“GREEN” LEASING: A PRACTITIONER’S OVERVIEW

by

John M. Sharp, Stoel Rives LLP

Published in the

Washington State Bar Association *Real Property, Probate & Trust Section Newsletter,*

Summer 2009

I. INTRODUCTION

The “green” building movement is advancing quickly despite the Great Recession’s negative impact on the construction of new (and the retrofitting of existing) homes and buildings. Just a few years ago, the notion of building green was, as observed by one legal expert, chanted more often around campfires (think “Kumbaya”) than it was welcomed in corporate board rooms. But the times, as Bob Dylan noted, they are a-changin’.

Green building (part of the larger movement known as “sustainable development”) has become much more than an aspirational, touchy-feely concept. It is now being driven by government regulation, market demand, shifting societal expectations and good business judgment. A lease of space in a newly constructed green building or an existing conventional building that is to be renovated as a green building (green leasing) is following suit.

The recent rollout of programs such as the “Certified Green Broker” by Washington’s Commercial Brokers Association (“CBA”), and the “Green Broker” conference jointly sponsored by the CBA and the Cascadia Region Green Building Council, indicates that the commercial broker community is rapidly becoming educated in this field. The International Council of Shopping Centers’ upcoming “Retail Green Conference and Trade Exposition on Sustainability, Energy & Environmental Design” further evidences the momentum behind this effort. Clearly, to stay relevant, lease practitioners will need to add green leasing to their bag of tricks.

II. WHAT IS DRIVING SUSTAINABLE DEVELOPMENT AND CONSTRUCTION?

There are myriad examples of sustainable development and construction. For example, building in a more compact and dense fashion than in the past, developing mixed-use and transit-oriented projects, erecting green buildings and constructing in ways that minimize impact on the surrounding area all constitute forms of green development. To the extent this differs from past practice, and can oftentimes cost more and take longer than traditional construction, why is it being done?
Climate change gets part of the credit (or blame) for this effort as our collective concern over global health is reflected in state, regional, county and city initiatives. The market is also at play in a variety of ways. Obvious examples include changing tastes and societal demands driven by the adverse reaction to rising energy costs and the desire to reduce our carbon footprints.

Legislative responses to these engines of change have included the City of Seattle Environmental Management Program’s Sustainable Building Policy, Resolution 30121 (2000); the King County Green Building Initiative (2001); the Governor’s Executive Order 05-01, Establishing Sustainability and Efficiency Goals for State Operations (2005); Revised Code of Washington Chapter 39.35D, High-Performance Public Buildings (2006); and the King County Green Building and Sustainable Development Ordinance (2008).

To standardize the field of environmentally sustainable development and construction, several third-party rating systems have been created, the two best-known being LEED (U.S. Green Building Council’s “Leadership in Energy and Environmental Design”), developed in 1998 (with version 3.0 having been launched in late April 2009), and Green Globes (Green Building Initiative’s Green Globes for Continual Improvement of Existing Buildings), released in Canada in 2002. There are now over 3,000 LEED-certified projects in the United States.

III. PROPERTY AND DIRECTIONAL GOALS – FOUR KEY QUESTIONS

To understand this area of leasing practice, we must be able to answer four key questions:

A. What Is a Green Building?

A green building is one that incorporates sustainable development principles to ensure that the ongoing operation and maintenance of the building minimizes environmental impacts. Goals include and relate to choosing a sustainable site (e.g., finding one with access to mass transit); water efficiency (e.g., using high-efficiency fixtures and rainfall); energy and atmospheric concerns (e.g., endeavoring to reduce energy use and considering sources of renewable energy such as solar); the use of green materials and resources (e.g., using recycled and locally sourced materials); consideration of indoor environmental quality (e.g., maximizing natural light and fresh air, and using nontoxic materials and finishes); and innovation and design process.

A green building may or may not be more energy efficient. Its green attributes may simply come from being built with green materials, the use of bike racks, an aggressive recycling program, etc. However, there may well be measurable benefits. For example, operating cost decreases are typically quoted as 8-9%, and there may also be building value increases, return on investment increases and occupancy ratio increases (these are reported to be in the range of 7.5%, 6.6% and 3.5%, respectively).
B. Why Would a Tenant Desire a Green Building?

The tenant’s desire may stem from a company directive designed to enhance its reputation by adopting a mission or philosophy to be green (e.g., “reduce carbon footprint”). Additionally, health and human resource experts have found higher worker productivity and employee attraction/satisfaction/retention in a green building. Corporate profitability may increase in a variety of ways, an obvious example being the potential for long-term utility cost savings.

Companies that have either opened green stores or branches or are constructing one or more such facilities include Starbucks, PNC Bank, Wal-Mart, McDonald’s, Subway, Staples, Kohl’s and Best Buy. Patagonia and REI have opened green distribution centers (Patagonia in Reno, Nevada; REI in Bedford, Pennsylvania). Starbucks has a prototype store approved by the U.S. Green Building Council, and although now opening fewer new stores than it did a few years ago, it has set a goal that all new company-owned stores worldwide will be LEED certified by December 2010.

While the above examples are owner-occupied properties, there will undoubtedly be companies that mandate green leases going forward. Such mandates will mean more tenants looking for green buildings in which to operate. Cities such as Seattle and Bellevue have so far not mandated the use of green leases even though one (Seattle) requires that all new civic buildings be certified LEED Silver.

A Building Owners and Managers Association (“BOMA”) Seattle survey recently showed that 61% of real estate leaders believe that green buildings enhance their corporate image, and 67% of the leaders believe that over the next five years, tenants will make (and are already making) the “greenness” of property a significant factor in choosing their space.

C. What Is a Green Lease?

Despite the generic definition above, it is important to note that there is no single answer to this question. The nature of the building and the desires of each party to the lease will drive the answer. A green lease could be as involved as the 2008 BOMA model commercial lease with its green lease language (discussed below), or as simple as a standard commercial lease with a green rider. Such a rider might mandate recycling and the use of energy-efficient light bulbs and light timers, and enable the use of day-time janitorial services to reduce the use of lights and the need to heat the building after hours. In this arena, green is not black or white; green is many shades of gray.

D. Why Use a Green Lease?

A green building can cost significantly more per square foot to build. Moreover, compliance with the chosen third-party certification system is an ongoing cost (e.g., reporting and commissioning), as is maintaining and managing the high-performance building. A green lease will help ensure that the building will meet or exceed its intended performance and help the owner recoup its initial investment as well as the ongoing costs attributable to its green character. Most importantly, the landlord and its tenant must agree on objectively measurable sustainability standards and devise a lease that meets those needs.
IV. BIG-PICTURE GREEN LEASING ISSUES

Whether you advise landlords, tenants or both, there are certain “big picture” issues that arise in almost every deal. Because the green lease is still relatively new and different, these fundamental issues take on heightened importance.

From the outset, each side should seek the advice of one or more persons who are conversant with green building issues, if not actually accredited by one of the dominant third-party certification systems. Green consultants and architects are plentiful. There are now well over 100,000 LEED Accredited Professionals. As an integral member of the team, the consultant may advise as to site selection, building comparisons, cost-benefit analysis, etc. In other words, sustainability must be in mind as part of the planning process.

Once the tenant selects a building and the parties have negotiated their basic deal terms, the letter of intent (“LOI”) becomes more critical than ever. The LOI must be thorough and clearly articulate both parties’ business goals, including their green goals. For a leasing lawyer, nothing is worse than receiving a draft lease to review but no LOI to use as a road map. The stakes can be higher with a green lease, meaning that a good LOI is that much more important.

Most of us are familiar with standard form leases such as those created by the CBA. While customization of these standard forms is routine, the documents will require even more work until such time as some green forms are created and distributed. The extent of the customization will depend on the parties’ goals and negotiations, but an obvious starting point (beginning with the LOI) is to define the building’s operating program through a third-party certification system such as LEED or Green Globes. Once the operating program is defined, the lease must complement the chosen standard (e.g., reference the third-party certification system in lieu of using the term “first-class office building”). Terms such as “Carbon Tax,” “Carbon Offset Credits,” “Renewable Energy Credits” and “Greenhouse Gases” should be defined, as should expectations regarding energy consumption, if applicable. Green leases do nothing if not burden us with more defined terms.

Finally, the parties must consider mandatory versus voluntary measures. This means thinking through the ease of tenant compliance, the method of monitoring the same and the suitable remedies for failure to comply with the green measures in the lease. In short, the green elements of the relationship must be integrated into the lease so they make sense and can be enforced by both parties during the term. The parties want this environmentally conscious relationship to work, meaning that the spirit of “Kumbaya” is not completely dead.
V. CURRENT SOURCES OF MODEL GREEN LEASE LANGUAGE

There are now three readily available, complete model green leases: (1) BOMA International’s “Guide to Writing a Commercial Real Estate Lease, Including Green Lease Language,” published in June 2008; (2) the Real Property Association of Canada’s (“REALpac”) “National Standard Green Office Lease for Single Building Projects - 1.02 - 2009,” released in March 2009; and (3) the “Model Green Lease,” released in July 2009 by the Corporate Realty, Design & Management Institute based in Portland, Oregon. The BOMA document and the “Model Green Lease” can be purchased online; the REALpac form can be downloaded from the Internet for free.

The BOMA document is likely to see widespread acceptance for a variety of reasons. First, it is flexible. It contains alternative wording depending on whether the parties are drafting a triple net or a modified gross lease, a retail lease or an office lease. Second, it is annotated, providing reasoning behind most of the green sections. Despite having a notable landlord bias, it helps tenants by including possible tenant responses to some of its green provisions. Third, while drafted to be rating-system “neutral,” it borrows heavily from LEED, which is the dominant third-party certification system in this country. Finally, although there are many references to “Landlord’s sustainability practices,” the term is not defined or attached as an exhibit. This will allow the landlord to create and redefine a sustainability plan as necessary.

Other sources of model green lease language include the California Sustainability Alliance’s sample green lease provisions, and the recently released Natural Resources Defense Council’s “Energy Efficiency Lease Guidance” product. The former is helpful though perhaps a little soft (e.g., several sections begin with “Lessee and Lessor will work together to achieve” their goals). The latter, while still in draft form, focuses on increasing energy efficiency in buildings through the use of lease provisions that more effectively allocate and align the costs and benefits of energy usage by landlords and tenants.

Lastly, the U.S. Green Building Council is set to publish a guide titled “Green Office Guide: Integrating LEED Into Your Leasing Process” by the end of August 2009. Judging from the table of contents, this publication should be a superb resource. Section headings include “Why Green the Leasing Process?”; “Greening the Leasing Process”; and “Tools for Greening the Leasing Process.”

VI. THE IMPACT OF SUSTAINABLE DEVELOPMENT GOALS ON A LEASE

Sustainable development goals impact a lease in three major ways: (1) design and construction; (2) economics; and (3) operations and maintenance. Each category is addressed below.

A. Design and Construction Issues

Design and construction issues will obviously impact the building itself and the tenant improvements within it. With regard to the construction of a new green building, the process requires even greater cooperation among the landlord, the tenant and their respective contractors than we have previously experienced. The traditional work letter may not suffice, as the green
building requires more integration and coordination of the landlord’s and the tenant’s design and construction efforts.

When it comes to the design and construction of the building, the tenant may require the landlord to represent and warrant that the building will achieve a specified green (e.g., third-party) rating. The tenant may also insist on a description of the shell and core that incorporates green building elements (e.g., reuse of wastewater or rainwater, high-efficiency building energy systems or the use of onsite renewable energy). Finally, the tenant will need to consider its remedies if the landlord breaches its representations and warranties relating to the green character of the building. Termination of the lease may not be a viable option; liquidated damages or a specified rent reduction may be more reasonable.

With respect to the design and construction of tenant improvements, the landlord gets its turn. It may, for example, condition approval of the tenant’s plans, specifications and construction contracts on the tenant’s and its contractor’s intended (and promised) compliance with the designated third-party certification system. The landlord may require that the tenant’s design deliver natural light into interior spaces and use energy-efficient lighting throughout the premises. The landlord may demand the use of green materials such as recycled products, nonendangered species and nontoxic carpet, sealants, adhesives, paint and floor finishes. Additionally, the landlord may expect the use of energy-efficient equipment and appliances (e.g., “Energy Star” appliances) and green fixtures and electronics such as low-flow fixtures and toilets, submeters and light timers.

B. Economics

1. Competing Factors

Much has been written about the economics of a green lease, and in particular, what form of lease best serves the parties’ interests. The overarching goal should be to align control with responsibility, and costs with benefits. The landlord controls the building and the tenant controls its space. Tenants typically pay for what they cannot control (e.g., building-wide operating expenses), which can be viewed as reducing the landlord’s incentive to conserve resources. But if both the landlord and the tenant act responsibly in terms of the most efficient use of materials and resources, regardless of the cost of energy, both parties should benefit from lower operating costs.

The landlord will want to recover the initial, increased higher cost of constructing the green building. The higher the third-party rating being sought, the greater the cost. To recoup this money, the landlord will want to set the base rent high enough to recover its initial investment in green technologies over a reasonable amortization schedule. A tenant faced with this argument during negotiations should be aware that the tax benefits of green building technology may shorten the payback period for the landlord, so that the cost to the landlord may not be as great as a straight amortization schedule would suggest.
2. What Form of Lease Should Be Used in a Green Building?

Generally, there are three types of leases: (1) the gross lease (gross rent with no pass-through of operating expenses and taxes); (2) the modified gross lease (base rent plus pro-rata share of increases in operating expenses and taxes over a base year, or operating expenses in excess of an expense stop); and (3) the triple net lease (base rent plus the tenant’s pro-rata share of operating expenses and taxes). Practitioners debate what form of lease best serves a green building.

Some argue that a gross lease is best used for a green building because it creates an economic incentive for the landlord to reduce operating expenses and the landlord sits in the best position to do so. To quote one well-known author:

“To create the green lease we must return to the gross lease format. The gross lease, with the appropriate language, transfers the fiscal responsibility for controlling operating costs back to landlords, who are far more qualified to do so than the tenants. It creates a financial incentive for landlords to effectively design, build and manage high-performance and sustainable buildings without sacrificing comfort or service while maximizing the landlord’s return on investment.” From “Green Lease” by B. Alan Whitson, RPA (2006).

A gross lease encourages the landlord to save on base building operating expenses, and to use more energy-efficient fixtures, appliances and systems. However, a gross lease creates no incentive for the tenant to reduce its operating costs because its gross rent is fixed. This attitude is contrary to the spirit of being green.

A triple net lease creates a so-called “split incentive” insofar as the landlord pays for the capital improvements but the tenants, who pay the utility bills, benefit from the resulting energy savings. The market will push landlords using a triple net lease to keep operating costs as low as possible in order to keep the building competitive with others. Lower operating costs may justify the landlord charging a higher base rent. But if under the triple net structure the landlord cannot recoup the higher costs of its initial investment in the high-performance building, it may require a gross lease so that it can recover the benefits of reduced operating costs.

At the end of the day, most commentators feel that no one form is inherently better, and that any of the three types of leases can be made equally green. Gross leases are widely used by U.S. government agencies, and the 2008 BOMA model (as noted above) can be set up as a triple net or a modified gross lease. The “Model Green Lease” employs a modified gross format.

C. Operations and Maintenance

Finally, we turn to the lease itself. Green language may be sprinkled throughout the document, and it is most often seen in the following dozen or so sections.
1. **Right to Relocate**

The tenant (particularly if it is subject to a corporate mandate to lease in a certain caliber of green building) should try to limit the landlord’s relocation right to replacement premises that meet or exceed the green certification for its current premises.

2. **Term**

Longer-term leases are considered more environmentally friendly because they conserve resources, reduce waste and minimize the impact of a tenancy in terms of future tenant improvements. As noted in the BOMA model green lease, LEED for Commercial Interiors provides a credit for leases greater than 10 years.

3. **Additional Rent**

Beyond the usual costs, examples of annual operating charges that may be added to a green lease could include the landlord’s right to charge for insurance endorsements that would be needed to repair, replace or recommission the building for third-party recertification. Additionally, the landlord may try to pass through the costs of certifying, maintaining, managing, reporting, commissioning and recommissioning the building to conform with the third-party certification system, subject to amortization under GAAP. As always, it pays to be specific at the outset to avoid potential disputes regarding operating charges.

4. **Use**

A green lease should prohibit the tenant from using the premises in any manner that conflicts with the landlord’s sustainability practices (including any third-party certification system). This may cause the tenant to consider whether the permitted use will conflict with its business needs. For example, will the tenant’s branding be impacted by restrictions as to light emissions from illuminated signage?

With respect to sustainable building operations, the lease may require that the tenant’s construction and maintenance methods and procedures, material purchases, and disposal of waste comply with minimum standards and specifications, in addition to all applicable laws. The tenant may be required to use proven energy- and carbon-reduction measures such as energy-efficient bulbs, lighting motion sensors and timers, Energy Star equipment, etc.

As to recycling and waste management, the tenant may be required to comply with all present and future governmental requirements regarding trash disposal, and with the landlord’s recycling policy and trash-sorting/separation system. The lease may grant the landlord the right to refuse to collect or accept waste that is not properly sorted and to require that the tenant arrange and pay for its own collection in the event it fails or refuses to comply with the program.
5. **Assignment and Subletting**

The landlord may insist that its consent to a proposed assignment or sublease can reasonably be withheld in the event the proposed use by the proposed assignee or subtenant will or could cause part or all of the building to not perform in accordance with the green aspects of the lease, including the third-party certification system.

6. **Maintenance and Repairs**

In maintaining and repairing the premises, the tenant may again be called upon to support the landlord’s sustainability practices. An example would be a requirement that the tenant’s light bulbs, fluorescent tubes and lighting fixtures be environmentally friendly. To prove its compliance, the tenant may have to report its lighting purchases to the landlord.

7. **Alterations, Tenant Improvements and Surrender**

To ensure that the tenant’s alterations and improvements comply with the landlord’s sustainability practices, a qualified third-party professional may have to review all plans, materials procurement, demolition, construction and waste management procedures. The landlord may require that the tenant seek and maintain a LEED for Commercial Interiors certification for any alterations and improvements. In exchange, the tenant may try to obligate the landlord to consent in advance to any alterations or improvements that promote green goals.

At surrender, the tenant may have to dispose of all equipment, furnishings and materials that are no longer needed by the tenant in an “environmentally sustainable manner,” or recycle or reuse the same, per the landlord’s sustainability practices. The tenant may be required to report this activity to the landlord.

8. **Signs**

Depending on their signage needs, the parties may have to address the amount of light pollution and energy consumption attributable to the tenant’s exterior signage (including external lighting for passive signage). If this is a concern, there exists even more reason than normal to have an exhibit to the lease that accurately depicts and describes the desired signage.

9. **Tenant’s Equipment**

The landlord may reserve absolute discretion to limit the watts per square foot of nonstandard equipment that the tenant may install in its premises. The tenant may have to pay for extra consumption of electricity, or buy carbon offsets (credits) to try to counter the potential negative impact that its equipment could have on the landlord’s reduction targets and the third-party certification system.

10. **Services and Utilities**

The landlord may reserve the right to purchase green or renewable energy, and may require a specific release from the tenant for business interruption or damage in case off-grid energy becomes interrupted or unavailable. The landlord may also require that the tenant submit electricity consumption data to the landlord (e.g., for use with the Energy Star Portfolio Manager
tool to benchmark energy consumption patterns against a baseline). In exchange, the tenant may want to negotiate for the ability to review the building’s “Statements of Energy Performance” upon the tenant’s reasonable, periodic request.

The landlord may also want the flexibility to conduct routine cleaning during normal business hours in order to save on after-hours lighting and heating. The tenant may want to negotiate a reduced rate for such services in exchange for its willingness to allow janitorial work to be performed during the day. As to business hours, the parties may consider reducing weekday and weekend business hours, if possible, to save energy.

11. Damage or Destruction

The parties may wish to consider whether any repair or rebuilding effort should exceed the building’s “prior condition” and instead use the then-current, post-damage green building standards. This may be hard to agree upon in advance, and the property insurer may object to the extent the building’s policy does not address such upgrades as part of the replacement coverage.

12. Other Green Ideas to Consider

There are a number of other issues that may be raised by one party or the other to a green lease. For example, green building systems have detailed operating and maintenance requirements. The landlord may prepare an “Operations and Maintenance Manual” for the building and require that the tenant comply with it. The tenant may wish to require that the landlord monitor indoor air quality (carbon dioxide and ventilation) and report the results to the tenant. Both parties may agree to use “environmentally friendly” cleaning materials. The tenant may negotiate for bicycle storage and showers. The landlord may create a program to encourage the tenant’s use of mass transit, and the landlord may establish preferred parking spaces for low-emission and fuel-efficient vehicles, and special spaces for plug-in hybrid cars.

VII. VIOLATIONS AND ENFORCEMENT

As briefly noted at the end of Section IV, traditional events of default and the landlord’s remedies in the event of a default are, arguably, too harsh with respect to breaches of certain green provisions in a lease. For example, the 2008 BOMA model does not distinguish breaches of environmental responsibilities in the section governing the tenant’s failure “to perform any other term, condition, covenant or agreement to be performed or observed” under the lease. Tenants may find this broad language troubling.

The problem with some of the more generic green rules (e.g., “Tenant shall turn off all interior lights and equipment when not in the Premises” or “Tenant shall comply with Landlord’s recycling program”) is that they are well-intended but vague. Performance or compliance is difficult to monitor, and minor but routine violations would be easy to overlook. Such violations could lead to big trouble, however. What if, for example, the repeated conduct of either party interferes with the third-party certification for the building?
To avoid undoing the very benefits sought at the outset, the parties should consider when and under what circumstances such seemingly minor violations would ripen into a default, and how “failure to perform” is defined. The issues of materiality, frequency and duration of the violation(s) will come into play, making precise drafting that much more critical. The parties might consider using alternative dispute resolution to settle squabbles related to certain categories of breach. Additionally, the landlord may want the ability to fine the tenant for certain kinds of violations (e.g., repeated failure to comply with the landlord’s recycling program). In order to create enforceable provisions of this kind, the landlord should agree to provide written notice and an opportunity to cure, indicate that the fine shall not be treated as a penalty and expressly preserve its full range of remedies despite the imposition of a fine.

VIII. CONCLUSION

The green building movement is well-established, and the green lease is hot on its heels. Real estate practitioners should not be surprised if the next draft lease that crosses their desk contains some amount of green language, be it blended throughout the document or limited to a green rider stapled to the back. Knowing how to find and use existing resources to effectively negotiate the many potential green lease provisions will help ensure our continued relevance for years to come.

The assistance of Eric S. Laschever, Thomas R. Page and Steven A. Teitelbaum in the preparation of this article is gratefully acknowledged.