array to be either personalty or a fixture (and if, for example, other relevant contracts, such as the underlying construction documents, support such intent), then the expressed intent found in such agreements may affect the characterization of the solar array.

Once a lender's security interest has been attached to the collateral, the lender's concern will be to perfect and remain perfected in that security interest. Depending on the characterization of the asset - whether personalty, fixture or realty - the proper perfection step will be different.

To perfect a security interest in personalty, a secured party need only file a financing statement in the proper jurisdiction's filing office. For example, if the borrower is a corporation incorporated in the state of California, to perfect its security interest in the solar array, the lender would file a proper financing statement with the California Secretary of State.

To perfect a security interest in fixtures, the secured party would need to file a fixture financing statement in the county's real estate recording office where the realty is located. For example, if the solar array is to be located on the borrower's realty located in the Mojave Desert, to perfect its security interest in the solar array, the lender would file a proper fixture financing statement in San Bernardino County's recorder's office.

What happens in the situation in which the character of the solar project assets is unclear? For instance, in almost all cases, the array, troughs or parabolic dishes would need to be securely fastened to the realty with bolts, footings and cement foundations. Aspects of the solar project might also be custom-manufactured to the specific needs of the climate, terrain and power grid of the realty, or they may not be.

A lender, relying on California precedent, might believe that as long as the loan documents are unambiguous in the characterization of the solar panels as personalty, then the lender should only file a general financing statement and not a fixture filing. However, to do so would be ill-advised.

This is because a private agreement between the lender and the borrower will bind neither a bona fide purchaser of the realty nor a bona fide mortgagee, and priority and perfection are of concern to the lender.

Thus, when financing even a modest solar array, the prudent action would be for the lender to file both a fixture financing statement with the county and a financing statement with the appropriate jurisdiction.

The worst action a lender could take is to select the wrong characterization, leaving the lender unperfected and last in line behind any subsequent properly perfected lienholder.

In any case, any lender financing a large solar energy project should be particularly careful in accurately characterizing its collateral. The lender and its counsel should ensure that the loan and the security agreements are consistent and unambiguous in their characterization of the solar assets, and should further consider whether the affixation and adaptability of the solar assets comport with the security and loan agreements' characterization.

To be prudent, the lender should file both a financing statement at the appropriate filing office and a fixture financing statement with the county in which the assets are situated. These steps will help ensure that the lender's security interests are properly perfected. ☞

Sosi Biricik is counsel in Latham & Watkins' project finance and development group. Dan Black is an associate in the San Diego office of Latham & Watkins. Biricik can be contacted at (619) 238-3059 or sosi.biricik@lw.com. Black can be contacted at (619) 237-8913 or dan.black@lw.com.
