FOCUS ON GREEN BUILDING

Legal Issues Arising Out of Green Building Legislation

BY STEPHEN T. DEL PERCIO, ESQ.

AS CONCERN ABOUT THE STATE of the natural environment continues to rate higher on the public's agenda, an increasing number of state and local governments have enacted legislation to combat the significant environmental impact of building construction and operations. As of August 2007, 24 states and 90 local governments had adopted the U.S. Green Building Council's (USGBC) LEED® green building standards, while 12 states had included the Green Building Initiative's Green Globes system in legislation. Moreover, recent information from AIA suggests that 14 percent of U.S. cities larger than 50,000 people have green building programs. Each program differs in terms of scope and implementation; some apply through a local building code, while others have been implemented through various types of zoning ordinances. Some municipalities mandate compliance with third-party certification regimes, while others provide various types of incentives as a means of encouraging projects to implement sustainable design features or seek third-party ratings. Nevertheless, in the rush to respond to what many believe to be an imminent natural crisis, much of this legislation has been quickly passed without consideration of its broader legal ramifications.

As a threshold issue, some pieces of legislation have been drafted poorly, incorrectly defining significant terms. For example, Washington, D.C.'s Green Building Act of 2006 (discussed in greater detail elsewhere in this issue by Bryan Seifert) seems to misunderstand the fundamental concept of a performance bond, and led the National Association of Surety Bond Producers (NASBP) to advise its constituency to refuse to issue such bonds until the Act's language was clarified. The purported "performance bonds" essentially serve as a penal sum under the Act in the event that a project fails to meet the requisite level of LEED certification. As drafted, the legislation presents other problematic provisions, including obvious conflicts of interest where the agency evaluating compliance is funded by forfeited fees from projects that fail to meet LEED requirements. Despite NASBP's protests, all indications are that the District is forging ahead with the legislation as drafted, which could have serious repercussions across the surety landscape.

While green building mandates originated in the public sector, an increasing number of laws are migrating to private sector construction, obligating projects over a certain size to comply with an independent, third-party rating system over which the local government exercises no control. For example, Babylon, New York, on Long Island, enacted an amendment to the local building code stating that it "hereby adopts, in principle, the U.S. Green Building Council's (USGBC) Leadership in Energy and Environmental Design for New Construction Rating System, Version 2.2. and, further, automatically adopts **any future versions** promulgated by the USGBC." Enacted

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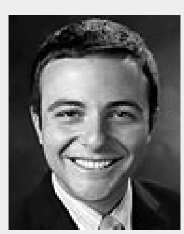

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in 2006 as the town's Local Law Number 40, the legislation presents numerous problems for a number of reasons that are detailed later on in this article. Fundamentally, though, this type of legislation is simply undemocratic. It takes local government completely out of the decision-making process and hands control of the building code to a third-party organization over which the public exercises zero oversight.

The legislation took effect in late 2007, and requires all projects greater than 4,000 square feet to receive LEED certification prior to receiving a certificate of occupancy. Has Babylon now tied itself to whatever that next-generation LEED system will ultimately look like? If so, it seems prudent for similar pieces of legislation to include sunset provisions or other grounds for periodic local government review to ensure that they are resulting in the desired outcome.

Legislation containing vague provisions of this type and insufficiently vetted by stakeholders may have serious practical consequences for insurance as well. While other sectors of the insurance coverage market are currently monitoring what's happening across the green real estate industry, the first coverage sector to offer a specific green building endorsement was the property insurance market. Fireman's Fund, Lexington, ACE, Liberty Mutual and Travelers all now offer various types of endorsements to their property insurance policies. For example, in the event of a partial or total loss (e.g., a fire destroys part or all of a building), property insurance policies will typically pay for the cost of rebuilding a building to its pre-loss condition. However, in the absence of a specific endorsement to such a policy, a building owner's property insurer may deny the owner's claim for the costs of certifying the building in order to comply with newly enacted green building legislation. In the current regulatory environment, it's critical that owners continue to monitor local legislative activity and review the terms and conditions of their property insurance with vigilance.

From a broader policy perspective, suppose an owner purchases one of these available green building endorsements, either to upgrade from LEED Silver to Gold or to simply get a rebuilt building certified after a covered loss. What if the rating system itself changes? We have certainly seen plenty of mid-year amendments to LEED, changing credit requirements and prerequisites, for example. What about the next-generation LEED system (LEED 2009) under development right now? Will a Silver rating under that iteration of the rating system be equivalent to a Silver rating under the current version of LEED? This is unlikely, and even more, what will the applicable LEED product look like in five years with the USGBC's avowed desire to continually increase the rating products requirements?

Much of the legislation enacted to date has left these types of key considerations unanswered. For example, will the legislation follow the rating system, or will it periodically be amended to reflect third-party updates? If legislation itself is a moving target, it's even more critical for owners to scrutinize their insurance policies to ensure that sufficient coverage will be available in the event that their projects must comply with a freshly enacted third-party mandate.

While the scope of green construction claims of negligence is beyond the range of this particular article, one practical application of green building legislation may be causes of action asserted as negligence per se. Generally speaking, negligence per se is a legal doctrine that allows a plaintiff to recover in negligence where it can demonstrate that a defendant violated a statute designed to address public safety. It is an easier claim to assert than negligence standing alone because expert testimony is not needed to demonstrate a breach of duty. For example, suppose a contractor is required by an owner to apply for third-party certification as mandated by local legislation. Suppose the contractor fails to do so, or the project itself merely fails to reach the required level of certification. The owner would not need to establish the four prongs of a negligence claim in order to establish that the contractor was negligent; rather, the simple failure of the project to reach certification would be prima facie evidence that the contractor had, indeed, been negligent. The negligence per se claim, of course, would sound in addition to any other causes of action, including breach of contract that the owner might be able to assert against the contractor. Municipalities that enact legislative mandates requiring specific certification levels for projects to achieve under third-party ratings may therefore unwittingly be greasing the wheels of litigation for aggrieved green building plaintiffs.

Third-party-driven green building legislation has the real potential to spawn litigation if project participants are not aware of the specific provisions of applicable state or local level regulatory schemes. The best paradigm for analyzing such a scenario comes from a recent project in northern California—called the Gaia Napa Valley Hotel—

where a local municipal incentive offered the developer of the hotel a $1 million tax rebate for occupancy tax revenues, conditioned on the project receiving LEED certification. The hotel opened in November 2006, but didn't formally receive LEED Gold until July 2007. The municipality did not budge, and required the developer to wait for the rebate until it actually received its rating.

While there hasn't been any reported litigation arising out of this particular project, imagine for a moment that, as is typical in many of the third-party-driven schemes that have been created, the local building code had conditioned a certificate of occupancy on receipt of formal certification, or was holding a fixed dollar application sum (generally a percentage of project square footage) in escrow until the USGBC officially made the award. These types of scenarios create the conditions for a developer to seek some sort of recourse, and demonstrate why conditioning official compliance with legislation, and essentially emphasizing process rather than product, is dangerous from the perspective of potential litigation. Moreover, municipalities that fall within the Gaia Napa Valley Hotel paradigm may face claims that they have violated the non-delegation doctrine by improperly delegating a governmental function (reviewing compliance with a local green building program) to a private entity (e.g., USGBC). Accordingly, it's critical that local programs include an appeals process through which projects are given the ability to contest third-party certifications or petition local government in the event that formal certification is delayed due to circumstances beyond either the municipality's or applicant's control.

Given the rapidly changing regulatory environment, it was not surprising that the first green building lawsuit in the country arose out of a project where the developer expected to receive more than a half-million dollars in tax credits under a state-level green building program keyed to LEED Silver. The case, *Shaw Development versus Southern Builders*, arose out of the construction of a 23-unit condominium project on the eastern shore of Maryland, and has apparently settled out of court. In order to take advantage of the credit, the project had to receive a certificate of occupancy by a certain fixed date as set forth in the contract. The project was delayed by more than nine months and the owner was unable to take advantage of the tax credit. The contract itself (which was the AIA's 1997 version of the A101 Owner/Contractor Agreement) contained no reference to the legislation and accordingly, there was no risk transfer mechanism drafted between the owner and contractor. Again, it's hard to draw any conclusion other than the parties (or their attorneys) did not understand the provisions of the legislation that the owner sought to leverage, and litigation was the unfortunate result of that failure. The lawsuit also demonstrates the danger of relying on form contracts in connection with green building projects, particularly where legislation may apply to either a mandate or an incentive.

The twist in the factual posture of the case was that the allegations were not that the contractor (or a design professional or consultant) failed to secure formal certification from USGBC, as much of the literature written to date in the liability context suggests will be the feeding ground for potential litigation. Rather, it was the failure by both the owner and the contractor to recognize the risk implicated by the regulatory scheme that led to the claimed loss of tax credits. The contract documents included as exhibits to the court papers were devoid of any risk transfer mechanisms whatsoever with respect to securing the tax credits. A tight contract that recognized the risk of failing to complete the project on schedule would have: 1) assisted the contractor in determining whether it was capable of bearing a significant portion of that risk; and 2) provided the owner some level of assurance that in the event the contractor could not deliver the project as required in order to secure the tax credits, it would still have the ability to assert a breach of contract claim for that specific failure.

The lawsuit also raised some important insurance implications. Could the contractor's commercial general liability (CGL) policy have provided coverage for the owner's claim for the lost tax credits? CGL policies typically cover only property damage, so it seems highly unlikely. From the owner's perspective, if there was a waiver of consequential damages provision in the contract documents (which was unclear from the court papers), the owner would have a difficult time arguing that the claimed damages for lost tax credits should not be considered consequential. Nevertheless, it's clear that various legislative and regulatory regimes will have significant implications for insurance issues, and the cases emphasizes the point that both owners and contractors must monitor and proactively participate in the activity in this area to ensure that sufficient attention is paid to all stakeholder interests.

Putting aside the practical impact of legislating third-party rating systems and pursuant to Supreme Court case law, constitutional questions may exist over the ability of a local government to regulate private land use through the application of rating systems that may not, in fact, bear a substantial relationship to the public health, safety, morals or general welfare. Pursuant to a well-known and well-settled case called *Euclid v. Ambler Realty* that essentially established the ability of the government to regulate land use, a local ordinance's provisions must be "clearly arbitrary and unreasonable" in order to be deemed unconstitutional. Alleging that LEED or any other green building rating system is "clearly arbitrary and unreasonable" would be difficult, though it may not be as difficult to show that portions of the rating system lack any objective basis for inclusion and enforcement by a government entity. Municipalities should demand that any third-party rating systems upon which their legislation will rest be supported by objective, performance-driven data in order to protect themselves from the potential—however slim it may be—for constitutional attack.

Legislating one specific building rating system into law may also present antitrust law implications under both statutory and case law authority. The Sherman Antitrust Act is the federal statute that permits a cause of action in federal court for anticompetitive business practices. In order to successfully allege a Sherman violation, a plaintiff must prove both anticompetitive conduct and—significantly in the context of sustainable building legislation—injury resulting from that conduct. When bringing suit against a standard-setting organization, a plaintiff must show either that its products were barred from inclusion in the standard on a discriminatory basis from its competitors, or that the conduct of the organization as a whole was manifestly uncompetitive and unreasonable.

The pivotal Supreme Court case dealing with standard-setting bodies, called *Allied Tube & Conduit Corp. v. Indian Head, Inc.,* is extremely interesting to analogize in the current green building landscape. In its ruling, after first noting that "private standard-setting associations have traditionally been objects of antitrust scrutiny," the Supreme Court upheld an antitrust claim against a member of the National Fire Protection Association. The plaintiff, a manufacturer of plastic electrical conduit, claimed that a rival association member, who manufactured steel conduit had packed the Association's annual meeting with other members who had agreed to exclude plastic conduit from the Association's National Electric Code.

The Court called the Code "the most influential electrical code in the nation," and noted that many governments adopted it into law by reference. It noted that "members of such associations often have economic incentives to restrain competition and that the product standards set by such associations have a serious potential for anticompetitive harm."

Moreover, it found anticompetitive effect in the case from what the Court called the "predictable adoption" of the Code into law by a large number of state and local governments. Ultimately, the Court held that the member entity could not "bias the process" by stacking the association with decision-makers sharing the entity's economic interest in restraining competition. However, it did note the potentially pro-competitive effects that might result from standards based on objective expert judgments, obtained through procedures that prevented the process from being biased by members with an interest in stifling competition.

A subsequent case to *Allied Tube,* called *Radiant Burners, Inc. v. Peoples Gas Light & Coke Co.,* demonstrated the potential for anti-competitive effect. There, an antitrust claim was brought by the manufacturer of a ceramic gas burner against the American Gas Association and ten of its member constituents, which included gas distributors. The plaintiff alleged that the Association's "seal of approval" was established not through "objective expert judgments," but with tests that were influenced by its own stakeholders who were competing producers of gas burners. According to the plaintiff, it had submitted its ceramic burner to the Association for approval twice, and although its product was safer and more efficient than the rival burners, it was rejected both times. Moreover, because the Association's gas distributors refused to provide gas for use in the plaintiff's burner, it had been effectively excluded from the marketplace.

The parallels that this line of case law offers to the current green building landscape are striking. USGBC, for example, includes a large number of industry stakeholders who actively participate in the organization's creation of the LEED-rating product attributes. It is not difficult to imagine a scenario where a product manufacturer, who may be excluded from a particular sustainable building rating system, brings an antitrust claim and alleges, as the plaintiff did in *Radiant Burners*, that the standard-setting process is not based on objective standards, but is instead influenced by its own stakeholders, some of whom are in direct competition with our hypothetical product manufacturer. It is clear from many of the attributes of the LEED rating system product that whole industries or material categories are to be shunned in an effort to acquire the certifications. Enshrining these biases into legislation seems an unproductive effort and has been recognized as such by at least some state green legislation that has specifically eliminated LEED system attributes when it appeared to be directed at local industries of import.

Thus, the argument could be advanced that the standard-setting determinations themselves are indeed being made arbitrarily and capriciously. If done so successfully, this line of argument could also help buttress a constitutional law claim that the rating system in question has "no substantial relation to the public health, safety, morals or general welfare."

These antitrust considerations, though somewhat theoretical, are real and grounded in well-settled federal case law. Although practically, an antitrust action is extraordinarily expensive to maintain, given the scope of what a plaintiff must prove, it's difficult to ignore the parallels that existing case law presents. What's most significant in the context of this article though, is that the *Allied Tube* Court specifically pointed to legislation as the basis of proof for market effect. As increasing numbers of state and local governments adopt, for example, the LEED rating product, barriers to market entry may be created, thus making this prong of an antitrust claim easier for a potential plaintiff to prove.

Indeed, USGBC itself seems to have, at least implicitly, recognized the potential for an antitrust claim. Its recent efforts to expand the certification options for wood products that will qualify for LEED credits suggests that it is taking the antitrust issue seriously, though the legal profession should continue monitoring the landscape. Indeed, antitrust may also be driving the "LEED Certifiable" concept in many legislative enactments. "LEED Certifiable," or regulations that allow flexibility in implementation in terms of the rating system, are one way of addressing the potential for antitrust litigation, though they are more often seen as a way to obviate the need for spending public monies that would go to the fees and administrative processes attendant on obtaining a LEED certification. In particular, where the pursuit of certification will increase the expenditure of public monies, the fiduciary duty of public officials may be in question. For example, the changes to the recent re-enactment of green building legislation in King County, Washington, were motivated by an analysis of the actual additional costs borne by the county in erecting public buildings required by the previous legislation to seek LEED certifications.

Finally, *Air Conditioning, Heating and Refrigeration Institute et al. versus City of Albuquerque*, a case that was just filed in July 2008 in New Mexico, may also have profound implications for state and local-level green building regulatory activity. The city of Albuquerque's proposed Energy Conservation Codes purported to raise the standards on the installation of HVAC equipment for all new and retrofit commercial and residential projects to a Seasonal Energy Efficiency Ratio (SEER) of 15 (for air conditioning) and an annual fuel utilization efficiency (AFUE) of 90 percent (for heating).

The suit, filed in U.S. District Court for the District of New Mexico by the Air Conditioning, Heating and Refrigeration Institute, the Air Conditioning Contractors of America, the Heating, Air Conditioning, and Refrigeration Distributors International, and 11 HVAC product distributors and contractors, alleges that because current U.S. Department of Energy minimum standards for energy efficiency for the same equipment that the Albuquerque Codes seek to regulate are lower (13 SEER and 78 AFUE), the city must obtain a waiver of preemption from the federal government in order to enforce the stricter local codes. The plaintiffs and other industry groups had worked with local officials to try and reach a compromise, but once a self-imposed deadline passed, the groups filed suit.

The essence of the plaintiffs' preemption argument was that because the federal government has already acted to regulate the same type of equipment, an implied preemption exists whereby the federal regulation is meant to occupy the regulatory scheme with respect to energy efficiency for HVAC equipment. The plaintiffs claimed in their complaint in the action that the Codes would increase the cost of construction due to higher installation costs and lead to illegal installation of cheaper equipment from unlicensed contractors.

Moreover, the current patchwork of green building regulations at the state and local level, mandating different types of requirements under different rating systems, is similar to the type of scenario that the plaintiffs in *Air Conditioning, Heating and Refrigeration*

Institute are fighting against. The new administration in January 2009 is likely to increase activity at the federal level related to energy consumption of buildings and larger-scale interventions based on either a carbon tax or a cap-and-trade system for greenhouse gas equivalents, which could have serious repercussions for state- and local-level legislation that is unable to obtain a waiver of preemption from the federal government.

Enacting legislation without considering these critical legal implications is irresponsible and dangerous to the long-term prospects for the sustainable building movement at large. Every real estate industry stakeholder will agree that environmental conservation is an important goal. However, by quickly passing legislation that does not consider serious legal ramifications, state and local governments may ultimately end up pushing the building industry, owners and developers away from that critical—and desirable—outcome. A morass of litigation challenging regulatory schemes that are poorly drafted or essentially illegal would ostensibly shoot the sustainable building movement in the foot. Questioning the validity of these schemes should not be construed as legal pessimism, but rather an important piece of the dialogue that will, hopefully, result in a more sustainable outcome. ■