ABA GREEN LEASE TASK FORCE - OFFICE GROUP

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Hypothetical #1

Your client, the tenant, is obligated to construct its build-out to a certain green certification level and does not achieve it. What are the consequences and what can you do?

In this hypothetical, the tenant is presumably *required*, by the terms of its lease, to perform the build-out of its premises in a manner that would achieve a certain green certification level. If the tenant is so required, its failure to achieve the applicable green certification level may be considered a breach of the tenant's obligations under its lease.

I. DETERMINE HOW THE LEASE DEALS WITH "GREEN" BREACHES

The tenant's attorney needs to determine how such a "green" breach is addressed in the lease. Some leases, such as the BOMA green lease, treat green breaches as general defaults, i.e. defaults captured under the "failure to perform any other term, condition, covenant or agreement to be performed or observed in this lease" provision. Presumably, the standard default remedies in the lease would apply (taking into account applicable notice and grace periods). This, of course, is not ideal for the tenant in our hypothetical. Ideally, a true green lease would have provisions that specifically address a green breach or default (in addition to the standard defaults found in non-green commercial leases). The lease would clearly define the parties' green building objectives and specifically state what happens if those objectives are not met, as opposed to simply treating a green breach the same as all other defaults. While the risk of failing to achieve an agreed upon level of green certification will always be present, whether the build-out is being performed by the landlord or the tenant, the parties need to fairly and equitably account for the possibility that the desired or required level of certification may not be achieved. Applying standard lease default provisions to a green breach may not adequately address the parties' goals and objectives in their green lease.

Other leases, such as the REALpac green lease, provide that landlords and tenants shall use "commercially reasonable efforts" to cooperate with one another in the case of a party's breach of its green obligations under the lease in order to come up with a suitable remedy. Such a green breach would not be treated as a default, but rather, the parties would endeavor to work together to achieve the lease's green objectives and ultimately arrive at a remedy acceptable to both the landlord and tenant. It should be noted that the latest version of the REALpac green lease also provides the parties with an option to treat the lease's green provisions as covenants, whereby a green breach would be treated as a standard default (similar to the BOMA green lease discussed above). With respect to this hypothetical, the REALpac approach where the parties do not treat green breaches as lease defaults would be much more favorable to the tenant. Instead of being held in default (and possibly subject to severe landlord remedies), the tenant would get together with the landlord and come up with possible solutions to the problem. Whether or not

this approach is feasible in the real world would likely depend largely on the particular landlord/tenant relationship.

II. MATERIALITY OF THE BREACH

The tenant's attorney also needs to be cognizant of the seriousness of its client's failure to achieve the promised green certification standard, and the impact this will have on the landlord's project. Will this type of breach jeopardize the landlord's financing or its ability to obtain incentives such as tax credits? Will the breach impact the landlord's ability to have the project certified to a certain green standard or will the breach affect the current green certification of a building? If the answer to any of these questions is yes, then the tenant's failure to achieve a certain required green certification will likely be a material breach of the lease. Consequently, the landlord will be much less likely to take the softer REALpac green breach stance discussed above.

III. EXAMINE DEFAULT REMEDIES

Once the tenant's attorney has examined the event of default provisions in the lease, the attorney should next focus on the landlord's applicable default remedies. Does the lease have remedies that relate specifically to green defaults? If so, are the remedies tied to the level of materiality of the default? Ideally, the lease will contain notice and cure provisions, allowing the tenant adequate time to confer with its contractors and green consultants in order to determine the proper course of action to either fix the construction issues or appeal the denial of certification.

IV. LOOK TO THE CONSTRUCTION/ARCHITECT CONTRACTS

A tenant who fails to achieve a certain green certification standard for its premises may look to hold its contractor and/or architect liable for such failure. The key concern here is with the service agreements that the tenant entered into with the contractor and architect. Unfortunately for the tenant in our hypothetical, contractors and architects are hesitant about incorporating specific green certification levels into construction or design contracts, as such provisions could be viewed as a guaranty or warranty by the design professional to the tenant. It should be noted that most professional liability policies for contractors and architects exclude coverage for claims arising out of a breach of warranty or guaranty, so the contractor and architect's reluctance to make such warranties and/or guaranties is understandable. Perhaps the tenant was able to negotiate a liquidated damages provision in the contract if the applicable green certification level was not attained. Of course, the contractor or architect will try to limit such damages to the extent the failure to attain the certification was caused by another party performing professional services at the premises.

V. GENERAL TENANT AND LANDLORD PERSPECTIVES AND CONSIDERATIONS REGARDING TENANT BUILD-OUTS AND THE ACHIEVEMENT OF A CERTAIN GREEN CERTIFICATION LEVEL

When negotiating a new green lease or lease amendment, it is important to keep in mind the following points, both from a tenant's perspective (in order to avoid the situation presented by hypothetical #1) and from a landlord's perspective (to be able to adequately deal with a tenant that has failed to achieve a certain required green certification standard).

TENANT

- NO GUARANTY TO ATTAIN GREEN CERTIFICATION. When negotiating a green lease, the tenant should do everything in its power to avoid agreeing to language that would obligate the tenant to achieve a certain green certification. It is difficult to make a guaranty in the lease that a certain green certification will be achieved and maintained because the project architect, general contractor, subcontractors, and the USGBC will all play a major role in determining whether or not the tenant's premises ultimately will meet the required certification level. The issue is largely about control. The tenant will not be able to control all of the activities of its design/construction professionals, and therefore, should not make any guaranty that the premises will achieve a certain green certification level. At best, the tenant may agree to use "commercially reasonable efforts" or "good faith efforts" to achieve a certain certification (but the parties could later disagree over what constitutes "commercially reasonable" or "good faith" efforts). Would a landlord find it acceptable if the tenant simply agreed to hire a LEED Accredited Professional and to go through the LEED application process (which is a very thorough process)? What would the impact be if the tenant said the project will be LEED "certifiable" as opposed to LEED "certified"?

- STAY CLOSELY INVOLVED IN THE BUILD-OUT PROCESS. Because there are typically a number of parties involved in the process of construction and certifying a tenant's premises as part of the LEED designation process, it is critical that a tenant work together and stay on the same page with all architects, contractors, consultants and other professionals involved in the project. This means staying involved throughout the entire build-out process, from site selection, plan preparation and lease negotiation through to the final build-out of the premises.

- LIMIT LANDLORD REMEDIES FOR GREEN BREACH. If a landlord insists on making breaches of green leasing provisions a default under the lease, specifically for the tenant's failure to achieve a certain green certification standard, then the tenant should attempt to limit the landlord's remedies as much as possible. Tenants could benefit from cure periods that allow for correcting mistakes that led to a certification denial (including adequate time to reapply) and/or time to appeal the original certification denial. Also, the tenant may benefit from having an alternative dispute resolution provision in the lease, providing for either binding or non-binding means of addressing the non-compliance with green lease provisions.

- CONSTRUCTION/ARCHITECT CONTRACTS. With respect to a tenant's contracts with architects and contractors, the tenant will want to protect itself by specifically describing the applicable green certification level desired and the financial incentives (tax credits, etc.) available to the tenant at the premises (should the premises be certified). The tenant will also want to spell out each party's liability for its own green performance and the exact amount of damages to be paid by any party which fails to meet its obligations.

LANDLORD

- DEALING WITH A TENANT'S GREEN BREACH: From a landlord's standpoint, a tenant breach of green provisions in a lease should be treated as an event of default. Because such a default may jeopardize (i) the landlord's financing, (ii) financial incentives (availability of tax credits), (iii) a building's certification to a certain green standard, or (iv) the ability to obtain certificates of occupancy, the landlord should consider making a green breach an automatic default, with no applicable notice and/or cure provisions in the lease. Of course, the materiality of the breach will certainly factor into the lease negotiation process. Breaches such as failure to comply with recycling requirements or leaving the lights on at night should not necessarily merit an automatic default (unless such breaches are continuous/repetitive and on-going); material breaches, however, such as the failure to achieve a certain green certification standard, should be dealt with more harshly.

- DEFAULT REMEDIES: If any green breach results in a loss of certification under any standard, interferes with the landlord's efforts to obtain certification under a standard, or precludes or prohibits certification under a standard, the tenant should be liable for any and all losses or damages suffered by the landlord as a result of the green breach, including but not limited to reimbursement of any and all costs expended by the landlord in obtaining or seeking certification under a certain standard (but would this position also make a tenant liable for consequential damages?). The landlord should be entitled in its sole discretion to receive reimbursement for such costs either upon demand, or through an increase in base rent, the amount of which shall be determined in the landlord's reasonable discretion. Other landlord remedies for green breaches may include self-help rights, lease termination, and/or ability to remove non-complying improvements or equipment. Finally, the landlord may want to consider negotiating a liquidated damages remedy into the lease, as certain tenant breaches involving green obligations under a lease may result in damages which are difficult to predict.

- OTHER ISSUES INVOLVING TENANT BUILD-OUTS. Unless the landlord provides specific building-standard specifications, the landlord may have very little control over the tenant build-out to ensure that the tenant achieves the desired green certification standard. Thus, the landlord will want to make sure that the lease requires the tenant to comply with the landlord's sustainability plan or other green requirements applicable to the project. The landlord can require that the tenant use a LEED or green consultant or

approved contractor for the tenant's work. Landlords may also consider implementing a green tenant handbook for tenant build-outs, setting forth certain green building materials, cleaning products, utility systems, and local vendors. Finally, the landlord should maintain the right to access the premises during construction to inspect and verify that tenant is complying with sustainability plan and the building's green requirements.

ABA GREEN LEASE TASK FORCE - OFFICE GROUP

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Hypothetical No. 2:

Your client, the landlord, purchases substantially more expensive clean energy for the building, and a tenant complains. How do you respond to the tenant?

Landlord's Response:

A. General Analysis.

In order to decide how to respond, the landlord's attorney should begin by reviewing the section of the lease that addresses operating expenses. The first question, which can be quickly answered, is whether electricity service for the building is an includable operating expense. In almost all multi-tenant office buildings, the landlord is responsible for providing electricity to the building, and in a net lease the cost of such service is reimbursed by the tenants of the building. The analysis is simplified by the fact the service in question is a true operating expense. The issue of capital expenses (e.g., could the landlord pass through some or all of the cost of installing new equipment to reduce the energy consumption of the building) does not come into play in this scenario.

The next question for the landlord's attorney to consider is whether the operating expenses section of the lease imposes any standards that would limit the landlord from passing through the full cost of the electricity service. In many lease negotiations, the parties expend a fair amount of effort in determining what is, or is not, an operating expense, and the list of exclusions often is very lengthy. Much less scrutiny is placed on whether the actual amount of a properly included operating expense should be limited. Landlords generally are entitled to pass through the full cost of the item. One limitation may be a negotiated cap on increases in operating expenses from year-to-year, but a properly drafted cap from the landlord's perspective would limit the cap to controllable operating expenses and the definition of such expenses would typically exclude the cost of utilities. Another limitation may be aimed at preventing the landlord from passing through above-market costs of services being provided by an affiliate of the landlord. As most landlords do not have power generating or marketing affiliates, this limitation would not come into play in this scenario. In general, there is no lowest cost requirement applied to operating expenses or the requirement that the landlord obtain multiple bids before making a purchase or selecting a service provider.

If a tenant has negotiated a reasonableness standard for operating expenses (e.g., "Operating Expenses shall include all reasonable expenses incurred by Landlord in connection with the operation, management, maintenance and repair of the Building."), then the tenant could claim that any additional cost for clean energy is unreasonable and should not be subject to reimbursement. Similarly, if operating expenses are tied to the practices of first-class buildings or other comparable buildings in the local market and such buildings do not use clean energy, then the tenant could claim that the extra costs of clean energy should be excluded. The tenant could also take the position that the landlord's decision to use clean energy was based on

marketing considerations; i.e., the landlord is using clean energy as a means to promote the building to potential tenants and therefore the additional cost should be excluded as a marketing expense.

In response, the landlord could take the position that the reasonableness standard applies to the types of expenses and not the amounts; i.e., was the service itself, in this case electricity, reasonably necessary for the operation of the building (the answer, of course, being yes). In the alternative, the landlord could take the position that "reasonable" does not mean "cheapest" and point out that clean energy is routinely available to, and purchased by, many households and businesses and that therefore the mere fact that there is an extra expense does not make it unreasonable. The landlord could also claim that the building's use of clean energy is in keeping with the character and class of the building, and that it is something that would be expected and desired by the tenants of the building.

Overall, the landlord's strongest argument is that, in the absence of express limitations in the lease, a landlord is allowed to contract for services and to incur expenses for operating the building as it sees fit, and it is not required to obtain the absolutely lowest cost for each service. The tenant is relying on the landlord's reputation and expertise in operating the office building and the landlord should not be challenged on every penny spent on expenses for the building.

B. Application to Typical Lease Language.

Consider the application of the fact scenario described above to the following language taken from a form office lease (Office Lease Form 1-1, ABA RPTE Commercial Lease Formbook). To the landlord's advantage, electricity service is an includable operating expense, and there is no reasonableness standard applied to operating expenses:

> The term "Operating Expenses" shall mean any and all expenses incurred by Landlord in connection with the operation, management, maintenance and repair of the Building…including, but not limited to,…the costs and expenses incurred in connection with the provision of the utilities and services set forth in Section 10.B…
>
> [Section 10.B.]: Provided Tenant is not in default under this Lease, Landlord covenants and agrees that it will furnish the following facilities, services and utilities, the costs of which shall be included in Operating Expenses:…Electricity appropriate for general office use supplied to the Premises.

Moreover, there are no provisions similar to the ones described above that would prevent the landlord from passing through the entire cost of the electricity service, even if it includes an additional cost for clean energy.

C. Drafting New Leases.

Two common green lease forms for office space specifically address the clean energy issue. The pertinent language from the BOMA Green Lease Form reads as follows:

> Landlord shall contract for the Building's electrical energy, which shall be redistributed to Tenant, and Tenant shall not be entitled to contract directly with any utility company for electrical energy to be supplied to the Premises. Landlord reserves the right to change electricity providers at any time ***and to purchase green or renewable energy***.

Similarly, the REALpac Green Lease Form states that:

> The Landlord shall be entitled at any time or from time to time to acquire (A) all or part of the power for its Common Area and Facilities; or (B) ***shared electrical power from sources with low Greenhouse Gas emissions***.

To avoid the situation in our hypothetical, landlords should include in their lease forms a provision similar to the ones above that specifically states that the landlord can purchase clean energy for the building and that the entire cost of the clean energy is subject to reimbursement by the tenants of the building. Using the language from the office lease form discussed above, such a provision might read as follows:

> The term "Operating Expenses" shall mean any and all expenses incurred by Landlord in connection with the operation, management, maintenance and repair of the Building…including, but not limited to,…the costs and expenses incurred in connection with the provision of the utilities and services set forth in Section 10.B…
>
> [Section 10.B]: Provided Tenant is not in default under this Lease, Landlord covenants and agrees that it will furnish the following facilities, services and utilities, the costs of which shall be included in Operating Expenses:…Electricity appropriate for general office use supplied to the Premises. ***Landlord shall have the sole right to select the provider of electrical services to the Building and the types and sources of electricity to be supplied by such provider, including, without limitation, electricity from wind, solar or other renewable or sustainable sources and/or from sources with low or no emissions or pollution. All charges and expenses relating to such electrical service shall be included in Operating Expenses. Landlord reserves the right to change electricity providers and the types and sources of electricity at any time and from time to time.***

Of course, merely including the language in the landlord's form of lease does not mean that the tenant will agree to it. A tenant may ask for a "commercially reasonable" or "comparable building" standard (both of which limit the landlord's flexibility, but neither of which provide a definitive standard) or a tenant could ask for a cap on the cost of clean energy (e.g., the kilowatt per hour charge for clean electricity that the landlord passes through cannot equal more than 120% of the kilowatt per hour charge for "standard" electricity, with appropriate mechanisms for determining the average rate if more than one rate applies).

ABA GREEN LEASE TASK FORCE – OFFICE GROUP

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Hypothetical #3

Your client, the tenant, is presented with a large increase in annual operating costs because the landlord is including the cost of obtaining a green certification for the building. What do you do?

Introduction:

Landlords attempting to make "green" modifications to existing buildings may encounter difficulties with tenants under existing leases, especially with regard to operating costs. Existing leases rarely address "green" issues, let alone whether "greening" will be included in operating costs, and the parties often are left without clear direction.

Accordingly, a tenant could find itself facing an unanticipated increase in operating costs, which is a situation the tenant likely exerted significant efforts to avoid in the original lease negotiations. On the other hand, because a number of green building standards require tenant cooperation in order to achieve the desired certification, landlords may be required to take a co-operative, as opposed to a "take it or leave it" approach when allocating the cost of green building upgrades.

This, however, does not mean that cooperation will be achieved or that all potential difficulties will dissipate. At least three further sub-issues could complicate any negotiations:

1. Because the building already exists, certain changes may not be practically available and any change could substantially impact business operations;

2. A "moral hazard" exists in that the landlord knows which types of expenses the tenant already has agreed to pay, likely has the ability to achieve certification in more than one way, and, accordingly, may choose to pursue certification in a manner that passes the greatest amount of costs along to the tenant, as opposed to the net cheapest way of greening the building. Further, the landlord may try to pass-off certain arguably inappropriate expenses to the tenant (e.g. a "greening" done solely to increase long-term rental return).

   This problem may be aggravated by: (i) a lack of disclosure requirements that allow a landlord to conceal necessary information in vague categories; (ii) the prohibitive costs of an audit of the landlord making the tenant unwilling to challenge the landlord's initial assessment; and (iii) the tenant finding out information significantly after the landlord, so that the tenant could be responding to a change that already has occurred and about which the tenant no longer can do anything.

3. Negotiations and coordination are likely to be quite costly, creating leverage for the party with the deepest pockets (usually the landlord) or a procedural advantage (also usually for the landlord). Existing leases rarely provide an adequate mechanism for quickly and cheaply resolving these disputes, meaning costly litigation may be the tenant's only alternative. Further, as the landlord likely will be dealing with multiple tenants, who may be legally prohibited from coordinating with each other, the landlord may be able to make use of strategies like divide and conquer or duplicating pleadings and spreading the cost of expert testimony over several actions.

This paper will address these issues and provide a framework for analyzing how to proceed.

Ultimately, however, one needs to keep in mind the motivations and relative strengths of the parties. A lawyer's job often is to render practical advice to his client, rather than providing a novel argument resulting in an extremely expensive lawsuit.

What's the motivation:

As a preliminary step, the motivation of the landlord and the tenant should be examined.

While many may agree that environmental sustainability is an end in itself, other motivations may lurk beneath the surface, and these concerns may provide either a basis for compromise or reveal that the parties' interests are so at odds that a negotiated resolution may not be attainable.

The landlord's motivation may include: (i) a general corporate policy of greening; (ii) branding and/or marketing goals; (iii) increasing rents; (iv) expediting municipal approvals and other legislative incentives or direction; (v) increasing the life and long-term value of the building; or (vi) even driving tenants out with the hope of redeveloping the site (although this motivation may not be very prevalent under current economic circumstances).

The tenant's reasons for objecting could include: (i) not wanting to pay more rent; (ii) the tenant genuinely being unable to afford to pay the increase in operating costs; (iii) concerns with the impact of the green requirements on its operations; (iv) concerns about the impact of the change on its improvements; (v) the tenant simply wanting out of its lease; (vi) concerns about how the change of the building could affect the tenant's ability to renew; or (vii) the tenant simply wanting to find out what is going on in the building.

One also should assess: (i) the value of the specific premises to the tenant; (ii) the number of renewals left; (iii) the value of the tenant's rental stream to the landlord and market conditions, generally; and (iv) most importantly, the ability of the tenant to access information about the improvements.

Ultimately, the parties' respective market power and objectives may be more determinative to the outcome than anything in the lease. If the tenant wants cheap space and the tenant is not a good tenant or the tenant is nearing the end of its term, any legal manoeuvring in favour of the tenant may be too costly (potentially more than the operating cost increase), and an assignment, sublease or surrender of the lease may be the goal.

Operating Costs:

The starting point for the analysis will be an examination of the lease itself.

A tenant will have attempted to set out its operating costs in as much detail as possible in the initial lease, whereas a landlord will have tried to keep the categories open-ended and flexible. Some leases may include caps on annual increases in operating costs or may be a gross lease (both of which will substantially change what the landlord may charge). Other strong tenants may have negotiated particular exclusions to operating costs. Accordingly, the strength of the tenant's current position will depend on the lease arising from the initial lease negotiations.

Assuming the lease says nothing about "green certification", both parties will have to characterize the proposed improvements. This will be a game of classification: the landlord arguing the expenses fall into categories that are included in operating costs and should be payable immediately, and the tenant arguing the improvements are properly characterized as items that have been specifically excluded from operating costs or should be amortized over long periods.

Factors to look to when arguing are: (i) whether the items in question are actually in need of replacement because they are at the end of their useful life; (ii) the time period over which the changes are to be made (if the changes are made over the course of a few months, a single change may be favoured); (iii) whether an actual cost reduction will ensue from the proposed change and how the reduction can be measured (if the tenant is receiving no net benefit, it is difficult to see why the costs should be borne by the tenant, and if the benefit is not concrete, perhaps the tenant's commitment and cooperation also should not be concrete); (iv) any credits received by the landlord for making the change and the allocation of these credits (it is simply inequitable for the tenant to pay for a benefit to the landlord); (v) whether the lease uses qualifiers like "reasonable", "actual", "actually incurred", "properly chargeable", "properly incurred", "without duplication", "as charged in similar locations" (if so, the items may be excluded); (vi) whether the change is being done for legislatively mandated reasons (if so, the tenant is likely going to have to accept the changes and pay for them, unless the lease expressly provides otherwise); (vii) previous estimates of operating costs; and (viii) the actual likely increase in operating costs (if the number is huge, it may be unreasonable).

An interesting issue that will arise with respect to the operating costs is whether or not the benefits received by the landlord should be deducted from the costs to the tenant. These benefits are two-fold: (i) the improvement in the value of the building (but this argument may be a bit of a reach for the tenant); and (ii) any government credits or offset. Both items should, arguably, be set-off against any increase in operating costs. However, if not addressed in the lease, it is likely these are the property of the landlord.

The tenant will argue that the landlord should not obtain a benefit, be it a tax reduction or some other form of credit (be it applicable to the building or another site), for expenses paid by the tenant. Nor, the tenant will argue, should the landlord benefit from the higher rents that may be obtained at the tenant's expense – the tenant has likely not agreed to pay for landlord inducements to future tenants. The landlord likely will counter that the lease does not contemplate the benefits, and, accordingly, there should be no right of set-off. Further, such

benefits are difficult to quantify, and any benefit from having a green building already will have flowed back to the tenant in having a more beneficial premises. Both these claims are dubious, but as mentioned above, the tenant may not be in a good position to assess the same.

Another concern for the tenant will be whether the landlord is facilitating the greening of the building by paying other tenants to replace their improvements and including the items in the operating costs. These items could be argued to be similar to tenant inducement allowances and may be excluded from operating costs properly charged. The landlord may take the position that the items are properly included, as they are meant to achieve lower overall operating costs, and the tenant will realize a benefit from such certification. The tenant may counter that it should not be difficult for the landlord to quantify an existing benefit if the benefit truly exists.

It should be forewarned that the tenant usually will be at a disadvantage in characterizing the costs, as the landlord will have control over the information about its options, and in order to second guess the landlord's assessment, the tenant likely will be required to make a significant investment in retaining experts to review and critique the landlord's plans.

Accordingly, it may be advisable to try to remedy this asymmetry by coordinating such expenses with other tenants.

Gathering Information:

A tenant should not assume that the landlord will be totally forthcoming with its greening plans, especially with respect to its alternatives.

Most leases include language requiring the landlord to provide an estimated statement of operating costs at the beginning of the year and the tenant to pay the estimated amount each month, with any difference between the estimated operating costs and the actual operating costs being reconciled following the end of the year. Sometimes the lease will require the landlord to set out these expenses in reasonable detail, but the meaning of "reasonable detail" may prove ambiguous. This provides the landlord with two key advantages: (i) the landlord will have first crack at the categorization game; and (ii) the tenant often will have to decipher where the greening expenses were included.

A further disadvantage to the tenant is that the tenant's opportunity to review the landlord's actual expenses and receive remedies for wrongful allocations often is limited by the lease. Specifically:

1. leases typically provide the time for auditing the statements is at the end of the lease year, which means: (i) the tenant already has paid the amount in question; (ii) the tenant may not find out how much an item actually costs until a year later; and (iii) pragmatically, the landlord can use the wrongly paid money to fight the tenant in being paid back;

2. leases may restrict the time and place of the audit and thus the tenant's ability to get information may become expensive and difficult to perform;

3. there may be limits on the time the client has to object to the statements;

4. the remedy for an overstatement of expenses is often set out in the lease, and often in a manner that limits the tenant's ability to recover money it has paid. For example, the lease may require the landlord be off by greater than 5% for the tenant to receive a refund and may allow the landlord to simply credit the overpayment to future rent (meaning the tenant has no immediate remedy); and

5. the landlord may prohibit tenants from acting together by placing restrictions on the ability of the tenant to share information obtained under the audit, meaning the tenants will each have to duplicate expenses in fighting the landlord.

Further, most leases will not contain a provision requiring the tenant to consent to changes to the common area of the building or other premises. This will make it difficult to object to the change being made.

Lastly, it should be remembered that if the tenant is not paying the full amount of stated operating cost, the tenant is likely in breach of the lease. Accordingly, the tenant may wish to think twice before acting by withholding payment.

In sum, the tenant likely will be in a very difficult position should it object to the greening and, given the information asymmetries, it may be advisable for the tenant to cooperate with the landlord as much as possible (at least initially). Further, if changes will be made to the lease or the premises, the tenant may wish to make efforts to obtain additional sources of information, like water and electricity use statistics gathered through smart meters.

Capital Costs, Structural Defects and Operating Expenses:

One of the key characterizations will be whether the item is a capital cost or, depending on when the building was constructed, a structural defect, and, if the item is a capital cost, the period over which the cost will be amortized.

Typically, the cost of items described as "capital" are amortized over the expected useful life of the item in question. For example, a lease may state that "capital improvements to the Land or the Building by installing energy conservation or labour-saving devices to reduce Operating Expenses, or to comply with any law, ordinance or regulation pertaining to the Land or Building" will be amortized over the useful life of the product as set out under Generally Accepted Accounting Principals ("GAAP"). That means that the tenants in aggregate will be responsible to pay for only a portion of the capital item for every year of the item's useful life. Thus, the cost of an HVAC system expected to last 20 years will be paid in annual instalments of $1/20^{th}$ the cost of the HVAC over the next 20 years (plus an interest factor for carrying costs for such time).

The tenant will want to ensure that: (i) the life-span of the relevant item is as long as possible; (ii) because the tenant likely is responsible for maintaining the item in question, that the cost of repairing the item is not prohibitive; and (iii) if possible, that some credit/rebate/tax saving is received by the tenant for the remaining life of items being replaced.

Conversely, the landlord will want to minimize the amortization period (especially if the tenant's lease expires before the amortization period is over) and minimize the existing credits for any capital improvement, likely arguing that the tenant will receive a net benefit from the item through a reduction in its yearly operating expenses, improvement in the quality of the premises and increased employee productivity.

The tenant should ask the landlord to provide support for these assertions. Several studies have indicated that operating costs are not necessarily decreased by the addition of purportedly green technology, and there may not even be an improvement in the environmental impact of the building. Further, warranties from "green" companies should be investigated, as should the ability to repair the equipment. Other inquires to be made include what the impact of the green item will be on insurance and whether the new item is compatible with the tenant's fixtures and business. Finally, it should be remembered that "certification" is an ongoing commitment and the technology is untested, so predicting the useful life of an item is not a straightforward process.

Why is Tenant Cooperation Desirable:

Notwithstanding the foregoing, the landlord likely will need substantial cooperation by the tenant in achieving certification; the focus of environmental leasing is no longer on changed technology, but on changing people's behaviour.

The main forms of certification for existing buildings are Leadership in Energy and Environmental Design for Existing Buildings ("**LEED–EB**"), BOMA BEst, and the Green Globes® for Continual Improvement of Existing Buildings ("**CIEB**"). Each of the preceding forms of certification resembles auditing systems, where continual improvement of the building as a whole is addressed.

It is doubtful that LEED-EB certification can be achieved without tenant cooperation, as the standard requires improvement to the "whole building" (as opposed to the "shell" certification available for newly constructed buildings), which means changes to the interior of the premises and client's operations may be required. Further, because the LEED-EB Operations and Maintenance guide provides a minimum occupation requirement (75% occupation before the application and 65% during application), the tenant may be able to show its displeasure with its feet, abandoning the premises and possibly leaving the landlord with the option to assign the lease, or choose not to get certified subject to the existence of a continuous operations covenant. Further, many of the certification strategies likely will require tenant cooperation. Notably, credits are often obtained for purchasing sustainable consumables and durable goods (e.g. furniture, equipment and food); reducing waste from the building; providing proper administration (including encouraging alternative transportation and documenting building costs according to LEED standards); and Green Cleaning, Occupant Health and Productivity, Energy Metrics and Operational Effectiveness all involve reducing energy consumption, reducing light use, and energy and water consumption. Accordingly, it is dubious such certification can be achieved without substantial tenant support.

CIEB also places a significant emphasis on tenant communication and cooperation. Further, like LEED-EB, the emphasis is on improving the ongoing environmental quality of the building as a

whole, as opposed to just the shell of the building. Accordingly, tenants are involved in assessing the functionality of the building and in guiding the certification process. As some buildings will require significant retrofits in order to qualify for CIEB certification, it is likely tenant cooperation will be needed. Several credit sources also require tenant cooperation, such as encouraging use of public transportation and metering energy and water sources.

BOMA BEst also deals with tenant usage.

It also should be noted that all of the three methods of certification are "ongoing", as opposed to “one off”, certifications. This means continual recertification and efforts to change conduct will be required. Accordingly, the landlord is well advised to build flexibility into its lease to deal with ongoing green issues.

Assuming the landlord truly wants to force the tenant’s hand, two sections of the lease should be examined: (i) the portion of the lease dealing with environmental concerns, and (ii) the portion of the lease entitling the landlord to make rules and regulations for the building.

Leases often address environmental concerns. These clauses typically prohibit the tenant from bringing “Hazardous Substances” into the building. The landlord may try to utilize this clause to force the tenant to comply with its environmental goals, arguing the clause should be interpreted flexibly. The landlord may look to the clause dealing with non-forgiveness of ongoing breaches and point out the length of the ongoing relationship. The tenant would counter that the clause deals with specific items that are either prohibited by law or should be read in light of the tenant’s objective of achieving certainty in its operation of the premises; simply, the parties did not intend to force the tenant to achieve a level of compliance above that required at law.

Leases also usually empower a landlord to create regulations binding the tenant. The result of these provisions will depend on the specific wording of the section and accompanying regulations, likely insufficient to force tenant cooperation. Re-writing what the tenant is able to do in its own premises would interfere with the tenant having a real interest in land, and new stringent environmental requirements that interfere with a tenant’s previous business actions are probably not of the same kind as not abusing the toilets or eating in the building. If the landlord changes its regulations and significantly ups the tenant’s costs, such action may not be reasonable, and may interfere with the idea of an estate in land or the meeting of mind in contract.

In any event, the landlord can benefit from the cooperation of the tenant, and a lease amending agreement may help facilitate and plan the changed landlord-tenant relationship.

Other items to look for:

Assuming the landlord may be willing to enter into some sort of arrangement with the tenant, several items should be kept in mind:

1. Improvements

As the tenant has already had its improvements approved by the landlord, does the landlord owe any responsibility to the tenant to ensure such improvements continue to be compatible with the building, and can the landlord later impose a higher standard? Most importantly, who pays for the change?

The greening of a building may require the tenant to replace fixtures installed by the tenant. Often these items became the property of the landlord after being affixed. However, the items were often approved by the landlord, so arguably the landlord has some responsibility to ensure the same are compatible as with any changes made by the landlord. Basically, there is no reason to believe that unless these items have deteriorated that they should be replaced by the tenant, and if the landlord is making a change to the plumbing, it will need to ensure the tenant's washrooms still work.

The landlord, however, can simply attempt to withhold consent to any future changes unless in compliance with the green standard (although this will result in substantial delay of green certification of the building), which may be its biggest struggle. The tenant may wish to help facilitate the immediate replacement of these improvements so as not to be caught by a significant bill later, trading financial help from the landlord for an immediate change. Further, the tenant will want to be sure that, if these items will need to be replaced, they will be excluded from the calculation of the renewal rate.

Lastly, the tenant should keep track of which improvements may add value to the building as a new source of revenue. Wind power or other forms of energy generation may be something the tenant wants deducted from its rent (depending on the amount of energy produced).

2. What happens to improvements bought with the tenant improvement allowance?

Often the tenant will have received a tenant improvement allowance upon leasing the premises. This allowance is a credit to the tenant, but usually impacts the amount of the tenant’s rent. Accordingly, if the tenant is forced to replace these items, it is, arguably, experiencing a loss, although the landlord will point out that it owns these items so any loss is its own.

It is worthwhile to address: (i) when will the tenant improvements need to be replaced; (ii) was the value of the improvements included in determining the rent and, if so, should the rent be reduced so the tenant is not required to pay twice for the improvements; (iii) what portion, if any, of new fixturing will be paid for by the landlord; (iv) who will pay for disposing of the existing fixtures in a green manner; (v) who will pay for extra costs associated in installing the new features and additional expenses; (vi) if the standards for certification necessitate a further replacement of features, who is responsible for this additional cost; and (vii) most importantly, how a cost saving will be determined and, if there is no net cost saving, who is responsible for the increased cost.

3. Requirements for New Materials

Both the landlord and the tenant may be under a responsibility to use new materials or materials that are for some reason now incompatible with the greening effort. Recycled materials may be excluded by requiring "new materials" for renovations. These clauses should be amended as opposed to ignored and, if no amendment can be obtained, should be noted on any estoppel certificates.

4. Abatement of Rent

Most leases will provide restrictions on the landlord's ability to interfere with the tenant's business, usually in an abatement of rent. The tenant should find out what disruptions will likely be required and who will pay for disruptions to its own business (should such disruption be required in making improvements). Provisions requiring the landlord to make efforts to minimize interference with the tenant's business may also be useful in determining what is going on with the building as a whole, and provide a useful basis for facilitating co-operation to reduce the total cost of the achieving green certification.

Simply, it may be in the tenant's interest to shut down to avoid higher operating costs, and to expedite the green certification process.

Also of note is the impact on the renewal rental rates. Is the fair market for similar premises or now for environmentally friendly/sustainable ones? If so, is the tenant going to pay for any improvements twice?

5. Recertification and Underperformance

A strong reason for amending the existing lease is that certification is not a "one-off event", but will likely become an ongoing process. LEED-ED requires re-certification every 5 years and CIEB requires yearly audits. Accordingly, the change to the relationship and the premises is likely to be ongoing.

The tenant will want to ensure there is a framework in place to deal with green certification issues as they arise in the future, and should also be aware that some of the promised benefits of green certification may not last 5 years, if at all, and if for some reason the improvements actually increase operating costs, are outdated or, worse, defective, it should be clear who is responsible for replacing the same.

Any plan for how to proceed should address the issue of what happens if the building underperforms and there is no promised benefit. The landlord will likely be extremely hesitant to make any promises in this respect, but the tenant should be insistent on obtaining some sort of assurances if this forms the basis for its agreement to make any changes to the lease.

6. Privacy laws:

Because green certification often is dependent on looking to the building as a whole, including day-to-day business operations of the tenants, privacy issues will need to be addressed in the lease.

A landlord cannot expect a tenant to cooperate in disclosing information if the tenant is not under a legal obligation to do so and has not arranged its affairs with its employees and customers to provide such information. This may require an amendment to the existing lease.

7. Rules and Regulations

The tenant may want to take steps to ensure that new rules and regulations do not hinder its ability to operate. Clarity and reasonableness requirements should be sought out. A quick way to green a building is to reduce the hours it operates. Accordingly, a tenant may wish to think about how this would impact its business.

8. Taxes

Most leases will not have addressed the issue of environmental taxes, be it energy taxes or tax rebates. The landlord and the tenant should discuss whether any tax credit is to be obtained by the "greening" effort, and who will receive the tax credit. They will also want to discuss what happens if the value of the property increases and ensure that potential taxes on carbon or fuel are properly allocated as between the parties.

9. Remedies

What remedies will result from non-compliance by the tenant? Simply not using the right kind of paper is likely to remain an unreasonable basis for terminating a lease. The tenant will also have an interest in spelling out the remedies as to who is responsible for paying for future changes or if work done by the tenant or landlord does not result in a lower rental rate or other benefits promised by the landlord. As always, lawyers should strive to reduce the agreement of the parties to writing, including all of the promises in a deal, and what happens if the same are not fulfilled.

10. Monitoring

The last point to note is that some form of monitoring will need to be put in place. As noted, the landlord will want to ensure it can show its tenants are complying with the relevant standard, but the tenant will also want to see other tenants' compliance and the landlord's own efforts actually resulting in cost savings. The tenant may wish to obtain statements setting out the building's improved performance, the breakdown of when and where the landlord's expenses occurred, and other performance information about the building, other tenants in the building and any abnormalities. If the landlord is already required to prepare this information for a certification agency, it is reasonable to think the tenant would want access to this reporting information.

Conclusion:

It is the author's recommendation that a lease amending agreement be obtained. However, this may prove impractical because of legal fees and/or reluctance by the landlord. Ultimately, one needs to assess the tenant's reasons for objecting and the landlord's reasons for proceeding. As with many real world legal problems, the correct manner of proceeding will be highly fact dependent and may be more practical than legal.

ABA GREEN LEASE TASK FORCE – OFFICE GROUP

Green Leasing Hypothetical #4

By: Michael Kuhn (mkuhn@jw.com)

Your client, the landlord, announces that it wants to obtain LEED-Existing Buildings: Operations & Maintenance certification. What does this involve, and do you need to add any special provisions to the standard lease form?

Your landlord client has identified its objective as obtaining LEED Existing Buildings: Operations & Maintenance ("***LEED–EBOM***") certification. It is important that the lease contains certain essential elements to incorporate the green building requirements and appropriately incentivize both the landlord and tenant to maintain a sustainable office building. Even before reviewing the existing lease to determine what special provisions need to be added, the landlord needs to recognize the extent to which obtaining and maintaining LEED-EBOM certification depends on the tenants' cooperation. Several of the categories of LEED-EBOM qualifying points, including mass transportation and materials purchasing, are largely within the tenant's – not the landlord's – control. Thus, in modifying the lease form and addressing tenant relations issues, the landlord must be mindful of the need for tenant cooperation to be successful in obtaining LEED-EBOM certification. Moreover, LEED-EBOM contains a re-certification process, meaning that tenant cooperation is not a one-time event, but an ongoing process that continues after the time of initial certification.

With this in mind, the landlord is advised to find a means to clearly articulate its objective of seeking LEED certification, including the value and benefit that certification may mean to the tenants. A helpful first step toward accomplishing this task is to clearly identify and express the landlord's sustainability goals. The landlord should express, in general terms, how the landlord will operate its building and how the landlord will require its tenants to operate in the building in order to achieve the stated objectives.

First Step – Sustainability Goals

In order to attempt to obtain the tenants' support and cooperation in this endeavor, the first step will be for the tenants to understand the sustainability goals of the landlord and the building and how these goals may affect the tenant's lease costs and use of the premises. These goals or objectives may be set forth in the lease in order to provide context and clarity so that the parties can understand the intention of the remainder of the green building provisions in the lease. The objectives may be broad and do not include enough specificity to dictate the day-to-day operations in accordance with green building requirements; however, in conjunction with the revised lease provisions discussed herein, they provide the necessary context. Some customary statements found in a lease statement of sustainability objectives may include:

> Tenant will, to the fullest extent prudent business practices allow, minimize its energy consumption, greenhouse gas emissions, water

use, outflow of waste material, and adverse impacts upon the indoor air quality of the Building and the Premises.

Landlord will operate and maintain the Building in a manner, consistent with commercially reasonable operational standards and practices and based on tenants' cooperation, minimize the Building's energy consumption, greenhouse gas emissions, water use, outflow of waste material, and adverse impacts upon indoor air quality.

Landlord will use commercially reasonable efforts to compel or induce other tenants of the Building to conduct their operations in the Building and their premises in conformity with these sustainability objectives.

If such provisions are incorporated into the lease, the remainder of the lease should then set forth specific requirements that must be followed by the parties in order to achieve the landlord's stated sustainability goals, especially in light of the open-ended language included in the sustainability goals.

Second Step – Examination of the Lease

The second step in achieving a green lease is then to examine the landlord's existing lease and determine what aspects of the lease need to be changed, or what additions need to be made, in order to incorporate green building requirements for obtaining LEED-EBOM certification.

Rent Structure

Before examining and revising individual lease provisions to conform with the landlord's sustainability goals, the landlord should consider whether the rent structure of the existing lease will maximize the benefits of obtaining LEED-EBOM certification for all parties.

Many commentators believe that a green lease should be a "gross" lease, because the landlord is rewarded through savings on base building operating costs and the landlord is therefore incentivized to reduce costs and increase net operating income. The argument is that a "net" lease, where the tenant pays base rent plus a separate charge for operating costs, effectively eliminates any incentive the landlord has to make energy efficient improvements or other environmental investments. This oft-repeated argument, however, ignores the competitive pressures on landlords to minimize operating cost pass-throughs to tenants under net leases, as well as the fact that even under net leases, landlords often cannot pass through all operating costs, so landlords have an additional incentive to reduce such costs.

Revising Lease Provisions

Once the landlord's sustainability goals have been set, certain existing lease provisions may need to be revised to permit the achievement of those goals. The following checklist

identifies areas of the lease that may be affected by the landlord's decision to obtain LEED-EBOM and highlights potential issues associated with those provisions, and the discussion following the list examines some of those provisions in further detail:

Lease Provisions	**Issues to be Considered**
Permitted Use	Does the lease prohibit the use of the premises in a manner that is inconsistent with the landlord's green building and LEED certification requirements?
Operating Expenses	Does the lease permit the landlord to pass through green building costs, including amortization of "green" capital expenditures as an operating expense?
Utilities	Does the lease provide the landlord with the ability to separately meter or submeter the tenant's premises, and if so, at who's cost? Does the lease set forth an energy allowance or otherwise regulate excess energy consumption by the tenant, and if so, how is this measured?
Building Operations	Does the lease set forth compliance standards for building HVAC systems? Does the lease contain green cleaning specifications, including requirements for the materials, procedures and protocols to be used in cleaning the building?
Maintenance	Does the lease provide for preventative maintenance programs or repair and replacement of existing equipment with green alternatives?
Alterations	Does the lease set forth parameters for renovations that will trigger compliance with green building requirements?
Assignment & Subletting	Does the landlord have the ability to withhold consent to a transfer of the lease if the proposed transferee does not agree to comply with green building requirements?
Default by Landlord	Does the lease set forth the consequences in the event that the landlord fails to achieve and/or maintain LEED certification?

Default by Tenant	Does the lease define what constitutes a default by tenant of green building requirements and set forth the consequences of such default?
Surrender of the Premises	Does the lease require the tenant to dispose of any equipment, furnishings or material in an environmentally sustainable manner?
Building Rules & Regulations	Does the lease provide the landlord with the ability to unilaterally modify the rules and regulations as compliance with green practices is needed? Are there remedies available to the landlord in the event tenant violates the rules?

Detailed Discussion:

Operating Expenses

From the landlord's perspective, the lease definition of operating expenses should capture all of the costs of the LEED certification, re-certification, commissioning and re-commissioning process, as well as costs of ongoing reporting and managing the certification. The tenant, however, may respond that LEED "soft" costs are no different from engineering and architectural costs incurred by the landlord for other capital projects, and thus should be excluded. Also, the operating expenses category should permit the landlord to reasonably amortize the capital costs of green building projects that will reduce operating expenses and to treat that amortization as an operating expense (and perhaps this approach could also include the LEED soft costs referenced above?). Some tenants will want to add the qualifier that the amortized costs passed through should not exceed the projected savings achieved as a result of such projects. The parties also should consider how the cost savings will be determined (e.g., energy costs may vary because of rate changes, building occupancy and weather conditions, not just operating efficiency of the building equipment).

Utilities

The lease should provide an energy allowance for the tenant, measured in kilowatts per square foot per year or some alternative formula, in order to account for after-hours or excess energy use by the tenant. In addition, the lease should permit the landlord to separately meter or submeter the tenant's energy use in the premises. In a net lease situation, separately metering energy expenses will incentivize the tenant to operate efficiently during normal business hours and keep its overhead costs low, while permitting the landlord to monitor energy use and collect after-hours operating costs for any use of excess energy or operations outside normal business hours. Issues to consider include: (i) what should the actual energy allowance be per foot; (ii) how will the tenant's consumption be measured; and (iii) who should pay for the cost of separate metering.

Building Operations

Indoor air quality and comfortable temperatures are important issues for tenants and often the source of tenant dissatisfaction. These issues should therefore be addressed in the lease by means of setting a measurable performance metric for the building's HVAC system. For example, the lease might state that the building's HVAC system will be operated in compliance with ANSI/ASHRAE Standard 55-204, Thermal Environmental Conditions for Human Occupancy and ANSI/ASHRAE Standard 62.1-2004, Ventilation for Acceptable Indoor Air Quality.

Alterations

Both the manner in which alterations are performed and the materials, fixtures and equipment used in such alterations may be important factors in the green rating of a building. The lease should include a provision requiring that all alterations be performed in accordance with the landlord's sustainability practices, including requiring the tenant to engage a qualified third-party LEED or similarly qualified professional to review all plans, materials, construction and waste management procedures to ensure compliance with the landlord's sustainability practices. Since the Work Letter will likely contain the detailed specifications of green construction practices within the building, it is often useful to require that the Work Letter parameters be complied with in any alteration work. Because third-party sustainability standards, such as LEED, change over time, the parties will have to consider how the landlord's sustainability practices also could change over time.

Building Rules and Regulations

The building rules and regulations that are incorporated into a lease provide the landlord with an accessible method to regulate tenants and encourage or discourage certain behaviors. The landlord may seek to have the ability under the lease to unilaterally modify the building rules and regulations so that the landlord can impose green operating regulations as the landlord progresses toward certification without requiring the tenants' consent to the changes, but a tenant likely would object to the landlord's unilateral right to modify the rules and regulations and even if the landlord has the right to do so, the landlord could face resistance (and litigation) if it actually attempts to do so in a way that materially affects the tenant's operations or costs. Typical green building issues that may be covered in the rules and regulations include: (i) compliance with building recycling programs; (ii) use of waterless urinals and low-flow faucets; (iii) prohibition on individual space heaters; (iv) use of screens and blinds to shield sunlight; and (v) scheduling of janitorial services during normal business hours (but question whether a professional services office will want vacuuming done during normal business hours). Sustainability practices are evolving at a rapid pace, and the building rules and regulations provide a possible means to allow the landlord to keep up with the emerging trends that often become incorporated into the re-certification criteria. It is equally important that the landlord have the ability under the lease to enforce the building rules and regulations to ensure compliance with the certification parameters.

Environmental Performance Reporting

The 2009 version of LEED-EBOM, as well as many local green building programs, require building owners to disclose the energy efficiency achieved by their buildings. Although there is sometimes resistance from tenants to mandated disclosure, the landlord's ability to comply with the performance reporting is dependent on obtaining information from individual tenants. The lease should obligate tenants and their employees to provide data regarding energy use and other criteria, such as use of public transportation, in connection with LEED certification and re-certification. The format of data reporting is important because the LEED-EBOM criteria impose a specific reporting regimen. The landlord also may consider revising the lease so that there are few limitations on the landlord's ability to access a tenant's premises in order to verify environmental compliance with green building requirements (but the tenant likely will not agree to open-ended access rights). The landlord may need to consider strengthening the lease default provisions as regards the failure of the tenant to comply with these reporting requirements, since the landlord's failure to produce the requisite data reporting for the building can, under current LEED-EBOM standards, lead to revocation of the building's LEED certification.

Work Letter

The work letter will require the most significant changes in order to comply with green building requirements. The work letter should require the contractor to engage a third-party LEED Accredited Professional or similarly qualified professional to oversee and validate that the improvement project has been the required standards for the landlord's sustainability practices. The rules and regulations for contractors performing work in the building or tenant's premises should specify the types of products and materials permitted for use in the premises, required energy efficiency standards, and standards for the removal and disposal of building materials. Additional inclusions in the work letter may require: (i) the development and implementation of an indoor air quality plan for the construction and occupancy phases of the premises in accordance with standards set forth by the landlord; (ii) the use of low- or no-VOC paints, solvents, adhesives, furniture and fabrics; (iii) documentation of all covered materials purchased and the associated costs in a format acceptable to landlord, (iv) low-flow faucets, shower heads, toilets and urinals; and (v) the use of energy efficient and Energy Star rated equipment, appliances, lamps, ballast and controls.

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By: Vicki Harding (hardingv@pepperlaw.com)

Hypothetical #5

Your client, the tenant, wants to have the landlord implement energy efficiency measures in order to reduce energy costs for both the leased space (which is separately metered and billed to the tenant) and the common areas (which are passed on through operating costs). What can you do?

General Analysis

This hypothetical presents a classic problem of split incentives: Generally the landlord is able to pass through to the tenants energy costs for both common areas and individual leased space. Consequently, the landlord may not have a direct economic incentive to implement energy efficiency measures (because the tenants are paying for the energy costs, a reduction in costs will benefit the tenants and not the landlord), but the landlord still may have competitive pressures from other buildings to keep operating costs low.

On the other hand, tenants would like to see implementation of energy efficiency measures in order to reduce pass through costs. However, tenants are not able to cause implementation of energy efficiency measures that are under the landlord's control, which generally include measures relating to the common areas and those relating to upgrading tenant spaces.

It has been suggested that a "gross" lease -- meaning a lease in which energy costs are included as part of the base rent -- addresses the issue of split incentives. The argument is that the landlord will both bear the costs of its energy savings measures and reap the benefits of reduced energy costs, so that it will make a rational choice about whether energy efficiency measures are justified.

That may be true to the extent that reduction in energy costs are due to building modifications. However, this approach has the down side that now the tenant does not have an incentive to take operational steps to reduce energy costs. For example, a tenant may be able to achieve significant savings by turning off lights, using energy efficient computers and other office equipment, or reducing "plug loads" by using power strips to reduce the energy consumed by computers, printers and other equipment that have been turned off but are still plugged in.

In addition, even if the lease gives the landlord the economic benefit of reduced energy costs, measures such as upgrading HVAC and lighting systems that often present "low-hanging fruit" in terms of reducing energy usage also typically require a significant cash investment up front, with a payback period that may be longer than the payback period normally required to support the decision to make a capital improvement. Tax and other incentives may help bridge this gap. However, payment for building modifications remains an issue even assuming a gross lease.

If you are addressing this issue in connection with lease negotiations, there will be more opportunities to discuss alternatives and perhaps reach agreement on specific measures. However, even if your client is operating under an existing lease, it may be worth approaching the landlord with specific proposals. Measures applicable to the leased space may have a useful life that extends beyond the lease term, which means they add value for the landlord as well as your client. Measures that reduce operating costs that are passed through to tenants can also benefit a landlord. Tenants looking at triple net leases evaluate the economics by taking into account both base rent and pass through costs, so a reduction in operating costs can help make the building more competitive in the future.

It is worth remembering that this analysis is based solely on private economic interests. To the extent that the future includes governmental mandates for retrofitting buildings to reduce energy usage and decrease the carbon footprint of buildings, there will almost certainly be significant changes in this analysis.

Analysis Under Typical Office Lease Form – Common Area

A form of lease in the ABA-RPTE Commercial Lease Formbook (ed. Dennis M. Horn, July 2004, Form 1-2) provides a typical lease scenario. Under this lease, operating expenses specifically include the cost of obtaining and providing electricity to the common areas of the building. Consequently, to the extent that operating expenses exceed the base year operating expenses, a proportionate share will be passed through to the tenant.

Thus, the landlord probably will not realize any economic benefit by reducing electricity provided to the common areas. (Because the lease does not require the landlord to reimburse the tenant if operating expenses are less than the base year expenses, it is theoretically possible that the landlord could realize a benefit assuming all other costs remained stable or declined. However, it seems likely that this benefit would be too speculative to justify an investment by the landlord.)

The provision relating to potential pass through of capital expenditures may be of assistance in persuading the landlord to implement the desired energy efficiency measures. Under the referenced lease form, if the landlord makes an expenditure for capital improvements by installing energy conservation devices to reduce operating expenses or to comply with any law, ordinance or regulations, it can pass the expenses on as operating expenses, provided that if the expenditure is not a current expense under general accepted accounting principles, the landlord must amortize the cost over the useful life of the improvement.

However, even with the ability to pass through amortized costs, measures such as upgrading the HVAC or lighting systems likely will require a significant cash outlay up front. Since the landlord only will be recovering its costs over time and will not be experiencing the full benefit of reduced energy costs (since the higher costs would have been passed through to the tenants in any event), it may be difficult to persuade the landlord to undertake these measures.

Analysis Under Typical Office Lease Form –Leased Space

In most office leases with base year and expense escalation clauses, a standard level of energy costs is assumed to be part of the base rent and base year operating expenses, and separate metering is used to determine whether or not the tenant is incurring excessive energy costs. The tenant is billed for excessive energy use, but is not reimbursed if its usage is below normal. Consequently, the tenant will not realize the economic benefit of reducing energy costs in its own space even though use of energy in the leased premises is separately metered.

So, as with the common area expenses, the landlord could realize an economic benefit if the tenant's usage is below normal (since the costs of providing energy to the leased space could be less than assumed in the rent provisions). However, as before, it seems likely that this benefit would be too speculative to justify an investment by the landlord.

Even if the tenant was billed based on its actual use of energy in the premises (thus giving it an economic benefit to offset the costs of implementing energy efficiency measures), there are several provisions of the lease that would inhibit implementation of energy efficient modifications to the leased premises by the tenant itself.

For example, as is often the case, the tenant is not permitted to make any alterations, decorations, replacements, changes, additions or improvements without the landlord's consent. Further, those changes cannot require any modifications to any of the building's electrical or other systems, the tenant may be required to remove any alterations at the end of the lease, and the landlord has a right to relocate the tenant to another space within the building with no obligation to recreate the tenant's alterations.

The tenant also faces the issue of justifying the upfront cash expenditure. This issue will be exacerbated when the useful life of the proposed energy efficiency measures (such as upgraded lighting systems or energy efficient film on windows) is longer than the remaining term of the lease. This means that (a) the tenant will not reap the full benefit of the efficiency measures (which may also mean that the costs reductions may not be sufficient to justify the measures based solely on the remaining lease term, even though the return over the useful life is adequate), and (b) the landlord will obtain the benefit of the energy efficiency after the lease term ends without having contributed to the costs.

Given these circumstances, it is reasonable to focus on obtaining the landlord's agreement to implement energy efficiency measures that involve modification of the leased space (as opposed to operation of the space).

Negotiations with Landlord

Under a typical lease, it is unlikely that the tenant client will be able to obtain the landlord's agreement to implement desired energy efficiency measures unless it is able to negotiate special treatment of the costs and benefits of the desired measures to counteract issues such as those identified above. One option may be to negotiate a sharing of costs and savings.

In developing solutions, it will be important to benchmark energy usage, as opposed to energy costs. Otherwise, the results will be distorted by changes in energy prices; if energy usage remains constant, but the price of energy goes down, there will be a reduction in energy costs that is not attributable to the efficiency measures. On the other hand, if the measures result in reduced energy usage, but the price of energy rises so that energy costs remain the same or increase, it will be important to recognize that there still is a benefit since otherwise the cost increase would have been even greater.

It can be difficult to achieve what appears to be the best result (i.e. implementation of energy efficiency measures that result in overall savings). It will be interesting to see how lease provisions develop in response to this issue. Solutions may come sooner rather than later with the added push of governmental mandates.