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Real Estate Law & Industry Report®

GREEN LEASING

As more building tenants indicate a preference for facilities that meet environmentally oriented standards, building owners and operators increasingly seek to attain certifications such as Leadership in Energy and Environmental Design. In this article, the author illustrates that reaching these goals can be relatively complicated and ''green lease'' agreements must be crafted to give both parties appropriate assurances as well as a degree of flexibility.

Green Issues to Consider in Drafting and Negotiating Office Building Leases

By Adam W. Walsh

For owners of office buildings that have delivered in the recent development cycle, it has become commonplace to seek various Leadership in Energy and Environmental Design (LEED) designations and U.S. Green Building Council (USGBC) ratings. Such designations have become a ''stamp of approval'' that the building design is energy efficient and that building operations will be sensitive to environmental and sustainability concerns. For reasons related to marketing and public policy, it is safe to assume such practices will continue for the indefinite future.

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Green issues have also affected owners of buildings that were constructed and designed prior to the recent focus on obtaining LEED designations. Many institutional landlords have adopted portfolio-wide green practices in an effort to achieve broad energy savings and other competitive advantages. Others have targeted individual buildings that might merit renovation and upgrades in hopes of attaining a LEED ''existing buildings: operations and maintenance'' designation (EBOM) and a repositioned asset.

And of course, it is often the tenant that is the driver of ''green' issues rather than an owner. More and more of corporate America has decided that its interior spaces need to be healthier, more productive places to work in order to be able to attract and retain employees. Green and sustainability matters have been a means to show that commitment. This has resulted in many corporate tenants electing to design their own premises to a LEED Commercial Interiors (CI) standard, and also exercising their considerable leverage to compel their landlords to make various base building accommodations and upgrades.

A net effect of these developments is that many office building standard lease forms require a ''greening'' in order to meet the above objectives. Any lease form that was composed prior to the last few years is unlikely to have anticipated and included lease provisions that directly address these green issues. This article will explain how those leases can be improved in order to be ''greener,'' and will suggest various compromises and

 ISSN 1944-9453

alternatives to address the inevitable pushback a drafter will receive when introducing new language regarding these green concepts.

Although green issues also permeate lease clauses such as use, insurance, casualty, and alterations, this article will primarily focus on three areas of an office building lease where the bulk of negotiations regarding green issues occur: (i) construction, (ii) tenant operations and maintenance, and (iii) the ability of landlords to pass through ongoing green operating costs and expenses to tenants.

Construction. If the lease at issue is for a recently delivered building or a building to be delivered, green construction issues play a prominent role in the provisions governing the required type and quality of the base building construction and design. For example, when selecting a building, if a prospective tenant in the market has been told that it will achieve a certain LEED or USGBC designation once the building delivers, it is not unreasonable or unfair for the tenant to request an affirmative lease covenant that such designation will actually be obtained and maintained. Although landlords will often commit to items they can control, such as how a building will be designed, constructed and operated, they are understandably averse to covenant to something they don't entirely control, such as whether a third-party certifying authority will actually grant a particular LEED status. This concern is made more acute because the authority may change the requirements for maintaining such status during the term of the lease.

However, the mechanics of LEED designation offer a way to bridge that gap. Currently, achieving LEED designations generally consists of accumulating a particular number of points on a LEED ''scorecard,'' with various amounts of points being awarded for various base building design elements, as well as for certain items that are outside the building footprint, such as proximity to public transportation. As a result, a common compromise is for landlords to covenant in a lease for a to-be delivered building that (i) the building will be constructed with the objective of achieving a particular LEED designation, (ii) that the building will, at a minimum, contain a certain number of the aforementioned elements, but (iii) that the landlord cannot guarantee obtaining the designation. This approach protects the tenant, who knows that the building will be consistent with its design expectations once delivered, as well as the landlord, who is less at risk for the possible vagaries of achieving the official designation.

There are also green construction issues inherent in the lease provisions governing the construction of a particular tenant's interior space and improvements (i.e., the ''work agreement''). These issues exist for both new buildings that will obtain a LEED designation as well as existing buildings where landlords have hopes for achieving a LEED EBOM designation in the future.

The initial issue in the lease for the tenant build-out is whether the landlord is going to require the space be constructed and designed to the LEED CI standard, the recognized standard for high-performance green interiors. Because achieving LEED CI for individual spaces is not necessary for maintaining an overall LEED building designation, few landlords are mandating such a requirement. A more common provision is for the tenant's design team to contain at least one LEED accredited professional (often the tenant's architect), so that landlords can be ensured that sustainability objectives are being taken into account.

Although constructing to LEED CI is not often a requirement, there are specific means and methods with respect to construction and outfitting of a particular space that may impact a building's overall sustainability goals. As such, landlords are prudent to insist on certain green requirements governing a tenant build-out, particularly if the tenant is selecting the general contractor and managing the construction process. These requirements include the tenant causing its contractors to comply with specified construction indoor air quality (IAQ) guidelines, particularly for partially occupied buildings, and with construction waste management specifications. These guidelines and specifications are published by the USGBC and can be attached to the lease. Also, a common requirement is that the tenant purchase and install plumbing fixtures with flow/flush rates that are in compliance with the EPA's Water Sense program, and that any newly purchased equipment will be Energy Star complaint. The foregoing purchase and material requirements have proven not to be too controversial, as it is often the case that a tenant moving into and constructing new space purchases new equipment. Tenants are understandably much more resistant to these provisions if they are compelled to replace existing equipment that is still viable, as may be the case for a less comprehensive build-out.

Operations. Even after the building has been delivered, the tenant build-out is complete, and the LEED designation has been achieved, green issues remain relevant. One specific area of the lease that is heavily negotiated are provisions governing tenant's operations. Tenant's operations and activities within the building and its space during the term may have an impact on landlord's ability to maintain a LEED designation, or, more likely, may have an impact on the landlord's ability to achieve the energy savings and efficiencies that were one of the underlying rationales for going ''green'' in the first instance.

For these reasons, green provisions that govern a tenant's activities during the term are becoming more common. These provisions range from the general to the specific, and contain both affirmative and negative covenants. For example, from a landlord perspective, general language should be added that tenant acknowledges the building currently has, or may seek in the future, a USGBC or ''green agency'' rating, and that as a result, the building will be operated pursuant to landlord's sustainable practices and that they be modified from time to time. The general language requires tenant to comply with this practice, and prohibit any action that could jeopardize such rating. The general language is then often supplemented with specific examples of possible sustainability provisions, such as:

(i) whole-building operations and maintenance issues including: chemical use, indoor air quality, energy efficiency, water efficiency, recycling programs, exterior maintenance programs, and systems upgrades to meet green building energy, water, indoor air quality, and lighting performance standards; and

(ii) specific operational examples such as the use of lighting controls, turning off lights and equipment at the end of the work day, and purchasing Energy Star qualified equipment, including but not limited to lighting, commercial and residential quality

  REAL ISSN 1944-9453

kitchen equipment, and purchasing products certified by the EPA's Water Sense program.

Other than recycling provisions, which have gained rapid acceptance as a result of overlapping governmental requirements, language similar to the above has created a fair amount of controversy. Tenant objections have two similar threads: (i) the provisions are too amorphous, and are subject to change, making tenants unwilling to agree without knowing exactly what they are agreeing to, and (ii) a fear that the provisions will result in the tenant incurring significant unbudgeted and unwarranted expenses.

These objections can usually be addressed in a variety of ways. With respect to the cost issue, most landlords will agree that a tenant should not have to incur a material out-of-pocket, non-reimbursed accretive expense solely as a result of complying with these green operational provisions. Typically, what a landlord should require from tenants is general cooperation and the sharing of information, particularly if electricity is sub-metered. For similar reasons, the language is often massaged by indicating that the tenant is merely required to use ''commercially reasonable efforts'' to comply with these operational provisions. This makes the provisions more aspirational, as opposed to a strict covenant that could result in a breach and lease termination if compliance by tenant ever becomes an issue. But because landlords are primarily looking for cooperation rather than a strict regulation of activities, they are often amenable to such an accommodation.

Operating Expenses. Although tenants may not be asked to directly incur any additional material expenses in connection with their own internal operations resulting from being in a green building, they are likely to be asked to indirectly share in the building's operational green expenses that are incurred by landlord over the term of the lease. This is because there may be expenses that a landlord incurs in operating a green building that would not be present in a non-green building. Because a landlord can justifiably argue that the tenants get a benefit from being in a green building, and that overall energy expenses will ultimately be lower over time, there has been general, grudging acceptance in the tenant community that at least a portion of a landlord's ''green'' expenses are permissible ''pass-throughs'' in an office lease.

As such, landlords should take a fresh look at the operating expense portion of their leases to make sure that such expenses would be covered and not subject to a broadly worded general exclusion. To avoid doubt, many landlords have added specific pass-through language to the effect that operating expenses include ''all operational Building costs incurred by Landlord in order to maintain any Green Agency (e.g. USGBC) Rating for the Building.'' Because the requirements to maintain this rating may change, it is preferable for landlords to have the language worded broadly to provide for maximum flexibility.

Of course, any new operating expense inclusion language will provoke exception language from any tenants, and landlords should be prepared for that. For example, for new buildings, most of the costs necessary to attain the green rating were inherent in the initial construction of the building, and therefore would not be permissible pass-through costs and are properly excluded. For an existing building that is seeking EBOM status, many of the initial green costs to achieve that designation may be in the nature of capital improvements. If so, any attempt to pass those costs through would be subject to the typical qualifications on amortizing the costs over the term of the improvement, and perhaps only passing the cost through if actual energy or other expense savings were realized as a result of the capital improvement. Not surprisingly, the most resistance to green operating expense pass-throughs comes from tenants entering into leases at existing buildings where the LEED designation has not been achieved, but landlord is looking for flexibility in the lease to pass items through if such status is achieved in the future. It is not uncommon for landlords in those situations to agree to cap the annual green-specific expenses that would be passed through, at least with respect to larger tenants. If there is a new ongoing green expense that is added during the term of the lease that was not present in the tenant's base year for operating expenses, landlord could retroactively attribute such a base amount to the expense. This practice essentially minimizes tenant's monetary liability for the increase in the expenses over the remaining term of the lease (and effectively excludes the initial startup cost of the expense).

In sum, recent green developments in the commercial real estate industry warrant taking a fresh look at ''sprucing up'' a standard lease form to include green concepts. Although the lease provisions remain new and will require an active dialogue between the parties, the good news is that as the provisions become more common, a market set of compromise positions is developing that often works for both parties.