

### Real Estate Trends

#### COMMERCIAL LEASES

## Local Law 97: Aligning L&T Interests Through ‘Green’ Lease Provisions

By Peter E. Fisch and Salvatore Gogliormella

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In 2019, New York City enacted Local Law 97 (LL97) as part of a suite of legislation aimed at combatting the threat of climate change. Given that New York City’s building stock is responsible for upwards of two-thirds of citywide greenhouse gas (GHG) emissions, LL97 specifically targets emissions emanating from the city’s largest buildings.

Through its implementation of the law, the city intends to achieve an 80 percent reduction in building emissions levels by 2050, relative to 2005 levels. *2019 N.Y.C. Local Law No. 97* §3.

To achieve the city’s emission reduction goals, LL97 places emissions limits on approximately 40,000 New York City buildings and nearly 60 percent of the city’s building area, or 3.15 billion square feet, according to a website created by the New York City Department of Buildings (DOB) to assist building owners in complying with LL97.



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<https://www.nyc.gov/site/sustainablebuildings/requirements/covered-buildings.page>.

Subject to some exceptions, “covered buildings” under LL97 include (i) buildings that exceed 25,000 gross square feet; (ii) two or more buildings on the same tax lot that together exceed 50,000 square feet; and (iii) two or more condominium buildings governed by the same board of managers and that together exceed 50,000 square feet. *2019 N.Y.C. Local Law No. 97* §5.

Beginning on Jan. 1, 2024, covered buildings will be required to comply with emissions limits set forth by LL97 and its accompanying regulations (1 RCNY §103-14), which were finalized this past December by the New York City Department of Buildings (DOB). The limits, as well as

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penalties for exceeding these limits, will vary depending on each covered building's size and property classification.

Issuance of penalties for noncompliance will begin by May 2025, which is when the first compliance reports are due to DOB and will be reviewed by the agency's newly created Office of Building Energy and Emissions Performance. *2019 N.Y.C. Local Law No. 97 §5-6.*

The size of the penalties will vary depending on the extent to which a covered building's emissions exceed its LL97-prescribed emissions limits. LL97 limits will become successively more stringent over the course of the law's five major compliance periods (2024–2029, 2030–2034, 2035–39, 2040–49, and 2050 and after.) *1 Rules of the City of New York §103-14.*

### **Existing Compliance Strategies & Challenges**

Ahead of the first LL97 compliance period beginning in January 2024, landlords have been considering a number of compliance strategies, including:

- investing in building retrofits (e.g., installing LED lighting, more efficient windows, and energy-saving HVAC systems);
- implementing greener operational procedures (e.g., optimizing usage of hot water and lighting);
- purchasing GHG offsets or renewable energy credits (RECs); and
- switching to cleaner or distributed energy resources, or small-scale energy resources usually situated near sites of electricity use (e.g., co-generation and other on-site renewable energy generation systems).

Oversight—Local Law No. 97: Hearing Before the N.Y.C. Council Committee on Environmental Protection (Apr. 22, 2022) (committee report),

<https://legistar.council.nyc.gov/View.ashx?M=F&ID=10718650&GUID=7257B7D2-8D24-432F-9BF8-CBF64152F05F>.

However, implementing any one of these strategies (or a combination of them) will inevitably impose significant financial costs on landlords. A 2019 study by Urban Green Council, an environmental advocacy nonprofit, estimated that the costs of retrofits alone—solely during the first and second compliance periods—would total almost \$20 billion. [www.urbangreencouncil.org/sites/default/files/urban\\_green\\_retrofit\\_market\\_analysis.pdf](http://www.urbangreencouncil.org/sites/default/files/urban_green_retrofit_market_analysis.pdf).

In addition, penalties and fines for noncompliance with LL97 are sizable and, according to a 2021 report by the nonprofit Citizen's Budget

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Commission, total an appreciable portion of a building's gross revenue in some cases. <https://cbcny.org/research/balancing-incentives-maximize-emission-reduction#:~:text=LL97%20sets%20the%20ambitious%20targets,into%20line%20with%20those%20limits>.

A 2023 report commissioned by the Real Estate Board of New York, a real estate trade association, estimates that by 2030, 13,500 properties could cumulatively face penalties as high as \$900 million each year, or an average of \$67,000 annually per building. <https://www.rebny.com/press-release/report-local-law-97-fines/>.

Tenants, especially in the commercial context, control a significant portion of a building's energy use. But as of now LL97 does not provide

a mechanism for imposing obligations on tenants or for passing along LL97-related fines to them.

In the absence of direct arrangements between a landlord and a tenant to share these burdens, they will fall upon the landlord, while the tenant will enjoy the benefits of the landlord's compliance (for instance, in the form of reduced energy bills).

This potential misalignment between the party bearing the costs of energy efficiency upgrades and the party reaping the resultant benefits is commonly referred to as a "split incentive problem," and may ultimately discourage landlords from investing in energy efficiency upgrades. In other words, while in theory LL97 penalties will motivate landlord compliance, the economic and practical reality is that the onus imposed by LL97 will need to be borne (at least in part) by tenants.

Tenants may not be completely opposed to this concept, as greener buildings have been found to be more valuable to tenants. A 2023 study by JLL, a global real estate consultancy, found that environmentally sound buildings with better sustainability credentials are achieving markedly higher rents. <https://www.jll.co.uk/en/newsroom/environmentally-sustainable-real-estate-attracts-higher-prices>.

For some time now, landlords and tenants have been negotiating "green leases," or leases containing sustainability or environmental provisions.

While the "green lease" concept is not new, it has continued to evolve over the past decade in response to a heightened awareness about the threat of climate change. Michael A. Bedke's Practical Law Practice Note, *Ownning and Leasing Green Real Estate*, provides a helpful catalogue of commonly used green lease forms, as well as best practices for negotiating key clauses in such leases. <https://us.practicallaw.thomsonreuters.com/4-586-4967?transitionType=Default&contextD>

*ata=(sc.Default)&VR=3.0&RS=cblt1.0&documentSection=co\_anchor\_a973362*. In New York City, these green leases are becoming tailored more specifically toward complying with LL97.

### Examples of Lease Provisions

In light of the paradigm shift LL97 represents to the New York City commercial real estate community, we have highlighted below several common green lease clauses that commercial landlords and tenants might consider adapting in order to more effectively allocate the costs and benefits of LL97 compliance.

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The size of the penalties will vary depending on the extent to which a covered building's emissions exceed its LL97-prescribed emissions limits.

**Operating Expenses.** In a modified commercial gross lease often used in the commercial context in New York City, the landlord passes through a proportionate share of the building's operating expenses (or any increase in operating expenses over a base year) to tenants. Such expenses typically cover cleaning, repairs, and other tasks required to maintain the building.

However, tenants typically seek to limit the landlord's ability to pass through the cost of the landlord's capital improvements to the tenant through these operating expense reimbursements. Tenants often have little incentive to invest in making upgrades to the landlord's property, especially when the fruits of those upgrades will extend far beyond the tenant's lease term.

In addition, from a tenant's perspective, the costs of compliance with existing laws is known to the landlord at the time of the lease, and should be reflected in the base rent paid by the tenant.

Consequently, tenants often try to limit the pass-through of capital costs to those required by a change in law. In many cases, tenants will also agree to pay a portion of the costs of capital improvements that are intended to (and actually do) reduce operating costs.

In the LL97 context, since many landlords will be compelled to make energy-saving retrofits in order to comply with the law, the tenant will get the benefit of savings on operating expenses, like heat and electricity charges, without bearing any upfront costs unless the lease provides otherwise.

This misalignment in interests illustrates the “split incentive” problem described above, and green lease forms may include clauses drafted specifically to address it. Forms like New York City’s “Energy Aligned Clause,” which was developed by Mayor Bloomberg’s Office of Long Term Planning and Sustainability and is still available on the city’s website ([https://www.nyc.gov/html/gbee/downloads/pdf/eac\\_overview.pdf](https://www.nyc.gov/html/gbee/downloads/pdf/eac_overview.pdf)), create a pass-through structure whereby tenants share the costs of energy-saving capital improvements by paying the landlord an amount equal to the predicted annual savings the tenant will enjoy as a result of the landlord’s improvements.

Parties can create a separate definition for capital improvements necessary to achieve LL97 compliance and allocate the attendant costs differently than other capital improvement costs.

Even if there is agreement generally on a separate arrangement for these green lease provisions, the tenant may seek to negotiate a mechanism to avoid paying for underperforming improvements.

For instance, if a co-generation system the landlord has installed falls into disrepair, the tenant may try to avoid making further payments related to the installation and maintenance of that system.

In addition, the tenant may seek to ensure that the prediction of annual savings is determined by a mutually agreed upon specialist, not a specialist unilaterally hired by the landlord.

Another provision beginning to appear in operating expense clauses is protection for the tenant in a case where the cost of LL97 penalties is lower than the cost of compliance. While the tenant may be able to pay its share of LL97-related costs, if savings can be realized by avoiding or deferring compliance, tenants may choose to force landlords to proceed in that manner.

Beyond looking to pass along operating expenses associated with capital improvements and retrofits, landlords may wish to share the administrative costs of compliance with LL97. For instance, many landlords subject to LL97 will likely need to hire specialists to accumulate their buildings’ energy data and file compliance reports with the city. In addition, if the landlord decides to purchase carbon offsets or RECs to achieve compliance, the landlord may seek to pass along a portion of the associated costs onto tenants. However, depending on their negotiating leverage, tenants may in turn seek to require consent before the landlord hires specialists and purchases offsets or RECs.

**Alterations.** The alterations provision of a commercial lease governs the rights of tenants to alter the leased premises—both during the initial build-out and over the course of the lease term.

As noted in a 2014 report by Boston-based non-profit A Better City, a typical green lease might include a clause prohibiting the tenant from making alterations that the landlord reasonably anticipates will adversely affect the building’s environmental certification status (for instance, LEED certification, Energy Star rating, or Green Globe accreditation). <https://www.abettercity.org/docs/abc-rpt%20green%20leasing%2012%2014.pdf>.

Similarly, in the LL97 context, an alterations provision might require the tenant to make a statement regarding a proposed alteration's expected impact on LL97 compliance and prohibit the tenant from making alterations that the landlord reasonably anticipates will adversely affect the building's LL97 compliance status.

Furthermore, the landlord might seek to specify that withholding consent to an alteration due to the proposed alteration's anticipated impact on LL97 compliance would not be considered "unreasonable" under the terms of the present lease.

From the tenant's perspective, the cost of any proposed alteration, especially during the initial buildout, will likely increase if the landlord is requiring the tenant to comply with strict energy efficiency standards tailored to LL97 compliance. Accordingly, tenants may insist upon higher tenant allowances from the landlord in order to cover this extra cost of compliance.

**Building Rules and Regulations.** Building rules and regulations generally govern the behavior of tenants occupying a commercial building. In light of LL97, landlords may seek to impose rules and regulations that further their compliance goals.

For instance, as suggested in a 2018 guide of Building Owners and Managers Association International, a professional association for owners and managers of commercial real estate, green lease forms may prohibit "energy-intensive" equipment (such as space heaters and portable air conditioners) from being used in the leased premises and may require tenants to install energy-saving time sensors on lighting and other equipment the tenant uses. <https://www.boma.org/GreenLeaseGuide>.

In the context of LL97, landlords may also want to ensure they have sufficient flexibility to amend

the rules and regulations over the course of the lease, because landlords will undoubtedly be forced to conduct LL97-related retrofits and other upgrades over the course of the lease term. For their part, tenants will seek to reserve the right to review and consent to these changes to the rules and regulations.

## Conclusion

The provisions discussed above are but a few examples of those that will likely need to be adapted in order to account for the city's implementation of LL97. Others include: assignment and subletting clauses that may need to ensure that the assignee or subtenant's use of the premises remains consistent with the landlord's LL97 compliance goals; legal compliance clauses that may need to account for the very real possibility of the building's noncompliance with LL97; and data sharing clauses that will need to ensure the landlord is able to obtain sufficient information about the tenant's energy usage in order to produce annual LL97 reports.

One thing is certain—the impending implementation of LL97 in New York City will give rise to significant changes in the way commercial buildings are constructed, operated, and leased. Similar changes will soon be felt by landlords and tenants in localities outside New York City.

In recent years, cities such as Houston, Los Angeles, and Miami, among others, have released decarbonization plans, all of which make reducing building emissions a centerpiece. As a result, landlords and tenants involved in commercial leasing activities across the country should contemplate the passage of laws similar to LL97 when drafting and negotiating these long-term relationships.