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## WHITE PAPER

February 2019

### Green Buildings: The Epicenter of Responsible Investing, ESG Disclosure Requirements and Financial Incentives

Energy positive buildings are a hot topic in the next wave in Environmental, Social and corporate Governance (“ESG”) investing, in anticipation of the EU directive which will require that all new projects built are “nearly zero energy” as from December 31, 2020. A successful green building project may involve much more than construction design and include initial soil decontamination, optimization of financial or fiscal incentives and creative occupancy contracts. Getting input from Real Estate and Environmental law experts will be key for investors and developers to ensure that proper documentation and contractual undertakings are in place, compliance with financing obligations and to protect their investments in the long term.

## INTRODUCTION

Investors and financing banks, as well as certain users of commercial buildings, in particular listed companies, are now subject to Environmental, Social and Governance (“ESG”) reporting obligations, making green buildings a hot topic that each of these market actors wants to highlight.

Meanwhile, sustainable buildings have become routine for many real estate investors and developers. Most major real estate firms now have a Head of Sustainability and aim at producing greener buildings in order to satisfy the increasing focus of stakeholders on climate change and sustainability issues. These efforts and the various approaches taken by real estate firms demonstrate that green building concepts require more than just getting a building certified as energy efficient.

Green buildings, however, are not only of interest to companies subject to reporting obligations and to real estate development firms. While not at the heart of the EU Action Plan on Sustainable Finance<sup>1</sup>, the Action Plan does recognize a link between sustainable finance and real estate, asserting the importance of adequate finance for smaller-scale, distributed projects<sup>2</sup>.

Furthermore, the European Commission announced in the Action Plan its intention to explore a potential re-calibration of capital requirements for banks with respect to investments in green buildings<sup>3</sup>. Unfortunately, it is by no means clear when such re-calibration will take place, given that sufficient supporting data has not yet become available.

Several initiatives are underway to find solutions to enable banks to serve the green building sector better. In its Final Report 2018<sup>4</sup>, the EU High Level Expert Group on Sustainable Finance identified the EU-financed European Mortgage Association’s work developing a standardized “energy efficient mortgage”, which would enable a correlation between efficiency improvements and lower probability of default of borrowers<sup>5</sup> as one way forward to address this need. In order to better understand the presumed correlations, banks are encouraged to use computer tagging of their real estate financings to allow improved monitoring of such financings and ultimately compare write-downs and losses associated with green buildings with traditional non-green buildings. Data available for the Netherlands suggests that there would be a

clear link between energy efficient buildings and the performance of loans financing such buildings<sup>6</sup>. Land and building owners, as well as property developers, could therefore benefit from such positive correlations through better interest rates and/or higher LTVs (Loan To Value). However, until the regulatory framework on capital requirements has been adapted, financial institutions’ options to benefit from financing green buildings are limited. Indeed, only large institutions following an Internal-Rating-Based-Approach (IRBA) would be in a position to reflect green building financings when determining their capital requirements, though even these institutions are likely to find it challenging to adapt their existing models until more data and better data quality is available.

Finally, in light of further legislative actions based on the EU Action Plan on Sustainable Finance, and in particular the latest proposals for the integration of sustainability aspects in the asset management sector<sup>7</sup>, green buildings are also likely to become of more interest to asset and fund managers and, most importantly, to managers of real estate funds.

## WHAT IS A GREEN BUILDING?

In general, a sustainable or green building is a building that, in its design, construction, or operation, reduces or eliminates negative impacts, and can create positive impacts, on the climate and natural environment. Green buildings preserve precious natural resources and improve quality of life.

There are a number of features which can make a building green. These features in particular can include:

- Efficient use of energy, water, and other resources
- Use of renewable energy, such as solar energy
- Pollution and waste reduction measures, and facilitation of re-use and recycling
- Good indoor environmental air quality
- Use of materials that are non-toxic, ethical, and sustainable
- Consideration of the environment in design, construction, and operation
- Consideration of the quality of life of occupants in design, construction, and operation
- A design that enables adaptation to a changing environment

Certain initiatives, such as the Energy Efficient Mortgage Initiative lead by the European Mortgage Association referred to above, have developed their own, more purpose-specific definitions of green buildings. In this regard, the Energy Efficient Mortgage Initiative defines an Energy Efficient Mortgage as follows<sup>8</sup>:

“Energy Efficient Mortgages are intended to finance the purchase/construction and/or renovation of both residential (single family & multi-family) and commercial buildings where there is evidence of: (i) energy performance which meets or exceeds relevant market best practice standards in line with current EU legislative requirements and/or (ii) an improvement in energy performance of at least 30%.”

### **A building that is efficient in terms of energy consumption**

With walls of greenery, plants cascading from terraces, and forests thriving on rooftops, architects and developers have recently been stretching their (and our) imaginations and achieving technical wonders to turn buildings green, not only visually, but also in terms of energy consumption.

Purchasers and tenants are now provided with energy ratings of buildings in order for them to make an informed decision prior to a transaction. And some countries, England for instance, encourage landlords to improve the energy efficiency of existing buildings by prohibiting them from granting new leases on properties that do not meet minimum energy efficiency standards.

As for new building constructions, several European Member State regulations already impose high energy performance standards. The European Union has taken further new steps towards more sustainable real estate by setting a target at “nearly zero energy” buildings for all new construction as of December 31, 2018 for public buildings and as of December 31, 2020 for all other buildings.

The recent Directive 2018/844/EU of May 30, 2018 has amended Directive 2010/31/EU on the energy performance of buildings and Directive 2012/27/EU on energy efficiency, and specified that the objectives set by each European Member State should also include renovation of existing buildings in order to achieve a highly energy efficient and decarbonized building stock by 2050.

Owners and developers will therefore need to take into account these new constraints, and design buildings by implementing measures ranging from enhancing the envelope of the building, selecting efficient technical systems and installing self-regulating devices, to solutions based on nature itself. Those measures are likely to be accompanied by the use of contractors with a strong green building record, thereby creating market opportunities for such contractors specialized in green buildings.

While these measures will improve energy performance and therefore make green buildings more cost-efficient for users, they may prove expensive to implement. The allocation of the increased construction and renovation costs will lead to new contractual negotiations between investors, developers, and construction companies, each of whom will also need to assess their ability to benefit from available incentives provided by the Member States. Several countries have indeed set up mechanisms to support the transition to greener buildings, be it financial incentives (e.g., buying electricity produced by the building at higher prices than the market average) or town-planning preferential rules (e.g., ability to build more square meters).

Moreover, lease negotiations in the future may focus more on energy efficiency and other aspects of sustainable buildings, such as the use of environmentally-friendly construction materials or materials sourced from socially responsible sources. At present, while it seems that tenants have a strong interest in renting green or otherwise sustainable space, their willingness to pay for such characteristics is not always paired with their ambitions for sustainability.

### **A building that generates energy**

EU Member States were left to define the exact notion of a “nearly zero energy” building provided for by the European Directive, and some have set up more ambitious objectives than others. France, for instance, has decided to implement the concept of “positive energy buildings”, i.e. all new buildings constructed as of December 31, 2020 should produce more energy than they consume (Law n° 2009-967, as last amended on December 31, 2018).

Defining a “green building” as a building that is carbon-neutral may therefore already be inaccurate. In Lyon, Trondheim, or Frankfurt, “positive-energy” buildings are emerging, integrating

solar panels, wind farms, water recycling, and experiences friendly to both users and the environment.

Depending on the applicable incentive scheme for renewable energy, as well as the technical options chosen by the operator, the renewable energy produced by the green building may either be injected into the grid and sold to the grid operator or used directly by the users of the buildings. The first option may be attractive in the context of regulated tariffs offering a price higher than market price for the electricity produced using the building as a production surface. However, in the context of decreasing direct aid from the state to renewable energy, as well as the increase of energy-storage solutions, green buildings may be designed to directly use the energy they produce.

These new buildings create new challenges both from a contractual and operational point of view. They cannot be designed just to host energy production facilities, with intricate volumes and co-ownership; they must be conceived in order to fully integrate these facilities. This new configuration implies a new generation of facility managers that are able to supervise the specific constraints of such installations and make sure they are operated harmoniously to meet the needs of the building, and it also implies a new category of users.

However efficient the building may be in its design, the actual consumption will indeed depend on the behavior of its users. Positive-energy buildings will require rethinking of the obligations of the parties, with contracts providing not only for energy performance guarantees from the builders to the investors, or from the investors to the tenants, but also undertakings from the tenants to the investors, far beyond the simple obligation to report consumption levels and works performed on the premises.

The behavior of users is also key in maintaining “in-use” environmental certifications and labels.

### **A building that stands on clean grounds**

A green building project may also be an opportunity to reclaim brownfields. Brownfields are former industrial sites, where the soil or ground water generally contain some contamination that may not be suitable for sensitive use such as a residential use. While decontamination measures come at a cost, redeveloping brownfields located in urban areas may be a desirable

alternative to sprawl in the context of sustainable urban planning and green building projects.

The large redevelopment of the Greater Paris Area, which is currently underway in France and will include all types of assets (commercial, office, residential, and administration), is a good example of a large project relying heavily on the conversion of old industrial sites. More generally, the lack of available land free from any other construction and building opportunities in the vicinity of big cities makes conversion of brownfields an option that an increasing number of developers and investors are considering.

A key issue, given the costs associated with such conversions, is the early identification of the existence of soil or groundwater contamination on a development site. As a rule, it is the responsibility of the developer to make sure that the contemplated construction takes into account the environmental condition of the site. In France, the authorities have been setting up public databases of former industrial sites and/or potentially contaminated areas to ensure that adequate information is available to owners, prospective buyers, and developers. In particular, the local préfets were required to identify soil information sectors (“SIS”) by December 31, 2018 to ensure, in the case of modification of the use of brownfields, that studies and (if necessary) decontamination measures are undertaken by the responsible parties in order to ensure the protection of public health and safety and of the environment.

Once contamination of a site has been identified, the next step is the inventory of the necessary remediation measures and associated liability. In France, where the environmental remediation responsibility generally lies on the last operator of industrial activities, the ALUR Act of March 24, 2014 introduced the possibility for a third party, called an “interested third party” or “third party applicant”, to assume decontamination responsibility and measures. This option may be attractive in the context of a redevelopment project and the construction of a green building on a brownfield. The developer needs to file a request with the environmental authorities, set up financial guarantees to ensure that the project will be carried out, and ultimately will receive authorization from the authorities to carry out the remediation measures necessary for the redevelopment program.

As an alternative to decontamination, or as a complementary measure, developers may decide to develop the building in such a way as to eliminate the potential health and safety concern raised by the existence of sub-surface contamination. For instance, the construction of the building may include underground levels used for parking or storage, with a ventilation system to avoid the concentration of soil-gas in the building. Contaminated soil may be covered by a slab or geotextile to eliminate contaminated air-borne particles and dust, and then turned into a parking lot or green areas with the addition of clean soil for new vegetation. Such structural measures may be part of the plan submitted to the authorities to demonstrate that the redevelopment plan is taking into account the environmental condition of the site.

### **A building that is certified “green”**

Many countries have developed their own certification body/rating system and standards for sustainable/green buildings. Such green building certification bodies are, for example, HQE (France), DGNB (Germany), BREEAM (United Kingdom), LEED (United States and Canada), and VERDEGBCe (Spain) which help investors to determine a structure’s level of environmental performance. They award credits for optional building features that support green design in categories such as location and maintenance of the building site, conservation of water, energy, and building materials, and occupant comfort and health. The number of credits generally determines the level of achievement. Depending on the level of achievement, which is issued by the respective rating system, green building certificates with the levels Gold/Silver/Bronze (DGNB), Platinum/Gold/Silver/Certified (LEED) or Outstanding/Excellent/Very Good/Good/Certified (BREEAM) are granted. The difference between these certification bodies is the different weighting given to the individual features.

The absence of a green building certificate may have a negative impact on the value of the building. Therefore, green building certificates become more important when drawing up contracts relating to buildings. This applies to the complete life-cycle of a building and includes its planning, erection, acquisition, letting and management contracts.

However, a green building certificate does not guarantee that a building is erected and used in line with the application documents underlying the green building certificate. Rather, it is assumed, when issuing a green building certificate, that the

self-declaration provided by the building owner included in the application documents is correct and complete. If it turns out that the self-declaration is not correct, for example if the thermal insulation does not in fact comply with the thermal insulation set forth under the application documents, there is a risk that the certification body revokes the issued certificate. Such revocation may in turn impact the financing of the building, as banks may no longer be in a position to offer more favorable terms reserved for the financing of green buildings. Banks may also see a need for revaluation of the property. If the value of the property decreases due to the lack of certification, certain financial covenants such as LTV or the net operating income ratio may be negatively affected, which could lead to a range of adjustment events, and in the worst case, to a default under the relevant financing.

Further, it should be noted that a green building certificate is only a snapshot so that if the relevant laws or regulations are made more demanding, the issued certificate may diminish in value. Against this background, LEED only issues certificates for a term of five years and the certificates must be renewed thereafter.

## **THE CONTRACTUAL ECOSYSTEM FOR GREEN BUILDINGS**

### **Certification agreements**

The scope of a certification is generally defined by the certification agreement concluded by the constructor/owner and the certification body. The certification agreement determines the basis of contractual requirements on which the certification body issues its certificate.

The certification neither replaces official approvals nor confirms compliance with applicable law. The certification body is not an official authority and, thus, only acts on a contractual basis. Therefore, in case that a certification is not issued or revoked, the constructor/owner needs to resort to the civil courts.

### **Agreements with experts and green building contracts**

In general, the certification process requires the services of an expert (architect or technical advisor) to be instructed by the building owner. If the expert is not only instructed to undertake the collection of documents necessary for the certification

process but also with planning advice and some or all aspects of building supervision, the expert will become liable for the correctness and completeness of the green building certificate. Therefore, agreements with experts should be carefully reviewed and negotiated to ensure that the scope of the mandate and any limitation of the expert's liability clearly reflect the intentions of the parties.

Apart from the instruction of an expert accompanying the certification process, the building contract concluded with the (general) contractor should make it clear that the contractor is obliged to erect a building that can be certified. The requirements for the certification must, therefore, be well-defined and an integral part of the service specifications of the (general) contractor.

## CONCLUSION

With sustainability becoming increasingly prominent at the center of debate in the political and financial worlds, green buildings are the epicenter of investment and reporting, with financial incentives driving close scrutiny of the "green" bonafides of any project. Having the right contractual elements in place, with the assistance of a team of specialized lawyers, will be key to protecting stakeholders in this rapidly evolving area.

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## ENDNOTES

- 1 European Commission, "Action Plan: Financing Sustainable Growth" dated 8 March 2018, COM(2018) 97 final.
- 2 European Commission, "Action Plan: Financing Sustainable Growth" (see footnote 1 above), page 5, with reference to the "Clean Energy for all Europeans" package, <https://ec.europa.eu/energy/en/topics/energy-strategy-and-energy-union/clean-energy-all-europeans>.
- 3 Action 8 under the European Commission, "Action Plan: Financing Sustainable Growth" (see footnote 1 above), page 9.
- 4 [https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf), page 60.
- 5 «Energy Efficient Mortgage Action Plan» oder „EeMAP»; <https://energyefficientmortgages.eu>
- 6 <https://eemap.energyefficientmortgages.eu/energy-efficiency-and-probability-of-mortgage-default-linkages-and-hidden-risks/>
- 7 Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD dated 19 December 2018 (ESMA34-45-569); Consultation Paper on integrating sustainability risks and factors in MiFID II dated 19 December 2018 (ESMA35-43-1210)
- 8 <https://eemap.energyefficientmortgages.eu/eem-definition/>

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