

LEGAL VIEW

The Green Building Lease Should Carefully Define Green Requirements and Navigate Owner-Tenant Split Incentives

By Larry Schnapf*

The past few years have witnessed an exponential growth in green buildings. The initial wave of green buildings centered on owner-occupied assets. More recently, non-owner-occupied green buildings have gained ground, becoming a larger proportion of the green building market. How does the non-owner-occupied green-building market affect commercial leases? This article will review some of the legal issues associated with commercial leases in green buildings that are not customarily addressed in the commercial leases of traditional buildings.

Green Building Lease Issues

A "green lease" is a commercial lease that has been revised to clarify the specific green building requirements that are to be attained, allocate the obligations and rights for achieving and maintaining the green building requirements, and identify remedies or consequences for failing to comply with the various green building requirements. Some building owners incorporate the green building provisions in an exhibit to their standard-form commercial lease while others have revised the body of the standard form leases on a clause-by-clause basis.

1. Identify Green Building Requirements

The first generation of green building lease agreements often just referred to a particular standard of the LEED rating system administered by the U.S. Green Building Council. However, there are no uniform federal or state standards for what constitutes a "green" building and LEED is not the only acceptable green building standard. Instead, federal, state and local governments programs tend to reference one or more voluntary consensus standards that have been developed by private, standard-setting organizations. Besides LEED, two other popular programs are Energy Star administered by the federal government and the Green Building Initiative's Green Globes rating system.

With the LEED program, since the ratings have mandatory and voluntary points, there are numerous paths to achieve a particular LEED rating. Accordingly, it may not be sufficient for a lease to simply provide that a building or tenant space will achieve a certain LEED rating. Instead, the lease should refer to the particular mixture of points that will satisfy the particular needs or goals of the parties. For example, the federal General Services Administration (GSA) green lease solicitation for offers (SFO) specifies eight LEED non-mandatory points that must be achieved.

For LEED-CI tenant spaces, the building must achieve an Energy Star Score of 75 or higher. In addition, the GSA SFO has specific language involving other components of green building design and location.

A green lease should set forth the renovation thresholds that will trigger compliance with green building requirements, such as square footage of a tenant build-out. For example, the GSA SFO requires compliance with LEED-NC for all leases, construction and renovations of 10,000 rentable square feet. In many cases, a local green building program will govern such thresholds.

The green building standards increasingly being incorporated into local legal requirements are often amended to reflect local environmental priorities. For example, many Western regional and local governments concerned about water supply constraints have imposed minimum water usage, recycling or storm water runoff requirements that may exceed minimum LEED requirements. Likewise, some jurisdictions are requiring more stringent energy efficiency standards. Many green leases now contain affirmative covenants that the tenant will use the leased premises in a manner that conforms to the building's green building requirements, or third-party certification. Some leases may prohibit uses that consume excessive energy.

If a building owner or tenant is seeking tax credits or qualifying for carbon credits, the lease should specify the level of design or operating requirements that would be necessary to maintain eligibility for that benefit. Accordingly, it is critical to be familiar with the specific requirements of any local green building program, and to incorporate any local modifications into the lease. In some cases, the parties may not want to pursue the costs of third-party certifications. If such certifications are not required by a local building code or green building program, the parties could agree that the building or tenant space be "certifiable" to a certain standard.

2. Operating and Capital Expenses—The Split Incentives Problem

Most multi-tenant leases are "net" leases where the tenant pays a base rent plus separate charges for operating costs while the landlord is responsible for capital expenses. Because the net lease effectively transfers the risks of operating costs to tenants, landlords have little incentive to make energy efficiency or other environmental investments. Likewise, tenants may have little incentive to reduce energy since they will not likely benefit if other tenants are not being energy efficient. Newer leases may allow a landlord to pass through capital improvement costs that lower operating expenses, or that are required by law.

See Green Leases, Page 9

From Green Leases, Page 8

However, these provisions do not normally authorize building owners to pass along the costs of investments that simply improve the environmental performance of the building, or comply with non-mandatory government sustainability “guidelines.” Even if a lease allows a landlord to pass along such costs as a permitted capital cost, it often does not allow recoupment of operating and maintenance costs associated with LEED for Existing Buildings (LEED-EB).

A green leases tries to better align the financial interests of both the tenant and landlord. In some jurisdictions, one way to accomplish this would be to use a gross lease in which the operating costs are built into the rent. The resulting lower operating costs could be used to lower the effective rent to attract tenants, and provide an incentive to become more efficient or simply to increase the net operating income of the landlord.

In most jurisdictions, though, net leases are the common form of leasing arrangement. One way to address the split incentive problem could be for the parties to agree that the capital costs of energy efficiency or other environmentally related improvements be considered operating expenses that are passed along to the tenant. Another approach may be to provide for individual metering of tenant spaces. This may be impractical unless all tenants agree to be separately metered. Tenants may resist individual metering because of the installation costs. Tenants that are individually metered should seek the right to audit the landlord’s energy records.

A landlord may incur other costs associated with operating a green building such as re-certification fees, re-commissioning costs, and “green” insurance for replacement of damaged building components under the green building requirements of the lease. Tenants will likely want such costs be amortized so that they pay only the portion of the cost related to the part of the premises they occupy or limit their costs to improvements that result in lower energy use. Some green leases also provide that a landlord will be entitled to all carbon-offset credits resulting from building improvements unless applicable law limits the credits to the tenant. The lease could also allow the landlord to pass along any carbon tax as an operating expense.

3. Tenant Alterations and Repairs

Commercial leases will allocate responsibility for initial build-outs to either the tenant or the landlord. Insofar as the owner or a tenant has established internal green building goals, the standard that has to be achieved (e.g., LEED-CI) should be clearly described. Standard leases also provide that a tenant shall not make alterations or additions to their leased spaces without consent of the

landlord. Often times, the leases may impose requirements on tenants that would prevent compliance with green building standards such as requiring new materials as opposed to recycled materials.

One of the difficulties met by building owners is that they may not have control over tenant build-outs where a good portion of the certification points may be accumulated. Thus, a building owner may want to require the tenant to comply with its green building requirements. Often, the landlord will seek a pre-work statement from the tenant that describes how the proposed work will comply with green building requirements. Likewise, when the landlord is doing the build-out or a renovation, a tenant will want to ensure that the work complies with its green building requirements such as LEED-CI.

4. Landlord Right of Entry and Inspection

Most commercial leases limit the right of the landlord to access the leased premises to such situations as emergency, to inspect building systems on notice and to carry out any repairs to the premises deemed necessary or desirable by the landlord. A green lease should allow the building owner to gain access to verify environmental compliance with mandated green building requirements.

5. Building Rules and Regulations

Commercial leases typically require tenants to comply with building rules and regulations and may allow the landlord to change the rules and regulations without first obtaining the tenants consent. A green lease should describe specific performance-related benchmarks. In many cases, the specific requirements are described in the building rules and regulations. Typical issues that are covered include complying with building procurement policies for low-impact environmentally products, use of waterless urinals and low-flow faucets, energy conservation/efficiency targets, including use of Energy Star appliances, specifications for HVAC systems, compliance with building recycling practices, and indoor-air-quality standards. In some instances, green leases may provide that janitorial services can be performed during normal work hours to save lighting costs, or to provide for a premium charge for cleaning services performed after normal business hours.

In general, landlords cannot unilaterally amend lease terms without consent of the tenant. In theory a landlord could implement green building requirements that would apply to existing leases by changing its rules and regulations. However, like all contracts, owners have an obligation to act reasonable under their leases and tenants could challenge attempts to impose costly new green requirements that do not benefit the tenant through amending the building rules.

See Green Leases, Page 13

From International, Page 12

Coupled with this is an individualized forecast risk-adjusted return score, developed in conjunction with a property market analysis, which is aligned with the sustainability score.

The Third Dimension syndicate members that took part in the 2008 U.K. analysis include **F&C Property Asset Management, Henderson Global Investors, Hermes Real Estate, ING Real Estate, Invista Real Estate Investment Management, LaSalle Investment Management, Royal London Asset Management, Schrodgers Property Investment Management, Universities Superannuation Scheme (USS), and Workspace Group.**

From Green Leases, Page 9

One way for a landlord to get around this issue would be to insert a reservation of rights allowing it to implement green-building requirements plan in the future that would apply to existing tenants. If third-party certification is required, the lease should specify a period for obtaining such certification. The lease should also indicate if the certification is a one-time obligation (e.g., obtain LEED-CI within 9 months of occupation) or an ongoing covenant. If the obligation is ongoing, the lease should specify frequency of re-certification (e.g. obtain LEED-O&M certification five years after LEED-CI certification).

6. Defaults, Breaches and Remedies

Not all failures to comply with green building requirements are material defaults. If the primary concern of a tenant was to achieve an energy efficient space, then the failure to obtain a certain LEED rating may not necessarily be a material breach since the building may still be energy efficient. On the other hand, a project could lose its financing, eligibility for tax credit, a zoning variance or be unable to obtain a certificate of occupancy if it fails to achieve a green building standard or certification within a certain timeframe.

In most cases, the "nuclear" option of lease termination is probably not a reasonable remedy. The best solution may be rent abatement or increased rent if a tenant space exceeds certain energy demands or water consumption. The parties may want to negotiate "cure" provisions to provide a reasonable period to correct the deficiency. For example, if a project does not obtain its LEED targeted points, the registrant can appeal. Counsel should also review grace and appeal periods in government green rules and regulations especially where a local program simply refers to the LEED standard but does not provide for a grace period.

Calendar**August 13, 2008**

NAIOP Webinar

Going Green: Tips, Tools, and Examples from the Field

Hosted by consultant Abby Johnson, the webinar will explore green buildings from a private investor's perspective.

<http://www.naiop.org>

October 1-3, 2009

West Coast Green

Mason Center

San Francisco, CA

The conference will focus on innovation in the built environment with topics geared to builders, contractors, developers, financial institutions, investors and other stakeholders.

<http://www.westcoastgreen.com>

October 14-16, 2009

ICSC Retail Green

A Conference & Trade Exposition on

Sustainability, Energy and Environmental Design

October 14-16, 2009

Renaissance Hollywood Hotel & Spa

Hollywood, CA

<http://www.icsc.org/index.php>

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