

Insights

ADOPTION OF GREEN LEASES IN HONG KONG SAR – PART 1

PIONEERING BEST PRACTICES

Aug 24, 2022

SUMMARY

In view of the rising popularity of green leases in various markets and the continued significance of sustainable practices, green leases must become an essential development in Hong Kong SAR. There is a wide range of sustainability standards, tenant obligations and methods for incorporating green practices – there is also a need for landlords and tenants to create a tailor-made solution in special circumstances for certain types of tenancies.

We will explore best practices for specific sustainability requirements with more specific examples in [Part 2](#) of this series.

INTRODUCTION

“Green leases” broadly refer to leases which contain terms setting out landlords and tenants’ obligations in connection with sustainability. The sustainability objectives underlying green leases may vary for different reasons including, among others, statutory or other legal requirements in relevant jurisdictions, market practices and, of course, commercial negotiations. However, we note that common themes such as energy efficiency, waste and water management and building certification requirements have emerged in green leases in various jurisdictions in recent years.

OVERVIEW OF ADOPTION OF GREEN LEASES IN HONG KONG SAR AND OTHER DEVELOPED MARKETS

Given that sustainability is now a prominent feature of corporate policies, we observe in a number of markets that it has become increasingly common for landlords and tenants to assess the level of sustainability of their lease portfolio. Sustainability-related obligations and commitments in leases may also form part of the measurement matrix of sustainability-linked loans. For investors who wish to maintain a sustainable portfolio, property developments which mandate standardized green

lease terms may also be a draw both for tenants and investors. We have observed that green leases have seen increasing popularity across various jurisdictions including the United Kingdom, Australia and Singapore. In the United Kingdom and Australia, industry organisations (*Better Buildings Partnership* in each jurisdiction) have developed model green clauses.^[1] Similarly, the Building and Construction Authority of Singapore has developed a schedule of standard lease clauses relating to sustainable design, management and wellbeing. Market studies suggest that globally around 34% of occupiers are parties to leases which contain “green” elements and a further 40% plan to sign leases of this type.^[2] However, the degree of “greenness” may leave one feeling somewhat underwhelmed!

On the other hand, in Hong Kong SAR, green leases “with any degree of substance” still appear to be relatively uncommon despite appearances and “market talk”. In particular, we have the following observations in relation to the adoption of green leases in the local market:-

- a. In 2014, the Hong Kong Green Building Council Limited published a guideline called “Green Tenancy Driver for Office Buildings”, which sets out a roadmap for encouraging the adoption of green leases in Hong Kong SAR, including opening up dialogues between landlords and tenants for standard-setting and identifying incentives for such parties.^[3] We note that the guideline had been prepared following consultation with various stakeholders including leading developers, property managers, public bodies etc and should have been an early and positive milestone for the development of green leases in Hong Kong SAR.
- b. At present, however, green leases are not the norm in the office and retail leasing market in Hong Kong SAR. Although a number of landlords have adopted fit-out or operation guides containing sustainability-related provisions, these guides tend to be non-binding. More recently, we are now seeing some improvements such as an opt-in scheme which has been introduced in some Grade A office buildings, so that tenants adopting environmentally or socially sustainable practices may obtain subsidies or rewards for retail spending. However, it appears that green leasing terms have yet to make their way in to the standard form leases of the majority of leading commercial landlords.

In light of the rising popularity of green leases globally and the apparent lag in adopting this form of lease in Hong Kong SAR, it will be helpful to examine the key considerations for parties when adopting sustainability-related leasing terms in other developed markets. We will summarise our observations in this series of two articles. We will focus on broad issues for setting out the groundwork of a green office/retail lease and considerations for landlords and tenants in this edition. We will explore specific issues relating to sustainability management in the next part of the series.

STANDARD SETTING

A green lease ideally should set out a measurement standard for sustainability, which will serve as a reference point for assessing whether the landlord and/or the tenant have fulfilled their obligations. In relation to tenancies situated in buildings which are or will be subject to certification assessment such as BRE Environmental Assessment Method (BREEAM)[4], these certification standards will be an appropriate choice and will allow landlords to ensure continued compliance of the applicable standards.

On the other hand, sustainability standards specific to the landlord's portfolio may be adopted. Landlords may prefer tailoring its standards based on its commercial needs. For example, our global team has advised landlords who develop their own carbon-neutral action plan for its portfolio, which sets out requirements for use of utilities and resources and is applied across such landlords' properties.

Considerations for Landlords

It goes without saying that landlords should consider whether the sustainability standard(s) to be adopted are in alignment with its own corporate policies and reporting requirements, as well as the preferences of its existing or potential investors and financiers. From a practical perspective, landlords should also assess whether the targets (e.g. achieving or maintaining a certain certification) are achievable in light of the specifications and use of the building. Landlords should also consider whether the targets are feasible for the relevant tenants and take into account how the standards may impact the overall commercial attractiveness of the lease.

A more refined approach may be for landlords and tenants to develop a co-management plan together with a tenant: based on the general standards adopted by the landlord, the tenant may propose the extent to which it targets to comply with the metrics under such standards over the course of the lease.[5] However, this will not be a uniform solution. There may be significant time costs for landlords to assess the individual management plan applicable to each lease. In a fresh leasing relationship and/or a new development, it might also be practically challenging to assess the feasibility of a management plan without prior leasing history. Landlords should set sustainability standards carefully and obtain input from environmental and construction consultants, property managers and legal advisors.

METHOD OF INCORPORATION OF GREEN TERMS

In general, there are a few major ways for incorporating sustainability-related practices into a leasing relationship, as described below. We have also set out the key features of each method:-

- a. **Guidelines to be issued by landlords from time to time** – Some landlords may prefer including requirements or recommendations relating to sustainability in their fit-out and operations guides. While leases often contain a requirement to follow the fit-out or operation guidelines (as issued by landlords from time to time), these sustainability-related practices do not form part of the tenant's material obligations under the leases and are generally non-binding. In the local market, we have

observed that a number of local landlords have adopted guidelines of this type, which is encouraging. Some will be binding to the extent that landlord approval is required. The key question here will be how strictly will the landlord insist on some of the greener elements of the guidelines, if a tenant seeks to resist!

- b. **Memorandum of understanding between landlords and tenants** – Similar to guidelines, memoranda of this type are generally non-binding. On the other hand, these memoranda are usually negotiated and record the parties' agreed position regarding their obligations in respect of sustainability-related issues. We note that in jurisdictions such as the United Kingdom, industry organizations have produced template memoranda to facilitate the implementation of green leasing practices.^[6]
- c. **Standard lease terms** – Sustainability-related requirements and obligations may also form part of the template lease of the landlord.

Considerations for Landlords

Timing, in many cases, limits the methods for incorporating green practices in leases. In fresh leases, the landlord will have more room to formulate and incorporate green clauses within the lease. For existing leases and renewal leases, the landlords are likely to face difficulty in obtaining the tenants' agreement to vary the terms of the lease. The most welcome option for the landlords in this case may be to insert sustainability-related requirements in its guidelines – the landlords may make these changes on its own. If the landlords are able to open up dialogue with tenants on green issues, the parties may at least prefer entering into a non-binding memorandum.

TYPES OF TENANT OBLIGATIONS

There is a broad range of green lease clauses in the market. Common requirements often fall within the following categories:

- a. **Compliance with standards:** In terms of use of energy and utilities, tenants may be required to ensure that its utilization levels meet the annual targets applicable to the premises. Landlords may also add sustainability requirements as part of its approval criteria for tenant activities such as alteration works.
- b. **Data sharing:** Tenants may be expected to take an active role in maintaining meter equipment for measuring energy performance in the premises and reporting such performance to the landlords on a regular basis. There may also be regular forums for landlords and tenants to evaluate their sustainability performance in a given period.
- c. **Co-operation with landlords:** Tenants may have express obligations to permit landlords to inspect or conduct works at the premises in relation to green practices (e.g. installation of energy-

monitoring equipment). Tenants may also have a general obligation to support landlords' sustainability-related initiatives from time to time.

Considerations for Landlords

There is no "one-size-fits-all" approach for green leases. As shown above, some types of tenant obligations such as the imposition of annual targets may be considered more restrictive, whereas obligations such as attending annual forums appear "softer". There is also considerable flexibility in imposing obligations under each category: for example, in relation to compliance with standards, as opposed to treating failure to meet such standards as a breach, landlords may reward behavior that meet these standards: for example, reinstatement obligations may be waived for tenants whose fit-out meets sustainable standards.

Given the wide range of green requirements and obligations which might be adopted, landlords should carefully take into account the nature of the tenancies in its property portfolio for the purpose of developing standard lease terms. For example, if the relevant building or development already boasts sustainable features in its specifications, its existing or prospective tenant base may be more sustainability-minded and therefore relatively open to accepting more stringent green obligations. In single-let buildings, the tenants may be more willing to develop a specific energy management policy together with the landlord and adhere to such policy. On the other hand, if the development generally attracts short-term single-unit tenants, these tenants may be dissuaded by the costs of compliance with the green practices, so that landlords should consider adopting more light-touch requirements.

PRACTICAL TIPS FOR TENANTS

We note that there are a few common practical issues for tenants to consider when negotiating green leases, though the negotiation process will vary widely depending on factors including the relative bargaining power and corporate sustainability policies of the parties:

- a. **Timing:** As green clauses (and in particular binding obligations) are relatively new and unusual in the market, tenants should seek to clarify the green obligations and requirements that the landlords have in mind as soon as possible. For example, it is preferable to request details of the landlord's requirements (e.g. standard green terms in the template lease or fit-out manual) and seek alignment in the offer letter stage.
- b. **Generalised obligations:** We have observed that the standard green terms in some markets include relatively general requirements, e.g. a joint obligation of landlords and tenants to adopt renewable energy and to share data on energy consumption, or an obligation for tenants to support the Landlord's green initiatives from time to time. Although generalised obligations reduce certainty for both landlords and tenants, they are more tenant-adverse as they tend to be enforced against the tenants (rather than vice versa). To the extent possible, tenants should

request for more precise drafting such as including a timetable for data-sharing and clarifying the types of green initiatives which it will be required to support.

- c. **Compliance costs:** Tenants should carefully assess its cost of compliance with green obligations, as such cost may come in various forms. In terms of usual costs, we note that installation and maintenance costs are commonplace, as tenants may be required to install energy-saving equipment (e.g. light sensors and meters) in the premises. Administrative costs are also key, as tenants may need to monitor its sustainability performance over time, either for internal compliance monitoring or for external reporting. Tenants may also need to obtain professional advice from, among others, construction and utility professionals to ensure compliance.

This article was co-authored by Andrew MacGeoch, Susan King and Koe Cheng.

[1] Building and Construction Authority of Singapore 2021, *Green Lease Toolkit – Green Schedule*, accessed 22 August 2022, <https://www1.bca.gov.sg/docs/default-source/docs-corp-buildsg/sustainability/20210917_green-lease-toolkit_upload.docx?sfvrsn=a94a4e7d_2>

[2] JLL 2021, *How are green leases supporting real estate’s decarbonization drive?*, accessed 22 August 2022, <<https://www.jll.com.sg/en/trends-and-insights/workplace/how-are-green-leases-supporting-real-estates-decarbonization-drive#.YfJHB4pTFks.link>>

[3] Hong Kong Green Building Council 2014, *Green Tenancy Driver for Office Buildings*, accessed 22 August 2022, <<https://www.hkgbc.org.hk/eng/engagement/guidebooks/green-tenancy-driver/index.jsp>>

[4] For example, the BREEAM standard is used in model green lease clauses in the Better Buildings Partnership (UK) 2013, *Green Lease Toolkit*, accessed 22 August 2022, <https://www.betterbuildingspartnership.co.uk/sites/default/files/media/attachment/bbp-gltk-2013_0.pdf>.

[5] Building and Construction Authority of Singapore 2021, *Green Lease Toolkit – Green Schedule*

[6] Better Buildings Partnership (UK) 2013, *Green Lease Toolkit*

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