Government Recapture Rights Under ARRA's Renewable Energy Grant Program

By Sosi Biricik & Scott Morris

The American Recovery and Reinvestment Act of 2009 ("ARRA") represented a significant legislative step toward encouraging the development of renewable and alternative energy projects in the United States. Responding to the challenged tax equity market, ARRA contains a provision making tax credits convertible into an equivalent non-taxable cash payment from the Department of the Treasury. This federal money is available to all qualifying energy projects that are either placed in service during 2009 or 2010, or placed in service after 2010 if construction for such projects began during 2009 or 2010 (www.ustreas.gov/recovery /1603.shtml). If a project qualifies, the owner is entitled to a grant, which equates to 30% of the total eligible project cost basis, in most cases.

Once money is dispersed, there remains a modicum of government oversight regarding the continued operation of the facility as a qualifying renewable energy source and the owner, thereof, as a qualifying owner. Specifically, Section 1603(f) of ARRA provides for recapture of the payment if "the project is disposed of, or otherwise ceases to be a specified energy property" within the five-year recapture period following receipt of the grant money. Recapture would mean over this five-year span, a portion of the payment received must be repaid to the Treasury.

Lenders providing long-term debt to projects receiving cash grants have had to consider whether a foreclosure on the project during the "vesting period" would trigger recapture of the grant, as well as the effect such recapture might have on a lenders' collateral package (over which project finance lenders typically hold first liens). A related concern is a change in ownership during the vesting period prompted by the borrower, its sponsor, or other equity participants in the project. Over time, lenders have become more comfortable with the grant application and disbursement process, and have been able to include loan covenants and other protections against borrower action, which might result in a disqualifying event. Similarly, lenders are also careful to ensure no disqualifying event occurs as a result of a lender foreclosure upon borrower equity or upon the occurrence of a borrower event of default. (For example, lenders may require holders of the debt and their transferees to confirm they're not "disqualified persons" under ARRA, and have developed innovative structures such as voting trusts and so-called "blocker companies" to insulate the entity, which is the grant recipient, from being "contaminated" by a disqualified person.) However, the question remains as to what risk, if any, the recapture right presents in a typical project financing.

Significantly, applicants are not required to post a bond as a condition of receiving grant proceeds and the government does not require a lien on project assets as a condition to disbursing grant money. Instead, any recapture liability is considered "debt owed to the United States," subject to the enforcement and collection by the US Department of Justice through "all available means," and against "any assets" of the applicant entity. Although this may appear to be a meaningful remedy, in cases where the applicant is a special purpose entity, created solely to hold the assets and debts of the project being developed, this entity may well be insulated from any parent companies that might have assets sufficient to satisfy any recapture liability.

Moreover, any recapture debt arising under ARRA rules are not considered tax liabilities. This implies the government will be an unsecured creditor without enhanced security rights in a bankruptcy proceeding of the project owner. Taken together, these subtleties seem to imply the government's recapture claim is only at the project owner level and, in a bankruptcy of the project company, the government would line-up behind all secured creditors—most notably the project finance lenders—to claim its share of the project company's estate. A judgment lien obtained by the government against the project company for the recapture liability would also be subordinate to prior perfected secured liens of the lenders.

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What does this all mean for project lenders and the government in the event a recipient of the cash grant suffers a disqualifying event that triggers recapture? As secured parties, the lenders would, presumably, have the prior rights to project assets—whether in a foreclosure scenario or as secured creditors in a project bankruptcy. In a foreclosure scenario, the project company could be left stripped of all meaningful assets, and the government would be required to enforce its claim against an "empty

shell." On the other hand, an equity foreclosure by the lenders may not be as attractive if the recapture right has vested in as much as the government's claim against the project company would remain, notwithstanding, the upstream change of control.

There is little, if any, guidance as to how the government would address the issue of lack of meaningful remedies to enforce its recapture claim. The government retains a mandate to recapture grant funds "by any means available," and one theory is that the recaptured amount could somehow be traced back to the ultimate recipient of the cash grant (the secured project finance lenders, for example). Is it possible the government could pursue lenders who have used the proceeds of the cash grant to repay debt on a restitution theory, predicated on an equitable injustice in allowing the project company to simply "shelter" the payment with the lender? Many industry participants might understandably assert the risk of such a creative approach is relatively small, especially given the chilling effect it would have on project development and financing that the cash grant was intended to stimulate.

One avenue to potentially reduce perceived lender risk would be to require a creditworthy parent company indemnity or guarantee of any recapture liabilities that may arise within the five-year recapture period. Of course, a project company's parent may be unwilling to provide such an indemnity, especially if the recapture event arose from actions it did not cause such as assignment of project company equity to disqualified persons by other equity participants. A sponsor may also be unwilling to provide indemnity in the event of a recapture liability stemming from an exercise of remedies by lenders.

Affiliates of the disqualified project might have more cause for concern than the project lenders. If a liable project company does not repay its grant upon a disqualifying event, the government might well seek repayment from one or more parent or affiliate companies, either through a claim of substantive consolidation in a bankruptcy scenario or by piercing the corporate veil. Substantive consolidation is a rather unpredictably used equitable doctrine that treats separate legal entities as if they were merged into a single survivor with all the cumulative assets and liabilities. The result is claims of creditors against separate subsidiary debtors become claims against the consolidated survivor; effectively exposing assets of affiliate companies to repayment of the government's missing funds. Piercing the corporate veil is a legal remedy used to reach beyond the corporate barrier to attach liabilities when corporate formalities are not followed. Again, these theories are as of yet untested in the ARRA recapture context.

In sum, ARRA Section 1603 has largely succeeded as a stimulus for new renewables projects. The requirement for commencement of construction in 2010 means construction financings will likely be active as developers seek to meet this deadline. However, participants in this program should keep in mind the government's recapture rights and ensure steps are taken to avoid a potential disqualification.

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