

Realities of Green Leasing: A Step-by-Step Guide for Landlords and Tenants

BY ELIZABETH KING FORSTNEGER

A quick survey of articles about green leasing show that most begin with an exposition on the impact of commercial buildings on the environment. This article dispenses with this step and emphasizes the “how” over the “why.” If you own and/or occupy space, you’ve considered how the green movement may affect your business operations or investments. Incorporating green features in the lease is critical to protecting a timely return on your investment of time and/or resources. Here’s what to know going in - the realities of green leasing from consensus to ongoing measurement.

Trends in Landlord Behavior

Currently, landlords display a wide range of appetites for greening existing

buildings. Motivation for green lease language can stem from tenant interest in the market, the need to protect a LEED-certified building, portfolio-wide corporate mandates or all of the above.

“Owners of Class B vacant spaces are doing the capital improvements, replacing dysfunctional equipment in a sustainable way to stay competitive with the Class A space that has been built with sustainable features and performance,” shared Doug Sharpe of Grubb & Ellis, San Jose. Eric Haskins of Grubb’s Portland office added, “The market is starting to see a movement toward two categories of Class A buildings, sustainably built and conventional.”

Trends in Tenant Behavior

While recent studies suggest some landlords see increased value for LEED-certified and Energy Star-labeled buildings over

conventional buildings, the market isn’t yet edging out buildings that are not certified or energy efficient. Even in markets traditionally known for green building practices, the need for green lease language seems to be a case-by-case basis. While a broker in green-friendly Portland shared that he “has yet to have a tenant insist on green language,” a Southeast broker tells of a tenant who walked away from a building because of the owner’s lack of green building policies, protocol or plan addressing sustainability. Even when it’s not a deal breaker, “it is more of a differentiator, a way for tenants to grade the building against other options,” said Sharpe.

Although deal breakers do not seem prevalent, they do exist. For example the U.S. General Services Administration strongly prefers buildings with the Energy Star label and currently requires new leases to be in a LEED-CI (Commercial

Interiors) certified space. Many companies have added standard prerequisites to find space that meets green standards by senior leadership or the board of directors.

Step-by-Step Guidance for Landlords and Tenants

1 Consensus building and goal setting for both parties. Each party needs to determine and communicate a vision of sustainability well before getting to the negotiating table. From the point of a request for proposal and/or letter of intent through final negotiations, know which points are (or are not) flexible in achieving sustainability-related goals.

Typically, the prime objective for both tenants and owners is cost reduction. However, with a green lease, mitigation of risk is a competing priority. Owners and/or tenants may want a green lease to leverage and protect their past (and in some cases, future) capital improvements, including the building and space's LEED certification, if applicable. The tenant may also be responding to shareholder and/or employee demands for increased recruitment and labor productivity. While several organizations (e.g., BOMA, RealPAC, USGBC) have developed green language intended to be woven into existing leases, these suggested clauses need careful review prior to incorporation, as some favor one party over another.

2 Modeling of financial implications to ascertain and limit financial exposure. Determining annual cost implications early in the process will allow the negotiators to examine the lease dynamics in play. The ability to model cost implications is a function of the lease. While the field is split regarding most appropriate lease type, all parties expect the lease type to mirror that of the market. While gross (full-service) leases allow owners to directly recoup investments that reduce water or lighting use and/or enable renewable energy by lowered utility costs, tenants favor separately-metered net leases. If the goal is to keep both owners and tenants motivated to support the building's green initiatives, the modified gross lease, net utilities with sub-metering and possibly an expense stop (full service except tenant pays utilities) may be a viable alternative. Defining



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THE FOLLOWING MAY HELP PRIORITIZE POINTS OF NEGOTIATION OF A GREEN LEASE:

- Are you pursuing LEED certification for the building/space or other designation such as Energy Star?
- Does the building/tenant's firm currently have a green lease or operations?
- Do you allow sub-metering of space?
- How will green tenant improvements work – partner or pay for?

Communication, including education, is critical. For example, one broker shared that a tenant's lawyer pushed when a landlord insisted on lease language that required the use of sustainable materials, but just needed to be educated that the specified materials were the ones his client was going to use anyway.

goals in advance and knowing what to ask for when delineating responsibilities and managing expectations will permit any of these lease types to support the goals of each party. For example, if the lease language allows, landlords can maximize their return on investment despite a net lease requirement by passing through improvements that reduce tenant operating costs through common area maintenance charges on an amortized basis.

According to Haskins, "The owner has an incentive to upgrade water fixtures, such as low-flow toilets and faucet aerators, in common areas because there are long-term savings and a quick payback in many cases." Moreover, with the exception of single-tenant buildings, the landlord is aligned with tenants and driven to reduce costs in the building because of the landlord-borne operating expenses for vacant space. The negotiation of tenant improvement (TI) allowances for green leases can include high-efficiency fixtures and HVAC equipment.

3 Determining operational protocols and managing ongoing risk. Clarity is needed when defining responsibility for specific activities by certain parties. A

typical list includes use of specified cleaning products, materials in build outs and a materials disposal protocol. Landlords can incorporate green provisions in the building rules. Other protocols include right-to-relocate provisions requiring temporary space to meet or exceed a certain Energy Star performance rating. It is important that the provision be specific in terms of rating (for example) and timing. Other provisions may address future opportunities, such as renewable energy and governmental regulation concerning carbon taxes and credits. Doug White, an Attorney at Weintraub, Gershlea, Chediak in Sacramento cited this example: "If a landlord wants to leave open the opportunity to provide energy through alternative means (e.g. solar, wind, geothermal) in the future, the tenant can further articulate the provision to require consistency in service delivery. Establishing protocol in the event of a future carbon tax and credit environment can help avoid disagreements regarding liability and ability to monetize such credits. Other provisions can include assignees and subleases, utility reporting requirements and insurance coverage to rebuild green office space.

Where possible, outlining remedies for non-performance or breach of contract ahead of time can be critical. According to a publication from the firm Perkins Coie, breaches that jeopardize the property's LEED certification or financing qualifications may allow the non-breaching party to terminate the lease or obtain liquidated damages. Less significant breaches may warrant rent reduction or reimbursement of operating expenses. If a tenant fails to meet energy conservation targets, the lease may demand that the tenant purchase carbon offset credits.

Conversely, "Owners can motivate tenant involvement by recognizing those tenants who meet recycling goals, either through an annual luncheon or a rent break," shared a broker in the Southeast. Those closest to day-to-day operations should know how the negotiated terms affect them. For LEED-certified buildings or buildings within jurisdictions that require measurement, lease provisions should dictate property manager, building engineer and tenant responsibilities.

Conclusion

In a down market, tenants drive negotiations and consequently, landlord behavior in some instances. Now is the time for landlords to balance costs against the opportunity to position themselves as green lessors with green practices in their local markets. As government involvement increases, the discussion will move from differentiating the building in the market to adhering and upgrading to comply with new codes. Green buildings and operations will shift from a marketing feature to a basic requirement. The lease is the opportunity to protect the interests of parties. The green lease may add a dimension outside of the comfort zone of one or both parties. Education and consensus building focused on these green lease provisions will clarify financial and risk implications and accelerate and improve negotiation.

About the Author



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