Green Leases and Green Buildings

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The Context of Green Leases

Leases are long-lived agreements. Terms of 5, 10 or even 20 years are not uncommon for office, retail and industrial premises, if you add in potential renewals. However, the recent critical awareness of global warming and local environmental degradation, and the emergence of regional and global targets for reductions in the production of greenhouse gases and the consumption of other resources, means that we must get commercial leases modified now, if we are to ensure these documents are flexible enough to accommodate the required adjustments in operations and standards. Both landlords and tenants will need to be involved in achieving these goals.

The variety of net and gross lease structures throughout North America means that landlords and tenants will each sometimes have all or most of the economic incentive to co-operate or conserve, and each will sometime have little or no incentive to co-operate or conserve. We need to make sure leases are structured to create compulsion, to create incentive, and to create flexibility, for both parties to do the right thing. If commercial landlords wait until all levels of government agree on greenhouse gas or water usage reduction standards, they cannot then discover we must wait another 5, 10 or 20 years for commercial contracts to be then up for renewal, to implement change. This article discusses the background for, need for, benefits of, contents of, and approaches to, green leases.

The Environmental Background

Commercial buildings are significant consumers of energy, the production of which creates greenhouse gases, the primary contributor to global warming. In North America, energy consumption by commercial buildings represents between 10% and 20% of all energy consumption.

The energy consumption may be of natural gas for heating, or electricity for heating, running electrical systems, and/or cooling.

Water is rapidly becoming a scarce resource in many parts of North America, and North Americans are the highest per capita users of fresh water in the world. In many applications, fresh, treated water is mis-used. As residential users, we are often encouraged to take shorter showers, water lawns less frequently, use reduced-water toilets and low flow shower heads. However, what is the commercial real estate sector doing to reduce its consumption of water resources?

Commercial buildings account for approximately 20% of the total annual water consumption. In commercial buildings up to 50% can be used in water cooled chillers, approximately 35% is for domestic use (e.g. flushing toilets) but only about 5% is actually consumed by the occupants of the commercial building. The fact that the Leadership in Energy and Environmental Design (LEED) rating system and others address water conservation is a key indicator of the need for landlords to be increasingly conscious of water conservation in new building design and existing building management. Water needs to be managed just as carefully as energy is.

Similarly, there is too much solid waste produced in tenant premises turnover and operating waste, and most of it is still going to landfills.

What's Wrong with my Current Lease?

While most commercial leases are drafted with clauses of general application, most cannot accommodate new “green” issues. For example, current commercial net leases generally don’t set out any shared or unilateral environmental objectives. These are important to tie permitted tenant and Landlord conduct to. While many leases contemplate the unilateral installation of smart meters for electricity, most don’t contemplate similar smart metering for water and natural gas. Few leases contemplate limiting waste production by the tenant, both in initial fit-out, and in ongoing operations. Most leases don’t obligate the Landlord to recycle with multiple waste streams. Most leases don’t match a “repair and maintenance” obligation to an environmental standard: normally these are only matched to a base building, prudent tenant, or comparable buildings standard. Most current leases don’t reconcile the targeted building maintenance standard (e.g. “first class office building”) to an emerging green standard (e.g. “LEED EB or equivalent standard”). Commercial leases generally do not match tenant improvement standards to LEED CI or equivalent standards. For example, most leases require a tenant to use only new materials in initial fit-out or alterations, but a green lease would allow recycled materials within a tenant’s premises. Similarly, most leases do not speak at all to the types of materials used within a tenant’s premises, whereas a green lease would mandate the use of low volatile organic compound materials exclusively to be used.

While many commercial leases allow a Landlord to undertake energy-saving retrofits as a permitted capital cost rechargeable to the tenant, few would allow the capital and operating costs associated with landlord retrofits necessary to improve the environmental performance of the building, comply with government sustainability “guidelines”, or achieve a standard (such as LEED EB) to be an operating cost pass through.

Most commercial leases are completely silent on the treatment of carbon credits, carbon taxes, or carbon anything. A green lease may allow the allocation of carbon credits by the landlord if the building can generate them in the future. Few current leases allow landlord access to the leased premises, except in the case of emergency, or to inspect building systems on notice. A green lease would allow the Landlord to enter premises to test for environmental compliance or to determine a breach of environmental objectives.

Current commercial leases generally do not require the use of environmentally friendly carpet cleaning products by the tenant. Commercial Leases generally do not allow the Landlord to purchase “green power” if it costs more and pass the costs on to the tenant.

The Role of a Green lease

Outside of owner-occupied commercial space, most retail, office and industrial premises are leased to third party tenants. The form of this lease varies greatly, both between these types of land uses, and by landlord, who may use their own “proprietary” form of lease, developed over many years of tinkering, legal advice, and copying. There are also stationer’s forms of commercial lease, and forms available on the internet. These landlords may not only have a preferred overall standard form of lease, but they may also use, on a building by building basis, different forms based on that building standard, and possibly inherited from a prior owner. Accordingly, the current commercial lease landscape can be seen to be comprised of a wide variety of lease types, each reflecting the diverse nature of land use types, individual landlord and tenant preferences, and building history.

The commercial lease, in its widest sense, governs the relationship between the landlord and the tenant: who can do what, when, how, and who pays. It gives exclusive possession of premises in return for rent and compliance with certain rules. In the office context, the landlord may control the shell, common areas of the building, and operations, but it is the tenant who controls activities within its own space. Both will usually have "standards" governing their conduct. Landlords may have to run a "first class office building", or act as a "prudent landlord would, having regard to the age and character of the building" (typical lease language setting standards and these standards may apply to cleaning, mechanical systems, building amenities, services, or maintenance obligations. These standards, and other more specific provisions in a commercial lease, generally do not encourage, allow, or fairly allocate the costs of, reduced energy usage, reduced water usage, reduced materials usage, or the diversion of waste or recyclables.

Tenants in 58% of U.S. office buildings occupy under a "gross" lease, where they may have energy costs for common areas, if not for their premises as well, included in their base rent, according to CoStar, a national real estate information company. This gives no financial incentive to tenants to conserve.

Proponents of the net lease say this creates a more transparent lease arrangement, and creates an incentive for tenants to use less energy (since they may directly save in reduced operating costs as a result of individual reductions in usage), but in the reverse case, it also gives little incentive for the landlord to conserve if tenants aren't individually metered, or for common area energy costs (since the savings aren't to its account), except to keep total rent within market ranges.

Of course, landlords have for decades have had an incentive to and in fact have carried through on many types of energy

saving initiatives, usually motivated by the desire to save energy costs and therefore make the building more competitive on a gross rent basis. Examples of this include re-glazing windows and double glazing single pane windows, upgrading the insulation and maintaining seals on building envelopes, undertaking lighting retrofits from inefficient lighting (perhaps with old PCB-based ballasts) to more efficient lighting systems and control systems, and undertaking retrofits of heating, ventilating and air conditioning systems to move to more energy-efficient systems, and changing building controls in respect thereto.

Resistance to Green Leases

There may be many barriers to further efforts by landlords to make their buildings more energy, water and resource efficient. These may include long pay back periods for some types of improvements, indifferent or unco-operative tenants, the inability to pass through the current portion of amortized landlord's environmental capital costs, and a lack of skill or knowledge. Other barriers may include a lack of knowledge of an achievable target by either the landlord the tenant; the lack of leadership, compulsion or incentive from senior levels of government; no measurement systems in place to determine existing levels of water, natural gas or electricity consumption; a lack of capital; the lack of building operational expertise.

There are likely to be many other restrictions in the individual master and existing lease documents within a portfolio. For example, there may be landlord build-out specifications that apply to the tenants premises, such as minimum foot candles of light at the desktop, tight permissible temperature ranges, limitations on the landlord in making changes to the premises or base building features, or restrictions on the type of materials or equipment that can be used. There may also be an inability to pass through co-

generation costs if provided by a third party, or an inability to pass through standby costs of the local utility if co-generation systems are used or proposed to be used.

However, landlords may not be the only ones interested in reducing their consumption of resources. What about tenants who lease space in a commercial building who want to measure, and reduce their energy and water consumption, and increase recycling?

In many cases, large tenants are leading the way, requiring commercial landlords to make their buildings greener. Barriers to efforts by tenants to make buildings they occupy more energy, water and resource efficient may include poor tenant premises-specific energy and water consumption data from the landlord. There may also be shared energy and water costs (e.g. a single building meter allocated on a building-wide per square foot basis), which in the tenant's eyes would mean that there is no direct relationship between energy or water savings initiated by a specific tenant and the costs allocated to that tenant: a tenant's efforts to conserve would be shared by all occupants in the building, so all others are "free riders". Tenants may also be faced with indifferent or unco-operative landlords, or may fear an unfair rent increase if they ask for a "greener" building, as the current portion of water and energy saving capital costs are possibly jammed through to the tenant on an unfair basis. Indeed, tenants may fear that the landlord will "green plate" (i.e. spend carelessly on green upgrades only because the cost can be 100% passed through to tenants) the building at the tenant's cost.

Tenants may also lack the skill or knowledge necessary to determine achievable targets for themselves or the building, and may not have access to the required independent technical resources, or find the costs prohibitive, especially for small tenancies.

One barrier unique to tenants is the potential need to get all tenants in the building together, forming a “union” by analogy, to get the landlord to green the building. This may a requirement to attain some “leverage” over the landlord, or may be a mandated pre-requisite by the landlord.

Lastly, there may be restrictions in the lease that limit the ability of the tenant to go green. Examples include the requirement that the tenant must use only new materials in all tenant improvements, that the tenant cannot alter base building features, common areas, or central systems; the inability to install any equipment outside the leased premises; the inability to compel more recycling by the landlord; the inability to compel installation of bike racks on or adjacent to the ground floor of a building; the inability to install on-site co-generating facilities such as solar voltaics; poor or no record keeping of individual tenant energy usage; poor disclosure of energy usage; and the inability to compel different water-saving fixtures to be installed in common area washrooms.

Defining a Green Lease

A “green lease” seeks to remove disincentives in a commercial lease to reduced energy, water and raw material consumption, increased recycling, as well as the use of sustainable materials in tenant improvements, and encourages sustainable practices by both the landlord and the tenant. A Green Lease works to ensure that tenants and landlords are required to adopt environmentally friendly practices.

What is in a Green lease?

There seem to be at least two (2) approaches to a green lease:

(i) A “paternalistic” approach where the obligations for reduced consumption and environmentally responsible behaviour are mandated by either the tenant or the landlord within the lease; and

(ii) A “co-operative” model, where mutual objectives are set out in the lease for both parties to achieve, leading to responsibilities and liabilities for both parties.

A tenant-paternalistic lease may be the case where government or a corporation with a strong green brand is a tenant, has internal “green” targets it is subject to, and wishes to force the Landlord to do its part to assist in compliance.

A landlord-paternalistic lease may be the case where a landlord wants to green its portfolio, or engage in carbon-trading, or be seen as environmentally responsible, and wants its tenants to toe the line in achieving certain environmental goals.

A co-operative model lease may be the case where both parties buy into the need to green an existing building and want to ensure each is doing their part to achieve the joint goal.

All three models may end up in the same place over time.

The following are some of the main elements of existing green leases:

- *Targets and Benchmarks* – the inclusion of targets, expressed either as a percentage reduction or an absolute target in terms of objective measures (e.g. petajoules, kilowatts, and gallons/litres of water per square foot per year) for the environmental performance of the

building to include water and energy reduction, waste reduction, and waste and water recycling.

- *Ecologically Sustainable Development Principles and Regulations* – this may include indoor air quality standards, and rules governing the use of materials and the recycling of products.
- *Performance Standards* – these may include specifications as well as procedures as to how environmental performance is measured.
- *Dispute Resolution Mechanism* – these may apply in the event of a disagreement between the landlord and tenant as to why a particular target or objective prescribed by the lease is not achieved. For example, this mechanism could outline those ramifications taken in the event that a tenant exceeds an energy use target or fails to comply with ESD principles set out in the lease.
- *Environmental Management Plan (EMP) and a Green Lease Schedule (GLS).* These components are commonly found in those green leases developed in Australia. An EMP is often featured within a GLS.

A green lease may specifically detail:

- Environmentally preferable products;
- Water conservation measures;
- Comprehensive landlord and tenant procurement guidelines;
- Energy conservation/efficiency targets;
- Requirements for natural or low water consumption landscaping;
- The permissibility of solar or wind applications on-site;
- The ability to specify higher cost but sustainable energy sources;
- Indoor air quality standards;

- Construction period recycling;
- Life-cycle costing;
- Day lighting, and the usage of screens to shield the sun's rays;
- Recycling room and practices;
- Efficient appliances and fittings;
- Waterless urinals and low flow faucets and taps;
- Efficient thermal control systems, and potentially operable windows;
- The use of EnergyStar rated photocopiers that reuse paper, or print double sided;
- An energy or operations standard, such as LEED, Green Globes, BREEAM, AGBR, Energy Star, or other rating system;
- Ventilation and fresh air requirements;
- Allowable cooling, heating and humidity;
- Cost apportionment of capital costs of new equipment;
- Incentives to invest in new equipment;
- Heating, ventilation and air conditioning specifications;
- Environmentally friendly leasehold improvement materials, or LEED CI (or equivalent) requirements; and
- Dispute resolution procedures and references to third party experts.

To the extent that the parties feel that technical goals need to be defined in a lease document or schedule (such as target kilowatts per square foot per year, or reduced water consumption to a target of litres/gallons per square foot per year) either or both the landlord and tenant may need technical consultants available to them to advise on the legitimacy and attainability of those technical goals in the particular building to which the green lease would apply. The same technical expertise would also need to be available

to determine compliance or to provide audits from time to time potentially for both parties.

Green leases may be considered as ‘partnerships’ or ‘alliances’ requiring greater cooperation between landlord and tenant than traditional leases.

It is also important to mention that poor performance within any particular tenancy will have the capacity to influence comfort and performance in other tenancies in a multi-tenant building. The underlying notion is that what one tenant does or does not do, could ultimately impact other tenants in the same building.

Conclusions and Recommendations

Commercial buildings are significant consumers of electricity and water, and significant waste is generated. Where the source of electrical power is coal or natural gas, the need to reduce energy consumption, and thereby reduce greenhouse gas emissions, is critical. Water conservation is just as important, and landlords need to be increasingly conscious of water conservation in new building design and existing building management. Similarly, too much solid waste is produced by commercial buildings. Many commercial landlords provide “blue bins” to recycle paper waste, but there is little commercial separation at source of cans and bottles, and organic waste. LEED and other rating systems encourage efficient building design, recycling of construction materials where possible, and the use of local materials where not.

Lawyers are on the front lines of lease negotiation, and can lead change. Of course, brokers, owners, and tenants all need to also be committed. Current commercial leases are a barrier to achieving significant reductions in greenhouse gas production, water and energy consumption, and material

usage. Given that they are long lived documents, efforts to modify base form leases to make them green should be undertaken now. Given the re-education program that all market participants will need, to prioritize and price green initiatives on a building-by-building basis, to agree on objectives and targets, and to understand new green lease standards, more green lease development, leadership and innovation is needed from real estate lawyers and other real estate leaders. That leadership is required now.

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