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Key Considerations for Back-Leverage Financings of Renewable Energy Projects

Lenders making back-levered term loans to wind and solar projects focus on tax equity terms that impact their access to project cash flows and ability to foreclose.

Key Points:

- Most operating period term loans to US wind and solar projects are back-levered to tax equity investments.
- Back-levered lenders need to understand the terms of the project's tax equity investment and how they impact the lenders' access to project cash flows and ability to foreclose.
- Back-levered lenders often require a consent to assignment from the tax equity investor to address provisions in the tax equity documents.
- Sponsors intending to obtain back leverage should consider including customary protections for back-levered lenders in their tax equity documents.

In the context of US wind and solar projects, *back leverage* typically refers to debt financing that is provided by lenders to a holding company that owns a controlling interest in a tax equity partnership, which in turn owns the project company that owns and operates the asset.

Most wind and solar projects developed in the United States are financed by tax equity investments. *Tax equity* refers to a form of preferred equity investment in which a bank or other financial investor invests in a wind or solar project in a manner that allows the investor to benefit from most of the federal income tax credits generated by the project, while the developer and the tax equity investor share the cash flows generated by the project. This structure allows a developer of renewable energy projects, which may not be a current US taxpayer, to monetize the tax benefits derived from the project.

In part due to the relatively small number of tax equity investors that are active in the market, tax equity investors have been able to dictate the capital structure of projects in which they invest. This has allowed tax equity investors to require that any debt financing that is outstanding after the tax equity investment is made (*i.e.*, during the project's operating period) be structurally subordinated (or back-levered) to the tax equity investor. As a result, the back-levered lenders make their loans to the holding company that owns the sponsor's interest in the tax equity partnership and do not have recourse to the tax equity partnership, the project company, or the project assets. Instead, the back-levered lenders receive a security interest in the sponsor's equity interests in the tax equity partnership and are dependent on the cash flows distributed by the tax equity partnership to service their debt.

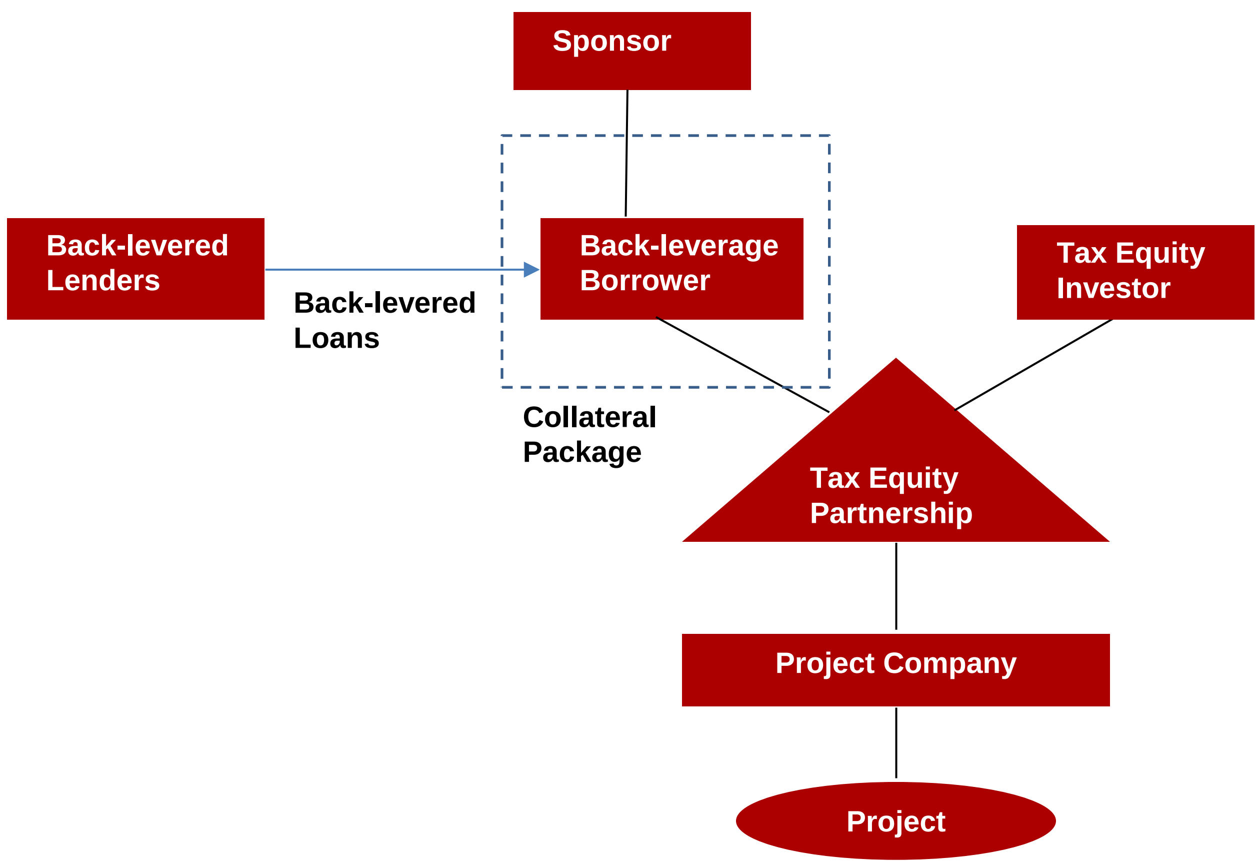
As such, back-levered lenders pay careful attention to the terms of the tax equity documentation, particularly the terms that impact the cash flows received by their borrower or the back-levered lenders' ability to foreclose on the equity in the tax equity partnership. Back-levered lenders typically require certain protections to be built into these provisions or provided through a consent to assignment entered into between the tax equity investor and the back-levered lenders.

Typical Back-Leverage Financing Structure

A typical back-leverage financing structure is depicted in Figure 1, below. Back-levered lenders enter into a credit agreement with, and make loans to, a holding company established by the sponsor to hold the sponsor's equity interests in the tax equity partnership. The tax equity partnership, which is typically structured as a limited liability company, is owned in part by the holding company that serves as the back-leverage borrower and in part by the tax equity investor. The tax equity partnership owns all of the equity interests in the project company, which owns and operates the project.

The back-leverage financing is secured by a pledge of all the assets of the back-leverage borrower, which typically consist of the sponsor's equity interests in the tax equity partnership (often referred to as the "Class B" equity interests) and one or more bank accounts (including the account that receives any distributions made by the tax equity partnership in respect of the sponsor's equity interests). The back-levered lenders also receive a pledge of the equity interests in the back-leverage borrower. The back-levered lenders do not receive any security interests in the assets of the tax equity partnership or the project company (and do not have direct recourse to either of them).

Figure 1: Typical Back-Leverage Financing Structure



Key Considerations Relating to Cash Flows

Cash flow waterfall

Tax equity documents typically include a “cash flow waterfall” provision that governs how cash revenues are distributed to the sponsor member (*i.e.*, the borrower under the back-levered financing) and the tax equity investor on a periodic basis after the operating expenses of the project have been paid. A cash flow waterfall often provides for different distribution ratios of available cash flows during different periods. During an initial period lasting until the sponsor has recovered its capital investment or until a pre-determined fixed date, the sponsor member receives most of the available cash. During the next period, the tax equity investor receives most of the available cash until the tax equity investor has achieved a target rate of return. Tax equity investments are typically structured such that the end of this second period is targeted to coincide with the end of the project’s principal tax benefits (*i.e.*, six years for investment tax credits, or 10 years for production tax credits). After the end of the second period (commonly referred to as the “flip date”), the tax equity investor receives 5% of the available cash, while the sponsor member receives the remaining 95%.

Cash flow diversion

The sponsor member is typically required to indemnify the tax equity investor for losses arising from breaches of representations it makes to the tax equity investor (which generally include representations relating to the project, the tax benefits associated with the project, and the tax equity partnership). The sponsor member also indemnifies the tax equity investor for losses arising from breaches of covenants by the sponsor member, including failure to satisfy its standard of care as the managing member of the tax equity partnership. The sponsor often is required to provide a guaranty of the sponsor member’s indemnification obligations.

To support their rights to indemnification, tax equity investors often have the right to divert project cash flows that would otherwise be distributed to the sponsor member to satisfy indemnity claims that have not been paid by the sponsor member or by the sponsor (under its guaranty of the sponsor member’s indemnification obligations).

Tax equity investors may have the right to divert project cash flows that would otherwise be distributed to the sponsor member for others reasons as well. For example, a tax equity investor may be entitled to divert cash flows if it has not achieved its target rate of return by the expected date or if its returns are impacted by a change of tax law that occurs within a certain time period following funding.

The ability of the tax equity investor to divert cash flows that would otherwise be payable to the sponsor member is of particular concern to back-levered lenders, because those cash flows are their primary source of repayment. Back-levered lenders therefore typically require that tax equity documents include protections against the diversion of all the available cash flows to the tax equity investors. In certain tax equity structures, this may take the form of an agreement specifying that the sponsor member will receive an amount of cash sufficient to pay the scheduled principal and interest under the back-levered debt before any distributions are diverted from the sponsor member to the tax equity investor. Another common approach is to limit the amount of cash that can be diverted to 50% of the cash that would otherwise be distributed to the sponsor member during the applicable period.

Sponsors that intend to obtain back-levered debt may wish to include these protections in the tax equity documents during their initial negotiation, even if back-levered lenders are not yet involved in the process.

If the tax equity documents do not include such protections, back-levered lenders may request a sponsor guaranty or a cash reserve to cover debt service that is not paid due to the diversion of distributions from the sponsor member to the tax equity investor. Such requests may lead to difficult negotiations between the sponsor and back-levered lenders.

Key Considerations Relating to Ability to Foreclose

Transfer restrictions

Tax equity documents typically restrict the ability of both the sponsor member and the tax equity investor to transfer their equity interests in the tax equity partnership without the consent of the other party, unless the transfer satisfies negotiated criteria for permitted transfers that don't require consent. Negotiated criteria for permitted transfers of the sponsor member's interest often include requirements relating to the creditworthiness of the transferee; the experience of the transferee in owning and operating similar assets, to ensure that there are no adverse effects on the ability to qualify for tax credits; the transferee not being in litigation with the tax equity partnership or the other members; and know your customer and other compliance considerations. These transfer restrictions generally apply to both direct transfers of equity interests in the tax equity partnership by members and to indirect transfers and changes of control of a member. Back-levered lenders focus on these transfer restrictions because they are typically triggered by a foreclosure on the equity interests in the tax equity partnership or on the equity interests in the back-levered borrower.

Some transfer provisions anticipate that back-levered financing will be incurred and make accommodations for collateral agents to foreclose while satisfying a more limited set of criteria, while others do not provide such flexibility. For example, tax equity documents may allow a collateral agent to satisfy any experience requirement by contracting with an experienced third-party manager and may include a carve-out from the requirement that the transferee not be in litigation with any of the members for foreclosure proceedings. When the tax equity documents do not include these types of accommodations, the back-levered lenders often seek to obtain them by including them in a consent to assignment with the tax equity investor.

Replacement of manager

Tax equity documents often provide for the sponsor member to act as the manager of the tax equity partnership and for the tax equity investor to have the right to remove the manager if certain negotiated removal events occur. These removal events may include breaches of obligations under the tax equity documents (either affirmative obligations to perform certain actions or obligations to seek consent of the tax equity investor prior to taking certain actions), bankruptcy of the manager, and violations of the transfer restrictions.

Back-levered lenders often view it as important that the sponsor act as the manager of the tax equity partnership. As such, manager removal events may trigger an event of default under back-levered loan documents, and back-levered lenders may request that the tax equity investor provide them with notice of the occurrence of any removal event and a cure period to cure the removal event.

Back-levered lenders often seek the right to appoint a replacement manager of the tax equity partnership if they foreclose on the sponsor member's equity interests (and for the tax equity documents to provide that any such foreclosure is deemed to cure any removal events that have occurred). This often requires a right to satisfy the experience requirements applicable to the manager by hiring a qualified third party to provide management services, as the back-levered lenders or their agent may not satisfy these experience requirements. These rights may be provided directly through the tax equity documents or through a consent to assignment negotiated between the back-levered lenders and the tax equity investor.

Key Considerations Relating to Project Letters of Credit

Key project documents for wind and solar projects, particularly power purchase agreements and interconnection agreements, may include requirements for the project company to provide credit support in favor of the counterparty. Often, the project company can satisfy this obligation by delivering a letter of credit issued by a lender. Such a letter of credit could be issued under a letter of credit facility obtained by the project company. In that structure, the lenders would be structurally senior to the tax equity investor (*i.e.*, the lenders would have direct access to the cash flows of the project and would be able to foreclose on the assets of the project company free of any claims of the tax equity investor). As a result, tax equity investors often require that such a letter of credit facility be structured as a back-leverage financing.

Given that these letters of credit are for the benefit of the project and therefore both of its owners (*i.e.*, both the sponsor member and the tax equity investor), tax equity investors typically agree to allow the costs of these letters of credit, and any loans resulting from drawings on them, to be paid before any distributions to the members. In this case, the tax equity documents may provide that fees relating to the letters of credit are paid to the sponsor member's back-levered lender as an operating expense of the project before determining the cash available for distribution to the members. In addition, in the event that such a letter of credit is drawn, the sponsor member is deemed to have made a loan to the tax equity partnership in an amount equal to the resulting reimbursement obligation by the sponsor member under the back-levered credit agreement. That deemed loan is then required to be repaid before any further distributions are made to the members.

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