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Who to Pay for New Energy Laws Compliance?

By **Peter S. Britell and Stuart Saft**

Examine closely existing tenants' lease clauses.

On Dec. 28, 2009, Mayor Bloomberg signed into law new rules governing energy use in New York City buildings. These rules will have an effect as great, if not greater, than earlier local laws that required façade repairs¹ and building-wide fire safety systems.²

Like those earlier laws, they will create new cottage industries of consultants and contractors and impose major new costs on building owners.

Despite effective dates as far out as 2025, there is great incentive for landlords to rush compliance with the new laws so as to recover costs from existing tenants, who are locked into pass-through clauses of their leases, while new tenants can bargain for the landlord to take the hit.

Such transfer of costs to existing tenants may be the major unintended consequence of the new laws. Landlords may also rush to comply now so as to sign up the limited number of qualified professionals when they are less busy than they will be when the dates for compliance get closer.

Earlier articles have detailed the new rules.³ This article analyzes the types of costs they will require and how those costs may pass through to existing tenants under their lease clauses.

The new rules are contained in Local Laws 84, 85, 87 and 88 of 2009. One applies to new construction, the others to existing larger commercial and residential buildings, "covered buildings"⁴ under the new laws.

Pass-Through Provisions

New York City commercial leases have clauses that pass through building expenditures to tenants. These clauses typically distinguish between ordinary expenses and capital costs.

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While such clauses often follow standard accounting rules, there is leeway for interpretation. In this context the difference between an ordinary expense, which can be passed through fully in the year incurred, and a capital cost, which must be depreciated or amortized, can have great significance (for example, the difference between paying \$100,000 in one year or \$10,000 annually for 10 years).

This article considers the new laws in this context.

New Construction

LL 87 adopts a new energy code for new construction and new alterations to existing buildings, effective from July 2010.

This code focuses on building envelope, mechanical systems, service water heating system and lighting and power systems. It applies “without requiring the unaltered portion(s) of the existing building or building system to comply with this code.”

This exclusion may be easier to state than apply because altering part of a system can impact other systems. Thus, fit-out for a new tenant might require upgrading systems outside the premises, which would entail other costs for the landlord, possibly chargeable to other tenants.

A landlord will try to impose all LL 87 fit-out costs on the new tenant who, in a tough market, may refuse, saying the landlord must pay the incremental costs (especially if the building is marketed as first class). It will be easier for the landlord to concede if other tenants bear these costs.

Some leases bar a landlord from passing on new tenant costs to other tenants; but many are silent. Also, if LL 87 costs relate to systems or areas outside the new tenant’s space, the landlord can argue that they are building, not new tenant, costs.

LL 87 costs of new construction or alterations will typically be capital costs (see below).

Existing ‘Covered Buildings’

For covered buildings, the new rules require: (1) energy audit, retro-commissioning and energy efficiency report [LL 88]; (2) “benchmarking” energy and water use [LL 84]; and (3) energy upgrades and sub-metering [LL 85].

Each requires qualified consultants; the upgrades and sub-metering require qualified contractors. In some cases these costs will be ordinary expenses; in others, capital expenditures.

Local Law 88 Requirements

The LL 88 “energy audit” identifies changes to building systems to optimize energy performance and reduce energy costs. The audit criteria are comprehensive.

Along with the audit LL 88 requires “retro-commissioning,” “a means to optimize the energy efficiency of existing building systems through correction of deficiencies,” including repairs, cleaning, adjustment of valves, sensors, control settings or operational practices. “Commissioning” had previously been used in new construction; LL 88 now applies this discipline to existing buildings.⁵

LL 88 directs the city’s Department of Buildings (DOB) to promulgate a list of rules for retro-commissioning to “ensure, at a minimum, that sufficient analysis, corrections, and testing have been done so” that the base building systems meet a list of specified criteria, which is long. Compliance requires not just analysis but corrective work (which may range from updating or recreating original building plans to replacement of subpar or defective system components).

Any “alterations” will, of course, bring into play the LL 87 rules for new construction.

Following the energy audit and retro-commissioning, LL 88 requires filing an “energy efficiency report” with the DOB on results of the audit and retro-commissioning. The report must also identify “all reasonable measures, including capital improvements, that would, if implemented, reduce energy use and/or the cost of operating the building.” LL 88 does not require the owner to start such capital improvements; but future laws may so mandate.⁶

Under lease pass-through clauses, costs of the energy audit and the retro-commissioning may be deemed “ordinary” if there is no construction. Costs of new alterations must of course be capitalized.

There is a further argument that all LL 88 costs should be capitalized and amortized over 10 years because LL 88 requires the audit, retro-commissioning and report every 10 years. (The starting date is 2013, keyed to the last digit of the building’s tax lot number).⁷

Local Law 84

LL 84 requires upgrades of building lighting systems and installation of sub-meters in tenant spaces, effective from 2025. Lighting systems include controls (interior lighting controls, light reduction controls, and automatic lighting shutoff), tandem wiring, exit signs, interior lighting power requirements, and exterior lighting.

The LL 84 upgrades must comply with the LL 87 standards for new systems for the “entire” covered building. Hence this upgrade must include tenant spaces as well.⁸ Obviously, to the extent this work is a “new alteration” LL 87 construction rules will apply.

In covered buildings sub-meters must be installed in “covered tenant space,” *i.e.*: (i) space larger than 10,000 gross square feet on one or more floors let or sublet to the same person; or (ii) a floor larger than 10,000 gross square feet leased to two or more different tenants.

Where LL 84 requires work inside tenant spaces, or conversion of a directly metered tenant to a sub-meter, the landlord may ask the tenant to pay these costs directly, not just via the lease pass-through clauses. This will depend on the tenant’s “compliance with laws” clause, *i.e.*, that the tenant must pay the whole cost if it is the tenant’s direct duty to comply with the law.

Costs of installing sub-meters and upgrading lighting systems are usually capital expenditures.

In residential buildings there may be tension between LL 84 and the New York State Public Service Commission. Although sub-metering can reduce energy use (particularly in multifamily housing), NYSPSC has made it difficult for residential buildings to sub-meter, to the exasperation of New York City officials.

Benchmarking Under LL 85

LL 85 requires annual benchmarking of energy and water use for covered buildings.

“Benchmark” means to input to the specified database “the total use of energy and water for a building for the previous calendar year and other descriptive information” as required. LL 85 will require the landlord to engage a consultant to advise on compliance, assemble required data, and perform the benchmarking. As an annual cost this should be an ordinary expense.

Who Pays?

Many New York commercial leases have “operating expense” pass-through clauses.⁹ Most such clauses require the tenant to pay its share of building expenses above a base year or a base dollar amount. (The tenant’s share is usually proportional to its space in the building.)

“Operating expenses” means, typically, the landlord’s costs of operating the building, computed according to the landlord’s standard accounting practices. Thus any ordinary or annual expense typically passes through to the tenants, *i.e.*, the annual costs of the LL 85 benchmarking and perhaps any consultant costs, such as for the LL 88 energy audit and energy report, or for LL 88 retro-commissioning.

As noted, however, there is also an argument that the LL 88 costs should be capitalized because this must be done every 10 years. Also, any retro-commissioning that involves alterations would be capital.

A few operating expense clauses bar the landlord from charging tenants any costs, ordinary or capital, of building-wide legal compliance, on the theory that the landlord must maintain the building in lawful condition. If a lease contains such a bar, the lucky tenant might argue that no costs of the new local laws can be passed through. However, there will be few such lucky tenants, since filing reports and complying with changing legal rules has always been part of the ordinary operation of a building.

A few operating expense clauses also bar the landlord from passing through any capital costs. The theory is that the landlord has a duty to maintain the building in as good condition as it was marketed to the tenant.

Most leases do permit the landlord to pass through capital costs, subject to some standard limitations. One such clause requires the tenant to pay its share of depreciation or amortization of capital improvements. The tenant’s share is usually limited to depreciation or amortization chargeable during the part of the useful life included in the remaining term of the tenant’s lease.

For example, suppose Tenant X leases 10 percent of a building with five years left in the lease term. Landlord spends \$10 million to upgrade the building to comply with LL 88. The investment has a 10 year life for depreciation. Tenant X thus pays \$200,000 per year, *i.e.*, 10 percent of the landlord's investment allocable to the five year remaining term of the lease.

Some operating expense clauses have a further limit: the tenant pays only depreciation on improvements that reduce the building's annual operating expenses. While it is likely that a landlord's LL 87 or 88 investments will result in reduced energy costs, this would be a question of fact to be confirmed.

In the end, if a lease permits pass-through of capital costs to the tenant, there will be two key issues: (i) Is a particular cost ordinary or capital? and (ii) If capital, what is the proper useful life?

As noted above, the tenant must pay 100 percent of an ordinary cost for the year incurred, while capital costs can be spread out, often with only a portion of the useful life chargeable during the tenant's lease. If a charge is capital, having a 39.5 year,¹⁰ rather than a 10-year, useful life is obviously better for the tenant. Selection of the useful life will depend on the language of the lease and the landlord's accounting practices.

A small minority of New York City leases may permit the landlord to pass full capital costs of building improvements, *i.e.*, not just the annual depreciation charge, directly to the unlucky tenant in accordance with the tenant's sharing percentage. Most leases will not permit this result, however.

Finally, of course, no pass-through clause will help a landlord with recession-related vacancies.

Rent Stabilized Buildings

For residential buildings subject to rent stabilization, a building-wide systems upgrade would seem likely to qualify as a "major capital improvement" for purposes of rent increases.¹¹

Whether the LL 88 costs of energy audit, retro-commissioning and energy report can be included as part of this cost may be a question.

So, You Want My Consent?

Another way for a landlord to require tenant cost-sharing under the new city rules may be indirect, by imposing conditions to the landlord's consent for new alterations proposed by a tenant, or by imposing conditions in connection with a proposed sublease or assignment.

Suppose a tenant submits plans to the landlord for renovation in the tenth year of a 20 year lease. A landlord sometimes agrees not to "unreasonably withhold consent" to a tenant's plans (provided they satisfy criteria in the lease).

There would seem a good argument that the landlord can "reasonably" require the tenant to pay all costs of LL 87 compliance.

Suppose the tenant's work will require LL 87 changes outside the tenant's premises. Since it is the tenant requesting the approval, it would be reasonable for the landlord to impose this condition.

Can a landlord condition consent to a sublease or assignment on the tenant's agreement to pay not only the LL 87 costs but also to pay the tenant's share of LL 88 sub-metering lighting system upgrade? The tenant might argue (i) that such a condition is "unreasonable" because the tenant should not pay for building-wide legal compliance and (ii) that such a condition has nothing to do with the landlord's duty to be reasonable in reviewing the qualifications of the prospective subtenant.

Consents to Lease Changes

Office leases often require the landlord to furnish a minimum power load to the premises, for example, five watts per rentable square foot.

Some leases give the tenant a right to draw additional power for future use (e.g., if the tenant wants to upgrade a trading floor or an IT facility). Also, many tenants have specific rights to direct metering.

Does the landlord need the consent of a direct-metered tenant where LL 88 requires sub-metering? If a tenant is required to comply with laws applicable to its space, does the tenant have a direct obligation to allow and also to pay for the sub-metering?

There is also another type of tenant right that may raise issues. If a landlord wants to locate a new energy facility, such as solar panels, fuel cell or mini-cogeneration plant, on a roof or set-back or in another building space, a tenant may have the right to that space. Tenants may also have rights to ducts and risers within the building. In such cases the landlord may need to re-acquire such rights from the tenants.

Conclusion: Examine Closely

There is no happy answer for dealing with the costs of the four new local laws.

The end result will be the promised land, a much greener New York City with updated energy systems and (hopefully) reduced costs. In the short term, however, there will be a major incentive for landlords to charge the costs to existing tenants under their lease pass-through clauses.

There will be new cottage industries of professional consultants and contractors. There may be a spike in costs as landlords compete for the services of a relatively limited number of qualified professionals and contractors, which is what happened during the first five Local Law 11 cycles.

Hence the advice to landlords and tenants is simple: Get out your magnifying glasses and review the fine print in your leases. There will be many interesting questions to answer when you prepare or receive the bills for the costs of Local Laws 84, 85, 87 and 88.

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Endnotes:

1. Local Law 11 of 1998, the so-called “Façade Law,” created a major new industry of design and construction experts and was a bonanza for the sidewalk-bridge/scaffolding business.
2. Local Law 5 of 1973.
3. See Charles S. Warren, Karen L. Mintzer, Inge Hindriks and Pamela Swidler, “New York City Goes ‘Greener’ and ‘Greater,’” *New York Law Journal*, March 15, 2010.
4. Generally, “covered buildings” means buildings containing (a) over 50,000 gross square feet; or (b) two or more buildings on the same lot that together exceed 100,000 square feet; or (c) two or more condominium buildings governed by the same board that together exceed 100,000 gross square feet; and (d) certain city-owned buildings.
5. Commissioning, now a LEED pre-requisite, is relatively recent as a separate discipline and has been applied mainly to new construction.
6. Before passage LL 88 required owners to make certain improvements identified in the energy report within one year. The final law omitted this.
7. *E.g.*, 2013-3; 2014-4; 2015-5; etc.
8. LL 84 does not address rates chargeable under sub-metering, perhaps assuming that sub-metering will allow the landlord to find ways to reduce electricity cost. However, sub-metering is a profit center for many landlords.
9. Landlords with porters’ wage, or consumer price index, expense sharing will not be able to pass through the costs of the new city rules to their tenants.
10. For example, 39.5 years is the standard useful life for many improvements to real estate under the Internal Revenue Code of 1986, as amended.
11. 9 NYCRR§ 2522.4.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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