

# The Split Incentive Problem: *Not Yet Resolved in Existing Model Green Leases*

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*Special to the Legal*

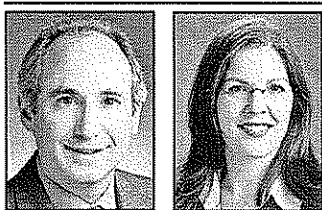
Energy Star and LEED plaques in the lobby. Recycling containers in break rooms and cafeterias. Firm logos on reusable tote bags and water bottles. The signs of the "greening" of American commercial buildings and their tenants are hard to miss these days.

Just a couple of years ago, an article on green leasing would devote as much time to the environmental "feel good" aspects of the greening of a commercial lease as the economic ones. Certainly leading green building organizations, such as the U.S. Green Building Council (developer of the LEED green building rating system), still promote the reduction of energy, water, and resource consumption as well as intangible benefits such as worker productivity and employee satisfaction in their publications and studies (such as in the recently released USGBC Green Office Guide). However, particularly in light of the current economic climate, the practical reality is that, unless required to do so by law or corporate policy, commercial tenants and landlords are much more likely to weigh the tangible economic impact over any other factors in deciding whether to "go green" in their lease agreements.

Unfortunately, as has been much-discussed in green leasing circles, the "split incentive" inherent in a typical triple-net commercial lease cuts against either party having the economic motivation necessary to promote green leasing outside of some type of mandate. This article will consider this dilemma in light of two of the leading available model green leases, each of which handles the issue differently, but neither of which resolves the issues completely.

Under the typical triple-net lease structure, the landlord is responsible for all capital improvements and the tenant is responsible for paying base rent, as well as all of its proportionate share of taxes, insurance and operating expenses, including utilities. While some capital expenditures may be passed through to a tenant, with the cost therefore amortized over the useful life of the improvement, those expenditures are usually limited and fairly predictable (e.g. roof replacement), and are carefully scrutinized by tenants in lease negotiations. Thus, the landlord has little economic incentive to make costly capital improvements needed, for example, to increase the energy efficiency of its buildings, because the beneficiary of those improvements is the tenant. Tenants have little or no input into the technologies used in the building, nor can they control the energy or resource consumption of other tenants. Moreover, the cost of their share of energy consumption may not be a significant enough portion of the overall costs to warrant energy-saving efforts.

Green building proponents often tout the ability of landlords to charge higher rents in buildings that are "green" to off-



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set capital costs. Tenants reap the benefits of higher employee satisfaction and productivity, and perhaps a market advantage as an environmentally responsible company. Unfortunately, in these tight economic times, landlords are wary of making that leap of faith, and tenants are less likely to pay for benefits to their bottom line that are hard to calculate. The result: little to no incentive on either side of the landlord-tenant relationship to take significant steps toward improving building energy efficiency and reducing natural resource consumption.

Despite the obvious obstacles and issues, property owners and managers, whether because they want to do the "right thing," they want to be ready when the market turns around, or they simply want to make sure they are not missing out on a potential market advantage, are eagerly searching for information and guidance on how to "green" their leases in a way that makes sense economically. That reality has not been lost on the institutions and organizations attempting to assist in the development of green leases through their publication of model green lease provisions and guides.

For instance, the Building Owners and Managers Association (BOMA) International attempts to address the split incentive and other impediments to green leasing in its *Guide to Writing a Commercial Real Estate Lease*, which was updated to include green leasing language. In the BOMA Green Lease, the all-important definition of "annual operating charges" (i.e. the charges that will be passed on to and paid by the tenant in its proportionate share), is broader than in a typical triple-net lease. The BOMA Green Lease includes, in addition to the amortized cost of all capital improvements, costs of the annual amortization associated with applying for, maintaining, reporting, commissioning and recommissioning a building under one of

the various green building rating systems, codes or standards, as well as the cost of insurance needed to repair, replace or recommission a building to meet a particular standard or goal.

BOMA concedes, in a footnote, that passing on the costs of capital improvements, whether "green" or not, is problematic for tenants. BOMA suggests a compromise could include charging the tenant only for the capital costs that actually reduce operating expenses, with perhaps an annual limitation or cost cap for each lease year based on the amount of savings realized, or estimated to be realized. Understandably, however, landlords are extremely reluctant, to the extent even possible, to estimate or guarantee these reductions.

Costly improvements to increase energy efficiency, water consumption and the like are even more problematic as many of them are new and remain unproven. Even with new technologies that enable building owners to carefully track and calculate building efficiencies, there are many unknown factors to contend with (such as fuel costs, weather, changing regulatory requirements, etc.). Moreover, tenants concerned with the potential for unpredictable pass-through costs will fervently look to push down their base rent while landlords will want the exact opposite to compensate for their capital investments. Landlords already wary of investing in green building improvements are unlikely to make the investment in these circumstances. Unfortunately, the BOMA Green Lease provides no practical solution to one of the more serious obstacles to investment in "greening" a building.

Perhaps one option is to deviate from the prevailing triple-net lease structure in favor of a gross lease that would place the efficiency incentives and benefits squarely back on the landlord. At least one industry group has considered this approach in its model lease. The Model Green Lease Task Force, a group of industry professionals organized through the Corporate Realty, Design & Management Institute, developed and released their model green lease in 2009 and took the bold step of insisting that green leases should be structured as gross rent leases. Under their model lease, the tenant pays a base rent that includes funding for taxes, maintenance, insurance and utilities. In future years, the base rent is adjusted upward to reflect the tenant's pro rata share of any increase in the building's operating costs over the base year.

Since there is no reduction in rent due to cost savings in energy efficiency, the landlord theoretically should benefit from a reduction in operating expenses below the base rent. To further encourage energy efficient investment, the definition of "operating expenses" includes the amortized costs of capital improvements that reduce building operating expenses, but only to the extent of the savings achieved. Tenants are also given reasonable audit rights

to ensure that the pass-through costs are accurate. Supporters of the Model Green Lease rely on modern measuring technologies to enable building owners and tenants to find workable comfort and trust with regard to energy costs.

In general, one would anticipate that a gross lease structure could successfully encourage landlords to make capital investments in resource-saving measures — at least to the extent such measures are proven to achieve results in the marketplace — and enable them to reap the benefits of lower operating costs. However, a landlord counting on recouping its capital costs through a gross lease structure may still be hesitant to implement broader green building measures, such as those required to obtain certification under one of the existing or future rating systems such as LEED and Energy Star, without the ability to recoup those costs as well.

The ongoing costs to obtain certification, and recertify, commission, recommission and comply with reporting requirements, are not insignificant. Further, a landlord who has made the investment to get certified will likely want to carry insurance to cover the cost of repairing, replacing and recertifying a building to the then-current applicable or desirable green standards. The Model Green Lease provides no mechanism for the landlord to recover such costs.

In today's climate, where owners and tenants are justifiably focused on actual savings more than labels, it may be difficult to justify the additional costs related to green building certification beyond measures that actually reduce operating costs. Of course, to the extent compliance with a green standard is required by law or a particular tenant's corporate mandate, negotiating the costs of green building certification into the operating costs remains feasible. For other leases, building owners are likely to rely on market forces to dictate whether green building certification is worth pursuing, but are going to want to have the flexibility built into their leases to do so in the future.

While the available model green leases have begun to address the split-incentive problem, they have yet to fully resolve some of the larger economic realities landlords and tenants grapple with. If, over time, the "whole-building" or building certification approach to sustainable building proves to have tangible economic benefits to landlords and tenants, the allocation of associated costs will be much easier to establish.

In the meantime, landlords, tenants and their counsel will need to engage in careful deliberation and detailed negotiations to ensure both sides are fully aware of the economic risks of "going green" in their lease documents, that the incentives to doing so are appropriately allocated, and that their leases can adapt to changing market forces as the economic realities of the green building movement come to light. •