PRESENTED AT

Renewable Energy Law

January 31 – February 1, 2017
Austin, Texas

Solar Leases for Utility Scale Installations Legal Considerations for Developers

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I. Introduction

The need for a well-crafted solar lease cannot be overlooked as it lays the foundation for a successful solar project. Every renewable energy project presents a unique set of facts and circumstances that developers and their counsel must work through to get the project built. In addition to being financeable, a good solar lease must provide the developer with the flexibility it will need to address the variety of issues that will be encountered during the development process. This paper provides core considerations and provisions for a solar developer or legal practitioner who is drafting, negotiating, or reviewing a solar lease. It is not uncommon to encounter clients who wish to convert their form wind lease into a solar lease. In some ways a solar facility is more analogous to a natural gas power plant than a wind project. Consequently, a conversion of a wind lease into a solar lease should be done carefully keeping in mind the significant differences between the surface uses presented by the projects. Throughout this paper I will highlight wind lease clauses that are either not appropriate for inclusion in a solar lease or require adjustments. The focus of the paper will be on the central provisions of a solar lease and will not address each and every clause that may be included in a lease.

II. Term Provisions.

In many respects the provisions pertaining to the various terms under a solar lease are very similar in structure to a wind lease in that both may contain a development term, construction term and operations term. As discussed in more detail below, careful consideration should be given to how each term is triggered and the types of activities that will be undertaken during each period of time.

a. Option Agreement or Lease with a Development Term?

Much like a wind lease, a solar lease may be comprised of an initial development term that should last long enough for a developer to evaluate the site and to secure interconnection, offtake, financing and other key agreements. This initial term may last five years or longer depending on market conditions that influence the availability of capital to finance a solar project. Unlike a wind project, however, a solar project has a much smaller footprint with a lot less flexibility to move project infrastructure in the event undesirable conditions are discovered. A solar project owner will also eventually need full and exclusive control over the area where the project is located. Consequently, solar developers tend to be focused on the costs and risks associated with putting property under lease. Prior to addressing in full what a development term clause may include, it is important to consider an issue many developers face initially: should the project company enter into a lease agreement with a landowner or just obtain an option to enter into a lease? Both approaches have benefits and drawbacks; however, if properly drafted, a lease may capture the benefits of an option while avoiding some of the potential drawbacks of having just an option to lease.

An option contract involving the lease of real estate typically gives the optionee the right to enter into a lease upon certain stated terms within a specified period of time, but with no obligation to do so.[1] No title passes at the time the option contract is formed.[2] In my experience developers will elect to enter into an option agreement rather than a full lease for two primary reasons 1) the developer believes an option will allow them to get the land in question tied up quickly and without the hassle of negotiating a full lease document and/or 2) the developer is concerned about environmental liability attaching to the project company if property is leased.

1. An option agreement may be faster, but not necessarily better.

With respect to the first consideration, an option agreement is faster than entering into a full lease agreement if the option does not attach a fully negotiated lease document as an exhibit. When a solar developer takes the option agreement route the option agreement typically contains the terms and conditions that apply to the option period and may either set forth key business terms to be included in the lease or it may simply state that the parties will enter into a solar lease containing reasonable and customary terms. Such an approach presents some potential risks. The biggest risk is that the developer will exercise its option to enter into the lease but the landowner will refuse to sign the lease because it finds some part of the lease objectionable or wants to renegotiate the business terms. I have also encountered situations where the landowner just changed their mind and no longer wanted to enter into a lease. Under Texas law, if a written option sets forth all of the terms on which the optionor offers to lease the property, or if an unexecuted lease form is attached to the option, the optionee's written exercise of the option may, without more, create a lease.[3] In order to avoid a potentially contentious lease negotiation and to have the clear right to specific performance, the developer would need to have attached a fully negotiated lease.[4] This approach extinguishes the desired speed factor. It could be argued that an option agreement that sets forth the key terms to be included in the lease is sufficient to obtain specific performance.[5] The problem with this argument is just that – it is just an argument the developer would presumably have to make before a judge or to the landowner's attorney.[6] Given the other documents a

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[1] *See* 17-252 Dorsaneo, Texas Litigation Guide § 252.01 (2016).

[2] *See McCaleb v. Wyatt*, 257 S.W.2d 880, 881–882 (Tex. Civ. App.—Fort Worth 1953, writ ref'd n.r.e.).

[3] *See Wilson v. Wagner*, 211 S.W.2d 241, 243 (Civ. App.—San Antonio 1948, ref. n.r.e.).

[4] A developer may go so far as to have the landowner sign the lease and have the lease held in escrow until the developer exercises its option.

[5] *See Wilson*, 211 S.W.2d at 243, Court of Appeals concluding that the option in question contained all of the essential provisions of an option for a ninety-nine year lease of real estate. Court stating, "[t]he parties are named, the property is fully and definitely described, the consideration for the option is $500; the lease when executed is to run for a term of 99 years; the rental is to be for certain specific sums per year; Wilson is to pay all taxes and assessments; the lease is to be assignable and is binding upon the heirs and assigns of the respective parties; all improvements located on the property at the end of the 99 year lease is to vest in Redmond, her heirs or assigns; Wilson has one year within which to exercise his option; when the lease is delivered to Wilson he is to pay the first year rental of $6,000; Redmond is to remove all existing structures from the property and deliver peaceable possession of the property to Wilson within sixty days after receipt of notice of Wilson's desire to exercise his option; the term of the first year of the lease is to commence upon the day possession of the property is delivered to Wilson." *Id*.

[6] The party seeking specific performance has the burden of showing that the contract is reasonably certain, unambiguous, and based on valuable consideration. *Paxton v. Spencer*, 503 S.W.2d 637, 643 (Tex. Civ. App.—Corpus Christi 1973, no writ). A contract that omits any essential terms is usually too uncertain to justify specific performance. *Botello v. Misener-Collins Co*., 469 S.W.2d 793, 795 (Tex. 1971); *Paxton*, 503 S.W.2d at 646. The terms of the contract must be expressed with enough certainty so that the court will be able to determine the duty of

developer may need to have signed by a landowner and the ongoing relationship of the parties, a developer would be ill-advised to develop a project on property where the landowner was forced to sign the lease. In other words, even if the developer has the right to specific performance, it may, depending on the circumstances, not want to avail itself to that right.

While an option agreement may provide the fastest way to secure rights to property, a developer should be cognizant of the risks outlined above. In my opinion, an option that does not attach a fully negotiated lease merely delays the lease negotiation process until the developer has less flexibility with its project. For example, if a developer waits to exercise its option to enter into a lease until it has completed its due diligence it may discover it has spent a sizable amount in development dollars on property that it is now trying to get under lease. The developer may even find itself chasing lease signatures as investors and lenders are coming into the picture. This is not the stage at which a developer wants to discover that a landowner is not ready to sign the lease. A further challenge presented by entering into an option agreement rather than a lease is that, in Texas, a title company will not provide title insurance for just an option agreement. In addition, any landowner mortgages or other encumbrances that are filed of record while the developer merely has an option on file will be considered superior to the lease. If a developer has a good relationship with a sophisticated landowner then an option agreement may be a good way forward for the parties as a temporary means of securing rights to the property. In any event, a developer should move toward a lease agreement as soon as possible.

2. <u>Environmental Liability</u>

The other common reason for a developer to elect to use an option agreement rather than a lease relates to concerns regarding environmentally liability that may attach as the result of the project company having a leasehold interest in the property. I should note here that I am not an environmental law attorney and there may be other legal issues to consider when evaluating environmental liability. What follows are my conclusions of how to obtain the benefits of having the limited site control that an option arrangement provides with the benefits that come with having a lease in place.

Given that a developer may know virtually nothing about a piece of property as it prepares to place the land under lease, concerns regarding environmental liability are well placed. For purposes of CERCLA, a lessee may be considered to be an operator.[7] A lessee's liability only extends to those areas or activities where the hazardous substances are located that the lessee has authority to

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each party and the conditions of performance. As a general rule, greater certainty concerning terms and conditions is required in equity than at law. *Lloyd v. Holland*, 659 S.W.2d 103, 105 (Tex. App.—Houston [14th Dist.] 1983, no writ) (price, method of payment, and partial release clause were too uncertain for enforcement by specific performance).

[7] *See* 42 U.S.C. § 9601(20); *U.S. v. Northernaire Plating Cos*., 670 F. Supp. 742, 748 (W.D. Mich. 1987). Like CERCLA, the Texas Solid Waste Disposal Act (Chapter 361 of the Texas Health and Safety Code) makes an "owner or operator" responsible for solid waste, but fails to define the terms "owner" and "operator". *Celanese Corp. v. Coastal Water Auth*., 2008 U.S. Dist. LEXIS 50729 (S.D. Tex. July 2, 2008).

control under the lease agreement.[8] A lessee's liability, however, does not appear to attach simply because a lease agreement is in place. In the case of *Commander Oil Corp. v. Barlo Equipment Corp.*, 215 F.3d 321, 328 (2d Cir. 2000), the Second Circuit provided some examples of situations where a lessee may be considered a de facto owner for purposes of CERCLA:

> (1) whether the lease is for an extensive term and admits of no rights in the owner/lessor to determine how the property is used; (2) whether the lease cannot be terminated by the owner before it expires by its terms; (3) whether the lessee has the right to sublet all or some of the property without notifying the owner; (4) whether the lessee is responsible for payment of all taxes, assessments, insurance, and operation and maintenance costs; and (5) whether the lessee is responsible for making all structural and other repairs.[9]

The Second Circuit declined to "define with specificity those factors that might transform a lessee into an owner;" however, the factors noted above appear to have been followed in subsequent circuit court decisions. [10]

Given that there is case law which potentially extends environmental liability to a lessee, some project developers believe that the use of an option agreement is the only way to insulate themselves from such liability. If properly drafted, however, a lease may provide the same protections without presenting the vulnerabilities discussed above. Anyone familiar with Texas wind leases is acquainted with the practice of having a development term or initial term which provides a period of time during which the developer conducts its initial due diligence. A similar approach may be taken with a solar lease. As noted above, the case law relating to environmental liability of a lessee appears to focus on the level of control the lessee has over the property and the activities occurring on the property. Prior to the start of construction a solar developer typically has little need or desire to control the property and generally only needs to access the property to do environmental studies, evaluate the solar resources available at the site and to do other general evaluations. During this time, the lessor typically retains the right to access and use the property. Given the minimal amount of site control needed prior to construction, and in order to address concerns related to environmental liability, the development term (or you may even want to call it the option period) of a solar lease should clearly articulate that the developer is engaged in site evaluation and that both the lessor and lessee may use the property at this stage. Although the landowner may continue to use the property, the lease should clearly prohibit any uses that would permanently impair the future use of the property as a solar site. In addition, the solar developer should reserve the right to have any surface uses end after notice and a reasonable expiration of time as the developer prepares to enter into the construction term.

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[8] *Nurad, Inc. v. William E. Hooper & Sons, Co.*, 966 F.2d 837, 842–844 (4th Cir. [Md.] 1992), cert. denied, 506 U.S. 940 (1992); see *Kaiser Aluminum v. Catellus Dev.*, 976 F.2d 1338, 1341 (9th Cir. [Cal.] 1992) (following Nurad and adopting authority to control standard).

[9] 215 F.3d at 328.

[10] *See Next Millennium Realty, L.L.C. v. Adchem Corp.*, 2014 U.S. Dist. LEXIS 150582 *, 80 ERC (BNA) 1026, 2014 WL 5425488 (E.D.N.Y. Oct. 22, 2014).

b. Construction Term

The surface area directly and permanently impacted by the solar project's infrastructure (panels, trackers, inverters, roads, collection lines, etc.) is continuous and does not allow for the utilization of the surface for other activities. Once the project moves out of the development term and into the construction term the solar developer will need sole and exclusive control of the project area. In this respect, wind and solar projects are very different and as a consequence a solar lease should have a construction term that is distinct from the development term in order to clearly mark this shift in control. Given this need for a clear shift in control, it is beneficial to both parties for the start of the construction term to be triggered by notice to the landowner rather than the construction term being triggered by work on the ground. For example, the lease may include a clause that requires that the lessee provide thirty days' prior notice of the start of the construction term. Such notice gives the landowner the opportunity to move its cattle off the property or have its tenants clear off the property. Allowing the developer to designate the start of construction allows the parties to better coordinate on the ground logistics.

The construction term may continue until the earlier of i) the expiration of some reasonable period of time or ii) the sale of electricity from the project. Some leases contain language that triggers the operations term only if the commercial operations date is reached within a certain period of time. My strong preference is for the solar lease to automatically extend into the operations term so long as the lessee begins paying the compensation required by the operations term. For example, if at the end of a two year construction period the project has not yet made the first sale of electricity but is otherwise constructed, or nearly constructed, the lessee should be able to continue the lease into the operations terms so long as the consideration for the operations term is paid.

c. Operations Term

The final and longest period under a solar lease is the operations term which typically lasts twenty-five to thirty years with an option to extend the period for ten or twenty additional years. The operations term, like the construction term, should provide sole and exclusive control of the project site to the solar developer. The solar developer will also want the right to conduct all activities necessary to operate, maintain, and replace the project. It may be that areas that the parties believed would remain a part of the project site can be released from the lease at this stage as the final footprint of the project is determined. The lessee may need to retain certain non-obstruct rights or easement rights to areas released from the solar lease that are immediately adjacent to the project site or that are needed for access purposes.

III. Rent

There may be a tendency among practitioners to apply the payment structure of a wind lease to a solar lease. In my opinion, it is a mistake to automatically default to the complicated wind lease payment structure for a solar project. As I have noted throughout this paper, a solar project has a defined footprint rather than being diffused over thousands of acres with varying levels of surface use. A much cleaner approach is to have per acre payments for each stage of the lease including the operations term.

a. <u>Development Term and Construction Term Fees</u>

During the development term (or option period if an option agreement is being used) and construction term, rent typically takes the form of an annual per acre, or flat, fee. Developers attempt to keep the rent low during these periods so that more money can go toward site evaluation, development and construction. As discussed in Section IV below, given the intensive surface use required for a solar project, a solar developer must satisfy itself and its lenders and investors that the project will not be disturbed by mineral development. Given this additional development term task, solar projects face a potentially significant layer of development costs associated with identifying mineral owners and securing surface waivers and/or accommodation agreements from those mineral owners, which, in turn, further dictates the need for a lower development term payment.

A developer may want to structure its lease so that development and construction term payments are made monthly rather than annually in order to avoid overpaying these fees in the event the construction term starts just months after an annual development term payment has been made. The better practice is to have annual payments (the fewer deadlines you have the fewer you are likely to miss) but allow for a credit of the development term fees toward the construction term fees. In any event, the practitioner should ensure the applicable provisions are clear and complete.

b. <u>Operations Term Fees</u>

Operations term fees may be structured in one of two ways. The first, less common approach, follows the wind lease structure and provides the landowner with a payment that is the greater of a percentage of gross revenues or minimum rent (collectively "Royalty Rent"). The second, more common approach, is to provide an annual payment to the landowner, which may be paid either as a per acre or per megawatt amount ("Annual Rent").

A solar lease that uses the Royalty Rent approach will necessarily be more complicated to draft, negotiate and administer. The parties to the lease will need to come to an agreement on the royalty percentage and minimum rent along with any future increases to both. The lease will also need to define which payments are included in gross revenues and which items are excluded. Much care should be given to the gross revenues definition and the developer should address the handling of hedge and other potential costs. The developer should also ensure that it is capable of calculating and sending out the Royalty Rent payments in accordance with the lease deadlines. Landowners and their counsel may expect to see the same percentage of gross revenues provided in a wind lease in a solar lease. This expectation is misguided as the capital costs and returns for a solar project are different from those of a wind project and therefore the royalty percentages and other payments cannot be identical.

The Annual Rent approach results in a lease that is much easier to understand, negotiate and administer. With this approach the parties are simply agreeing to an annual payment in exchange for the use of the property. The Annual Rent may either increase over time based on agreed to increments or may increase each year based on CPI. Solar projects lend themselves to a more straight-forward per acre approach because the project is sited on contiguous acreage all of which is occupied by the solar company's improvements. The Annual Rent approach presents fewer drafting and negotiation challenges and the landowner and their counsel do not need to become experts on the ins and outs of the ERCOT settlement process. In addition, the landowner will be able to quantify the value of their solar lease from day one.

IV. <u>Minerals</u>

Mineral issues may be addressed in a solar lease to the extent the landowner owns an interest in the minerals. In Texas, it is rare to find a surface owner who owns all or a majority interest in the minerals and more likely than not the landowner has no interest in the minerals or only holds a small fraction of an interest. In the event the surface owner does own a mineral interest, the solar lease should address how such minerals may be developed and/or produced. Understandably the lessor will want to reserve the right to all subsurface oil, gas and other minerals. Such a reservation may be allowed *provided that* the lease includes a covenant running with the land ensuring that the subsurface minerals will not be developed using the surface of the project site and an area located between the surface and an agreed to depth beneath the surface of the project for purposes of exploring, developing, and drilling for oil, gas or other minerals. The lease should further contain language that clearly waives the lessor's right to develop, explore, or produce the minerals in a manner that will disrupt the solar facility. The memorandum of lease that will be recorded in the public record should include the restrictions and waivers related to the mineral estate.

In the event the surface owner does not own all of the mineral estate, in addition to addressing use of the mineral estate in the lease, the solar developer will need to obtain surface waivers and/or accommodation agreements from the owners of the mineral estate. Such agreements will address how and where minerals may be produced and are intended to protect the project site from disturbance by oil and gas operations. A solar developer may, depending on certain circumstances, set aside portions of its leased acreage as drill site areas for the benefit of future mineral development. For an excellent and comprehensive discussion of surface waivers and accommodation agreements please see, Gregory S. Friend, *Sharing the Road: Surface Project Development and Severed Estates*, 41 OIL, GAS & ENERGY RESOURCES SECTION REPORT Volume 1, (Fall 2016) at 55—71.

V. <u>Mortgagee Provisions</u>

This is the part of the lease where most people's eyes start to glaze over, however, in order to be financeable, a solar lease must contain certain mortgagee protections. A solar lease must provide the solar lessee with the right to sell, assign, hypothecate, encumber, transfer, grant or pledge its right, title or interest under the lease agreement and/or in the improvements placed on the property to any leasehold mortgagee as security for the repayment or indebtedness and/or the performance of any obligation. In addition, the right to mortgage the leasehold interest should not be subject to the lessor's consent. The mortgagee provision should be drafted broadly enough to capture any party who may require security from the lessee. In addition to the right to mortgage the leasehold estate, the leasehold mortgagee must also have the right to assign and enforce its mortgage, the right to assign, transfer or enforce the lease and to generally exercise any rights of the lessee. A mortgagee will require the right to take possession of and operate the solar project or to appoint a receiver to do any of the foregoing, each without the lessor's consent. A leasehold mortgagee will require that the lessor be obligated to provide the leasehold mortgagee with notice of any lessee defaults and will want an additional period of time to cure any default. A leasehold mortgagee will also want its liability to be limited to any period of time when it directly owns an interest in the leasehold estate or in the project. A leasehold mortgagee will typically want the right to obtain a new lease in the event the original lease is terminated or rejected in bankruptcy. There should also be a requirement for the lessor to provide an estoppel certificate if so requested by either a lender or tax equity investor.

Mortgagee provisions in both wind and solar leases are often the most difficult part of the lease for landowners and their counsel to get comfortable with. Developers and their counsel can provide some context and language that may ease some landowner concerns. For example, the mortgagee provision can clearly state that any mortgage granted by the lessee may only attach to the leasehold estate and shall not attach to the fee. Landowners may not like the idea of having to provide additional cure periods for the leasehold mortgagee, however, the presence of a leasehold mortgagee provides a safety net to the landowner in the event of a default. For example, if the lessee has defaulted on a payment or is otherwise in breach of the lease, the leasehold mortgagee may step in and make the payment or cure the non-monetary default. On the whole, the mortgagee provisions are tedious to read and explain but given the amount of capital at issue, the leasehold mortgagee's need to secure its investment is necessary and understandable.

VI. Termination, Default and Cure

A solar lease should address the circumstances in which the lessee and lessor may (or may not) terminate the lease. From the lessee's perspective, it will want to retain the right to terminate the lease as to all, or a portion, of the property at any time and for any reason. This right is needed for any number of reasons including the need to drop acreage from the lease in the event a portion of the property has a title problem or presents environmental liability. Termination may also be necessary if the developer concludes it cannot build its project. In each instance the solar lessee should file a release and termination of record as to the portion of the property that has been released.

Because of the ongoing capital expenditures involved in the development and building of a solar project, the lease should only allow the lessor to terminate the lease in a limited set of circumstances. An event of default clause should require that the lessor provide the lessee, and its mortgagee, with a notice of default and allow the lessee and its mortgagee with the right to cure such default. Longer cure periods should be provided for non-monetary defaults that cannot reasonably be cured within the specified period of time and for defaults which cannot be cured without the mortgagee first obtaining possession of the property. If possible, the lessee should include a clause that only allows for termination of the lease in the event of an uncured monetary breach. At a minimum, it should be clear that only an uncured material breach may result in the termination of the lease.

VII. Other Clauses of Note.

a. Conservation Reserve Program and Similar Programs

The Conservation Reserve Program ("CRP") which is administered by the United States Department of Agriculture Farm Service Agency, pays a yearly rental payment in exchange for farmers removing environmentally sensitive land from agricultural production and planting species that will improve environmental quality.[11] In the context of wind, whether property is enrolled in the CRP is of little consequence since the amount of acreage that may come out of CRP as a result of a wind project being located on the land is typically negligible, given the limited land use and the compatibility of some wind infrastructure with the program. In addition, wind turbines installed on CRP land may be considered a permissive use of CRP land.[12] In the context of solar, however, depending on the length of the contract the penalties that may result from removing the land from CRP can be significant especially if the entirety of the solar site is enrolled in the CRP. A solar developer should include a clause in its lease that requires that the landowner disclose whether the property is enrolled in the program and should obtain a copy of the contract to determine the amount that may need to be paid back to the program along with interest and penalties. The amounts that need to be paid back are likely not fatal to a project, but those amounts should be taken into account when modeling the project. The CRP contracts are typically not filed of record so the developer must rely on the landowner to make this disclosure. There are a number of similar programs administered by the USDA that likewise assess penalties for early withdrawal, consequently, this clause should be approached in a broad manner.

Land may also be enrolled in a state program that provides tax exemptions or deductions based on the use of the land. The placement of a solar project on the land may result in a reclassification of the land making it ineligible for such tax benefits going forward and triggers a rollback. Landowners typically expect for the solar developer to pay the cost of such rollbacks which could have a significant financial impact on the project. Again, a broad conversation with the landowner regarding the programs and tax exemptions applicable to the land along with an understanding of the financial implications of a reclassification and removal is important in order to properly model the project.

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[11] *Conservation Reserve Programs* available at https://www.fsa.usda.gov/programs-and-services/conservation-programs/; (last visited January 4, 2017).
[12] *See* 7 CFR 14.1410.63(d)(5) (2015).

b. Water.

Lease clauses addressing the use of water on the property should be tailored to the specific project type and property location. For example, if the solar project utilizes photovoltaic technology, the developer will likely have the greatest water usage during construction and then only modest use during the operations term for cleaning the panels and dust control. In such an instance, the developer may decide to buy water from one of the landowner's existing wells or have it trucked to the site rather than drilling its own well. If the solar project will have an on-site operations and maintenance building, then there may be a need for a continuous water supply at the site. The developer may, in this circumstance, either want to drill their own water well or determine whether utility services are available at the site. Unfortunately, the developer may not have a handle on what the most cost-effective approach is for a particular site until after the lease has been executed. The most prudent course of action is to have a lease that provides the developer the option to drill a well on the project site and utilize the water from that well.

VIII. Conclusion.

Solar developers who are actively engaged in leasing property for the development of a solar project will confront a host of issues as the development process proceeds. A lease that anticipates and addresses those issues helps smooth the development process and keeps legal costs down. A solid understanding of what a lease must contain in order to be financeable helps attract project investment and precludes the need for multiple lease amendments. Finally, a good relationship with the landowner is critical to a successful project. Being candid with the landowner and their counsel about the development/construction/operation process manages expectations and creates trust between the parties.