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Important transactional considerations of green building construction projects

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Green building construction projects have become increasingly common for a variety of social, economic, and regulatory reasons. Accordingly, the commercial loan and investment markets are witnessing an uptick in requests to fund such projects. This article briefly examines many reasons for such demand and explores the critical considerations of which parties should be aware to maximize the success of transactions involving green building construction projects.

If you Google "cost of green construction" you will be presented with hundreds of papers all reporting green construction to be only 1-2% higher; some say it is no more costly. The question that is never asked or answered, however, is "higher than what?" If you're comparing a LEED certified facility to a code minimum building with the lowest cost mechanical and electrical systems, the difference will be substantially greater than the oft quoted 1-2%. Unfortunately, in today's market, that less expensive code minimum building leases and finances on nearly the same terms as the more expensive higher performing building. The problem with most of these studies is that they make no distinction between building types and sizes. The smaller the building, the more financially difficult it becomes to build a LEED certified building that can compete in the marketplace. One thing becoming increasingly evident is that as design teams and contractors become increasingly familiar with green building features and as necessary materials become more readily sourced, the initial costs associated with green building projects are likely to decrease.

Does that mean a code minimum, low performance building is what you should be constructing? Of course not! The benefits of a high performance building can't be judged on initial cost alone. It's important to consider the potential savings high performance construction provides. Lower energy costs (up to 30% compared to code minimum buildings) reduce the building's operating expense, raising the net income and, theoretically at least, the asset valuation. As tenants become more knowledgeable about, and begin demanding, high performance buildings your code minimum facility will be quickly outclassed in the marketplace. Unfortunately, we also know that the usual sources of capital do not necessarily place the appropriate valuation on "green" features that make buildings more hospitable to their environment and the people inside. Furthermore, energy initiatives such as tax credits under the United States Energy Policy Act of 2005 and other federal, state, and local grants provide incentives for owners to explore green building projects.

Another advantage of building green is to keep ahead of the regulatory requirements. It is a matter of time before green building features become the standard and, in some areas the regulations are already in place. For example, specific environmental building standards applicable to all new buildings 50,000 s/f or larger have been adopted by the Boston Zoning Commission.

A brief overview of Leadership in Energy and Environmental Design (LEED) is required to understand the relationship of due diligence investigations and covenants. The United States Green

Building Council (USGBC), a non-profit corporation developed to the LEED Green Building Rating System, to establish a uniform method by which to evaluate various types of construction projects. Some level of LEED certification is a common requirement for green building projects and it allows a lender or investor to qualify the level of energy efficiency that a borrower or investment vehicle must achieve. LEED certification may not be pursued on all green building projects, after all, certain worthwhile improvements may be difficult to justify on a cost-benefit basis, and some level of increased efficiencies certainly can be obtained without incurring the elevated cost that are sometimes associated with LEED certification. However, in the absence of LEED certification requirements, the use of terms such as "energy efficient", "sustainable", "environmentally sound" and "green" to describe the goals of green building projects are often open to wide-ranging interpretations.

GREEN BUILDING DUE DILLIGENCE QUETIONAIRE

One method transaction parties may use to establish expectations about the energy-efficient nature of a project is the completion of a green building due diligence questionnaire during the information-gathering stage of the transaction. This questionnaire would cover matters such as whether the construction of the building will be completed with the goal of LEED certification (and if so, the level of certification should be specified); a description of the green building features contemplated, a list of energy efficiency performance goals; a list of the projected costs and maintenance requirements associated with the project ; a list of energy credits or other financial incentives expected; a description, including credentials, of the design and construction team; a representation of whether the necessary variances have been obtained (e.g. whether a wind mill would violate a regulation governing building height limits).

GREEN BUILDING COVENANTS

In addition to conducting a "green" aspect of due diligence, a lender or investor may consider adding milestones or on-going requirements related to building green. Potential covenants are wide-ranging in nature, and actual requirements should be tailored to the particular project. Examples of areas that may be subject to green building covenants include the achievement of a certain level of LEED certification, the procurement of energy tax credits, the maintenance of particular operating cost levels (which may be affected by energy efficiency projections), and the stipulation that contractors must be bound by any relevant requirements.

To most effectively establish useful covenants, a lender or investor should consider the consequences of the failure of a company to meet such requirements. For example, in one closely watched lawsuit filed in Maryland circuit court, a developer claimed that the failure by a builder to meet a silver level of LEED certification cost the developer projected tax credits of \$635,000. Though this case settled out of court, it raised the question of what outcome would result if the underlying contract specified whether damages would apply, and the amount thereof, in the event the builder failed to meet certain expectations related to the green building project. Lenders and investors clearly have a stake in mandating these types of covenants to the extent that the cash flow of their borrowers or investment vehicles may be affected.

Commercial lenders and investors will be well poised to take advantage of the current market trend toward green building projects by learning about the various green building features that are available, establishing and managing expectations of transaction parties with respect to outcome,

and properly allocating risks and responsibilities among transaction parties.

One challenge we see is in educating owners, financiers and users of real estate about the long term benefits of designing and constructing a higher performing building. Until such time as high performance green buildings are afforded the higher asset and lease valuations they deserve, designing, financing and leasing a green building will be a challenge. On the build side, contractors, subcontractors and vendors need to get comfortable with the challenges of building green. We have seen evidence of a "fear factor" priced into projects demanding high performance materials and systems. This will change with time and experience. The early adoption of internal practices and policies relating to green building projects will facilitate successful and profitable transactions for years to come.

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