



News & Publications

ESG Leasing Provisions: The Art Of Balancing Aspirations With Realities

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Environmental, Social, and Governance (“ESG”) generally refers to policies, standards, and behaviors that can be used to address an organization’s external impacts and internal processes regarding a range of issues related to environmental sustainability (such as greenhouse gas emissions), social issues (such as diversity, equity, and inclusion), and corporate governance (such as transparency, ethical practices, and executive compensation). While many companies are seeking to increase the role of ESG in their businesses, it is critical that they also understand how ESG initiatives can quickly become significant enough to compel reassessment of lease agreement provisions, and how best to modify the lease accordingly. Currently, leasing is mainly impacted by the “E” in ESG, but since environmental concerns are now commonly packaged together with social and governance concerns as a single ESG concept and goal, discussing any one of these concerns collectively as an ESG concern provides a fuller view of the shifting trends in policy and market dynamics impacting leasing now and potentially into the future.

ESG Drivers, Limits, and the Businesses Caught in Between

Aside from the broader humanitarian or environmental goals owners and tenants may have, ESG initiatives can create efficiencies that may provide immediate or long-term financial benefits to a project. Requiring efficient equipment, products, and materials can potentially lower building energy costs significantly, while tracking and reporting energy consumption allows owners to stay better informed of energy efficiency in their properties. Additionally, ESG efforts can make projects more desirable for communities if they can mitigate negative impacts such as truck traffic or pollution that result

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from a building's operations.

However, external pressures from regulatory constraints and investor demands also play a role in ESG's prevalence. For example, new final rules from the U.S. Securities and Exchange Commission require certain businesses to report climate-related information in registration statements and periodic reports. In addition to California's AB 802 (requiring annual public disclosure of energy usage for certain commercial and multi-family buildings), two new laws in California (SB 253 and SB 261) now require certain public and private businesses to make climate-related public disclosures. These disclosures will help steer ESG-committed investors to the companies with the best ESG score cards, and screen off companies with low ESG scores, thereby creating a strong incentive for businesses to implement ESG initiatives. Investors may additionally take a more "hands on" approach by requiring a company to show data, policies, and strategies related to ESG advancement. Illinois recently took this more active approach by passing HB 2782, which requires investment managers for the state's public pensions to disclose how they integrate sustainability factors such as greenhouse gas emissions, air quality, labor practices, and diversity and inclusion into their decision-making, investment analysis, and portfolio construction. As another regulatory example from California, certain new commercial buildings and multifamily residential buildings over three stories are now required to install a system of photovoltaic/solar panels and a solar battery storage system pursuant to the updated 2022 Building Energy Efficiency Standards, title 24, part 6, of the California Code of Regulations, adding to the solar mandate already in place for residential buildings up to three stories high (See Cox, Castle & Nicholson's previous publication on this solar mandate for more details: (<https://www.coxcastle.com/publication-harnessing-the-power-of-solar-californias-new-commercial-and-multifamily-residential-buildings-must-now-include-solar-panels-and-battery-storage>)).

Investor requirements and government regulations provide significant impetus to propel ESG initiatives forward; however, business and legal considerations can place limits on ESG implementation. ESG initiatives can be too cost-prohibitive for businesses to undertake, and pursuing ESG aspirations at the expense of profitability raises concerns regarding fiduciary duties to shareholders. Indeed, in some cases, a company may face a moral and legal dilemma that pits profits against ESG considerations when the cost of paying fines for failure to comply with new regulations is substantially less than the cost of implanting expensive new improvements required by such regulations, and some companies may have decided it was more cost effective to pay such fines rather than comply. While it may become increasingly costly (and even unlawful) for a business to pay too little attention to ESG, focusing too narrowly on ESG may bring high costs and legal challenges of its own. Thus, ESG compliance strategies present an extremely complex balancing act, and any decision should only be made after consultation with counsel who, as part of such compliance strategy, can review and update relevant lease provisions to help achieve the desired balance going forward.

ESG Lease Provisions

Which provisions to revise or add to a lease agreement completely depends on the particular ESG initiatives being implemented. The following is a non-exhaustive list of potential ESG-related concepts that a building owner may want to consider inserting into the lease:

- **Costs:** In order to reduce the expense of ESG implementation, a building owner may want to insert a provision passing ESG-related costs on to the tenant, at least to the extent such costs are not within landlord's control. Such costs could include the cost of bringing the building and/or project into compliance with new ESG statutes,



regulations, and ordinances, the cost of ESG fines if Landlord elects not to comply with certain ESG regulations where the consequences are strictly monetary, and the cost of acquiring and maintaining green certifications.

- Minimizing Energy Usage/Emissions: An owner may additionally consider requiring the tenant to (or requiring the tenant to endeavor to) conduct operations in the building to minimize energy consumption and greenhouse gas emissions, water consumption, waste, and negative impacts to indoor air quality, while also reserving to landlord the right to operate the common areas in the same manner.

- Green Certifications: A tenant may be required to conduct operations in a manner that permits the building to achieve and maintain various green ratings, certifications, and performance programs.

- Reporting Energy Usage: When utilities are separately metered and the tenant contracts directly for utilities, a landlord may not be able to know energy usage information unless the tenant agrees to the release of such information to landlord. To address this issue, the lease can include a provision requiring tenant to release utility usage information if requested by landlord or a governmental agency, and sign documentation necessary to evidence tenant's consent to such release. The lease may also include a provision giving landlord the right to install a power metering device to collect energy usage data and maintain corresponding software in connection with such power metering device.

- Solar Panels: Solar panels have proven to be a popular ESG modification with building owners, even when no regulation requires their installation. However, an owner does not want to be in the position of depending on a tenant's consent. A lease provision reserving solar panel installation rights to the landlord (whether rooftop, ground mount, or carport) helps avoid surprise objections and hang-ups from the tenant if the landlord desires to install solar panels during the term of the lease. Additionally, an owner will want to reserve for itself any tax benefits, and pass through any costs (such as power purchase agreement ("PPA") costs) to the tenant, but if the tenant pushes back on costs then the landlord may need to limit certain pass through costs to the extent they are offset by the tenant's utilities savings. Rather than buying the solar panel system, owners often enter into a site lease with a solar provider for installation and access rights (which may involve the co-use of space with another tenant), plus a PPA. If a tenant is given the right to install solar panels then the landlord should reserve the right to review and approve installation (paying close attention to any roof work and how such work may impact any roof warranty), and the parties should address what happens to the solar panel system at the expiration or earlier termination of the lease term.

- Electric Vehicle Chargers: Many owners now desire to install electric vehicle chargers, both for tenant exclusive use and for in-common use among multiple tenants. Industrial owners are also installing large truck charging depots for non-exclusive use among tenants in multi-tenant industrial warehousing and distribution projects. Landlords must be careful to draft provisions in leases reserving rights to develop electric vehicle charging areas, and to avoid granting to tenants parking and other common area rights that may prevent landlords from developing electric vehicle charging areas.

Conclusion and Takeaway



While the drivers of ESG initiatives vary from company to company, the need to balance ESG with business and legal realities is ubiquitous. Tailored ESG lease provisions can help businesses achieve the desired balance that works best for their unique needs, whether by inserting such provisions in standard lease forms or adding them to the next lease amendment. If you would like to know more about ESG-related leasing considerations, please contact Dave Wensley, Julian Freeman, or Gabe Pitassi.