

## ENERGY STAR Buildings: Is ENERGY STAR Going to Lose its Shine?

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The U.S. Environmental Protection Agency (EPA) expanded from ENERGY STAR® products to ENERGY STAR buildings in the mid-1990s. Following a pilot program that showcased buildings implementing measures to reduce energy use, EPA began developing an approach designed to objectively benchmark the performance of buildings against each other.

By 1999 this included the ENERGY STAR energy performance scale, which assigns a building a score from 1 to 100 based on its performance compared to other similar buildings. Buildings in the top 25 percent are eligible to receive the recognition of an ENERGY STAR label.

A key element of the EPA energy performance scale is the data used for benchmarking, which relies heavily on the Commercial Building Energy Consumption Survey (CBECS). This survey collects energy use and related information for commercial buildings on a nationwide basis. After the CBECS data is collected, it undergoes a significant amount of processing – which brings us to the heart of the issue. The survey began in 1979 and is conducted every four years. Since this is 2011, one would expect that a 2007 CBECS report would be the current standard.

However, the 2003 CBECS report is the most recently issued report. Earlier this year the U.S. Energy Information Agency announced: “EIA regrets to report that the 2007 Commercial Buildings Energy Consumption Survey (CBECS) has not yielded valid statistical estimates of building counts, energy char-

acteristics, consumption, and expenditures. Because the data do not meet EIA standards for quality, credible energy information, neither data tables nor a public use file will be released.”

As a near-term solution, one could hope that the 2011 CBECS report will be issued in the foreseeable future. However, EIA also announced that budget cuts for fiscal year 2011 required significant cuts in EIA’s activities, including a decision to: “Suspend work on EIA’s 2011 Commercial Buildings Energy Consumption Survey (CBECS), the Nation’s only source of statistical data for energy consumption and related characteristics of commercial buildings.”

Some have raised questions about the validity of benchmarking buildings against data that is eight years old, given the expectation that significant progress has been made in implementing energy efficiency measures since then. However, EPA’s view is that “EPA has found that the key drivers of energy use in commercial buildings have remained largely consistent over the past 10 years,” and “The ENERGY STAR scales remain the best representation of commercial building energy performance in the market.”

This has implications not only for ENERGY STAR itself, but also for other programs and benchmarks that rely on the ENERGY STAR scale. Perhaps the government can be persuaded to provide adequate funding to permit completion of the 2011 CBECS report. In the meantime, it would not be surprising to see private initiatives attempting to fill a perceived void.

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# LEASING CORNER

## Tenant Improvements: Who's Doing, Who's Paying, What Are the Remedies?

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In this Leasing Corner we will discuss tenant improvements. Almost every tenant of a commercial space will need to make some changes or improvements to the space to make the space work for them. Of course, the extent of needed improvements will vary depending on whether the space in question was previously occupied, how old the existing improvements are and whether the prior uses and the new contemplated uses are the same. A new building that has not been previously occupied may have bare concrete floors, no drop ceilings and no distribution of mechanical, electrical or plumbing systems and may require extensive improvements. On the other hand, a space that had been occupied for a short period of time for a similar use contemplated by the new user may require few changes. In this case the tenant improvements may be limited to new paint, carpet cleaning and minor touch-ups and repairs.

When addressing tenant improvements in a lease, there are two main questions that need to be addressed: “Who is doing what?” and “Who is paying for what?” We will start with “Who is doing what?”

A common phrase in real estate leasing is “turnkey build-out,” which is meant to imply that the landlord is doing all the work needed by the tenant to occupy and use the space – that the tenant can “turn the key,” open the door and start working. Realistically, it is rare that a space is ever truly “turnkey” as most leases allocate to the tenant the responsibility for some portion of the improvements, namely installation of furniture, phone and data cabling and communication and computer systems. Other phrases include variations of “a white box,” intended to describe a space that has finished floors, ceiling and walls, lighting and heat/air conditioning; and “a cold dark shell,” which is a demised space that has no heat, no light, and no finishes. Of course, different people can have different meanings for the same phrase and those differences can be material. The key is to make sure that both parties are using the term in the same manner. As real

estate practitioners, we do not rely on such phrases and prefer to describe with words and exhibits what the parties intend.

If the landlord is performing the tenant improvements, then those improvements need to be clearly specified. This benefits both the landlord and the tenant. The landlord needs to know what it is obligated to deliver under the lease. Likewise, the tenant needs to know that the landlord will deliver the space to it in the manner described so that the space will have the utility that the tenant expects. One of the easiest ways to clearly describe the tenant improvements is to attach to the lease detailed plans and specifications for the improvements. Many leases include a plan showing the layout of the proposed tenant improvements and provide that the landlord will perform those improvements using “Building Standard” materials and finishes. Again, the parties should clearly describe the “Building Standard” materials and finishes.

The tenant also needs to know that the work being performed by the landlord will be done by the time the tenant needs the new space. Many landlord-friendly lease forms provide that the landlord will perform the tenant improvements but fail to specify a time period by which the improvements will be completed. In these cases the tenant may be obligated to commence payment of rent before the work is even completed. The tenant must demand that the tenant improvements be completed prior to the commencement of the lease term and its obligation to start paying rent. In addition, the tenant should demand that the landlord agree to an outside date for the completion of the tenant improvement and delivery of the completed space to the tenant.

Presumably, the tenant who signs a new lease needs the space for its operations within a given timeframe and any delay in being able to move into and use the new space could have very negative implications. In fact, if the tenant's current lease term is expiring, it could find itself in a lease holdover position in which

it could be liable for increased rental rates and could be subject to quick eviction. This is why it is so important for the tenant to identify new space well before the tenant's current lease will expire. The tenant needs to know that there is sufficient time (with some contingency time as well) for the landlord to complete the tenant improvements and deliver the new space to the tenant. If the landlord cannot deliver the space with the tenant improvements completed by the outside date, the tenant needs to have some remedies.

The lease should provide to the tenant one or more remedies to address the landlord's failure to complete the tenant improvements on time. For instance, the tenant may be given the right to terminate the lease and find a new space. However, since it is unlikely that the tenant will have sufficient time to find a new space and complete the improvements that will be needed following the landlord's failure to complete the tenant improvements, the right to terminate the lease and find a new space is often a hollow remedy. Another option is to make the landlord liable for any holdover rent for which the tenant is liable under its current lease and otherwise indemnify the tenant for its losses due to the landlord's failure to complete the work on time. Of course, the landlord is unlikely to agree to assume this liability unless it is comfortable that it will be able to deliver on time. This is another reason it is so important to identify new space well before it is needed – the landlord is less likely to accept the risk of holdover damages when the timeline is too tight. Alternatively, the tenant could demand free rent for the landlord's delay. This can be done in a number of ways, such as one day of free rent for each day of delay, two or more days of free rent for each day of delay, or some combination of the foregoing. These remedies give the landlord

an incentive to complete the work on time. However, as a last resort, the tenant should still have a right to terminate in the event the landlord never completes the work.

If the tenant is performing the tenant improvement work, the landlord usually agrees to provide a set period of time for the tenant to complete the work before the tenant is obligated to start making regular payments of rent. The tenant will want to make sure that the agreed period of time is sufficient for it to complete the tenant improvements before the lease term (and the obligation to pay rent) starts. The important thing for a tenant to remember in this instance is that it will have to start paying rent on a given date whether or not it has completed its tenant improvement work. This means that the tenant may be obligated to start paying rent but will not be able to use the space for its intended purpose. In order to avoid this result, the tenant should engage design and construction professionals early in the lease process to determine a realistic timeline for the tenant's improvement work and to ensure that the work will be completed on time.

Often, both the landlord and the tenant are responsible for some portion of the tenant improvement work required by the tenant for its anticipated use and occupancy. In this situation, it is critical for the parties to cooperate and for the work to be coordinated. The lease should address the coordination of the work and provide that a party's obligation to perform its work may be suspended during a period of delay or interruption caused by the other party. For example, it is not uncommon for the landlord to be required to perform certain base building improvements for a space, such as the construction of structural components and the installation of the building systems, before the space



## Peppercast: SNDAs - An Important Aspect in Commercial Leases

In this podcast, Matt Swett, a Pepper partner and co-chair of the firm's Real Estate Practice Group, discusses the importance of a subordination, non-disturbance and attornment agreement, or SNDA, in connection with a commercial lease and what could happen if a SNDA has not been executed between the parties.

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is turned over to the tenant for the tenant to install its tenant improvements. In this case, the time period agreed by the parties for the tenant to complete its tenant improvement work should not commence until the landlord has completed the work the landlord is required to perform, or at least the portion needed to be completed in order to permit the tenant to commence its work. If there will be overlap of the work to be performed by the tenant and the landlord, then to the extent one party's work interferes with the completion of the other party's work, that interference should constitute a delay and otherwise extend the other party's time to perform its obligations.

The parties should also address any other penalties that may arise out of a delay. In addition to extending time periods to perform, a delay by either party has other implications. For example, if the tenant is causing a delay preventing the landlord from completing its work on time, then the tenant should expect to be responsible for the lost rents that might arise from such delay. Likewise, if the landlord delays the tenant's completion of its work, then the landlord may be liable for tenant's holdover rent arising out of its delay in vacating its existing premises or may be required to provide the tenant some free rent once the new lease term commences.

A remaining question is: who is paying for the cost of the tenant improvements and how does that impact the lease transaction? The tenant needs to remember that the cost of the tenant improvements is considered by the landlord in agreeing to a rental rate. If the landlord is funding the cost of the tenant improvements, a portion of the rent being paid by the tenant will reimburse the landlord for those costs. If the landlord is performing the work on a "turnkey" basis it will need to know exactly what work it has to perform for the reasons stated above, but also because the landlord needs to make sure that it knows how much the required work is going to cost. If the landlord incurs additional costs that were not included in the calculation of the agreed rent, then the landlord is not going to fully recover its costs (or will have less profit in the lease transaction).

If the plans are not complete and approved by both parties at the time of lease signing, the landlord should not agree to "turnkey" the improvements because it does not know what the cost of the undetermined work will be. In that instance, the landlord could agree to provide an improvement allowance, a sum of money usually stated on a per-square-foot basis, to be used to pay for the cost of the tenant improvement work. This allows the landlord to calculate the rent based upon the known

tenant improvement allowance. If the cost of the work exceeds the agreed amount of the improvement allowance, the tenant is usually required to pay the excess costs. However, in some cases, the landlord will agree to incur the excess costs (subject to a cap amount) and increase the rent accordingly.

If the tenant is going to be liable for the cost of the tenant improvements in excess of the improvement allowance, then the tenant needs to make sure that the landlord who is performing the tenant improvement work is doing the work in a cost-effective manner. This usually means that the tenant improvement work will be required to be bid out to multiple contractors. The tenant needs to be sure that the landlord is not unfairly profiting from the build-out project. The tenant should also require the landlord to provide it with the bids and an opportunity to revise the plans to reduce the expected costs of the work if the costs exceed the improvement allowance being provided by the landlord. This process is called value engineering and is intended to allow the tenant to make revisions to the plans so it can get the most out of the improvement allowance.

If the tenant is performing the tenant improvement work with an improvement allowance being provided by the landlord, then the process of bidding and construction is controlled by the tenant and the tenant takes all of the risk that the cost of the work exceeds the given improvement allowance. The key here is for the tenant to be comfortable with the likely costs of the planned tenant improvements before it executes the lease because, as discussed above, the tenant's obligation to commence the regular payment of rent will usually start on a given date irrespective of the status of the build-out process. If, for example, the tenant decides to re-design the tenant improvements to reduce the anticipated costs, the tenant's work could be sufficiently delayed such that the tenant could find itself paying rent on space before it can move in.

The process related to constructing tenant improvements is a complicated one and can have a material impact on the parties' business operations. It is crucial that the parties clearly provide for each party's rights and obligations under the lease with respect to the completion of the tenant improvements in order to ensure each party achieves its business objectives. A real estate lawyer from Pepper Hamilton can greatly assist the parties in this regard.

## Zoning Variances in Pennsylvania

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On many occasions, a proposed real estate development or use of land does not strictly comply with all of the provisions of a municipality's zoning ordinance. In these situations, a developer or landowner may be required to obtain one or several variances from the municipality's zoning hearing board. Although the proceedings before a zoning hearing board sometimes appear to be informal (especially in the more rural townships and boroughs of central and northern Pennsylvania), the criteria for being granted a variance are strictly defined by statute and many years of Pennsylvania land use jurisprudence. Moreover, an applicant's appellate rights are limited should the zoning hearing board deny the request.

Variances are, essentially, permitted violations of the zoning ordinance that may be granted by the municipality's zoning hearing board following a public hearing. Variances are different from other commonly sought zoning relief, such as special exceptions (a permitted land use, but requiring a hearing before the zoning hearing board), conditional uses (a permitted land use, but requiring a hearing before the governing body), curative amendments (a challenge to the validity of a zoning ordinance, often to permit an otherwise prohibited land use), and ordinance text and map amendments (a legislative request to the governing body to amend the text of a zoning ordinance or the zoning map).

### CRITERIA FOR GRANTING A VARIANCE

Under the Pennsylvania Municipalities Planning Code (MPC), a zoning hearing board "may grant a variance, provided that all of the following findings are made where relevant in a given case:

1. That there are unique physical circumstances or conditions, including irregularity, narrowness, or shallowness of lot size or shape, or exceptional topographical or other physical conditions peculiar to the particular property and that the unnecessary hardship is due to such conditions and not the circumstances or conditions generally created by the provisions of the zoning ordinance in the neighborhood or district in which the property is located.
2. That because of such physical circumstances or conditions, there is no possibility that the property can be developed in strict conformity with the provisions of the zoning ordinance and that the authorization of a variance is therefore necessary to enable reasonable use of the property.

### ZONING HEARING BOARD PROCEEDINGS

SOMETIMES APPEAR INFORMAL, BUT CRITERIA FOR BEING GRANTED A VARIANCE ARE STRICTLY DEFINED BY STATUTE AND MANY YEARS OF LAND USE JURISPRUDENCE.

3. That such unnecessary hardship has not been created by the appellant.
4. That the variance, if authorized, will not alter the essential character of the neighborhood or district in which the property is located nor substantially or permanently impair the appropriate use or development of adjacent property, nor be detrimental to the public welfare.
5. That the variance, if authorized, will represent the minimum variance that will afford relief and will represent the least modification possible of the regulation in issue."

In addition, a zoning hearing board, when granting a variance, may attach reasonable conditions and safeguards that it may deem necessary to implement the purposes of the MPC and the zoning ordinance.

Pennsylvania appellate courts have summarized the variance criteria by stating that a variance should be granted only where it is not contrary to the public interest and where the property involved is subjected to an unnecessary hardship unique or peculiar to itself, and not to general conditions in the neighborhood, which may reflect the unreasonableness of the zoning ordinance. Further, courts have held that zoning hearing boards may only grant variances for reasons that are substantial, serious and compelling. A landowner's mere economic hardship if not permitted to pursue his plan does not support the grant of a variance.



## USE VARIANCES AND DIMENSIONAL VARIANCES

During the past two decades, Pennsylvania appellate courts have distinguished between requests for use variances and requests for dimensional variances. A use variance is one in which a landowner is permitted to use a property in a manner contrary to the zoning ordinance (*i.e.*, permission to use a property in a residentially zoned district as a factory or shopping mall). Landowners seeking use variances are subjected to the strict “unnecessary hardship” standards and must demonstrate that the property cannot reasonably be used unless the requested variance is granted. Needless to say, the grant of a use variance is rarely justified.

In 1998, the Pennsylvania Supreme Court, in its seminal opinion of *Hertzberg v. Zoning Board of Adjustment of the City of Pittsburgh*, 721 A.2d 43 (Pa. 1998), announced a less stringent standard for the granting of dimensional variances, which include relief from setback, minimum lot size, and building height requirements. In *Hertzberg*, the court stated:

[W]e now hold that in determining whether unnecessary hardship has been established, courts should examine whether the variance sought is use or dimensional. To justify the grant of a dimensional variance, courts may consider multiple factors, including the economic detriment to the applicant if the variance is denied, the financial hardship created by any work necessary to bring the building into strict compliance with the zoning requirements and the characteristics of the surrounding neighborhood. To hold otherwise would prohibit the rehabilitation of neighborhoods by precluding an applicant who wishes to renovate a building in a blighted area from obtaining the necessary variances.

Pennsylvania appellate courts have been careful not to extend the holding of *Hertzberg*, stating that while *Hertzberg* eased the hardship standard borne by those seeking dimensional variances, it did not create “free-fire zones” for which variances could be granted when a party merely articulates a reason that it would be financially hurt if it could not do what it wanted to do with the property.

## DE MINIMIS VARIANCES

Although not statutorily authorized by the MPC, zoning hearing boards may also grant *de minimis* variances, which are very minor deviations from the dimensional provisions of a zoning ordinance where rigid compliance is not necessary to protect the public concerns inherent in the zoning ordinance. There is no set

of criteria upon which *de minimis* variances are granted; instead, they are evaluated according to the particular circumstances of each request for relief.

## PROCEEDINGS BEFORE THE ZONING HEARING BOARD AND APPEALS

The MPC provides that zoning hearing boards have the exclusive jurisdiction to grant variances. While the formal rules of evidence do not apply, an applicant must still create a record during the hearing to establish the necessary criteria to justify the requested variance. In the usual run of cases, this is a landowner’s only opportunity to articulate the reasons for which a variance should be granted, and preparation for the hearing may be paramount to the success of a real estate development project or lease/sale transaction. Although a landowner is permitted to appeal an adverse decision of a zoning hearing board to the court of common pleas (and higher appellate courts thereafter), unless unusual circumstances exist, only the record created before the zoning hearing board will be considered on appeal. In cases in which no additional evidence is received, a zoning hearing board’s decision will be reversed only when it is determined that the zoning hearing board committed a manifest abuse of discretion or an error of law. Further, the business aspects of a development project or transaction depending upon the grant of a variance may not be able to be delayed while an appeal is pursued.

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