

GSA Leasing: Will the Politics of Austerity Increase Costs To Landlords and to the Federal Government?

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In 2012, leases are expiring for approximately nine million square feet of office space leased to the General Services Administration in the DC region. Approximately seven to eight million square feet of GSA leases are due to expire in each of the following four years. In the not-so-distant past, building owners and developers could expect that such annual rollover numbers would translate into opportunities to attract federal tenants armed with approved prospectuses for new or upgraded space. Indeed, given today's mounting political pressure on federal agencies to do more with less, one might expect GSA to be out in the market shopping for more efficient office space. However, with prospectus approvals stalled on Capitol Hill and a contentious Congress determined to cut agency budgets, federal tenants often are left without the funds or legal authority to seek new space. The federal leasing community is thus faced with a new reality: federal tenants increasingly are staying put, at least for the short term. In this climate, it is particularly important for lessors of space to the GSA to understand the legal issues and business risks associated with the lease renewal and extension processes. Chief among these risks is the holdover tenancy. This article provides a brief overview of GSA renewals and extensions, explores how the current politics of austerity could increase the likelihood of costly holdover tenancies, and addresses basic issues associated with holdovers and their legal cousin, leasehold condemnation.

Overview: GSA Lease Renewal and Extension Processes

In the wake of the financial crisis, political factors are aligning that could hinder the successful renewal or extension of GSA leases. However, before exploring what happens when the lease renewal process goes wrong, it is useful to review briefly what happens when it goes right. Ideally, several years prior to the end of the lease term, the GSA (the direct tenant under

the lease) sits down with its tenant agency (which occupies the property pursuant to an occupancy agreement with the GSA) and discusses the fundamental choice between seeking new space and staying in place. This choice is mainly driven by the tenant agency's space needs and budgetary considerations. Historically, more often than not, the decision has been to stay in place. Indeed, the average length of a GSA tenancy has been just over 30 years. This is not surprising, as staying in place is generally cheaper because it avoids moving costs and the costs of new improvements. In order to renew in place, GSA must advertise the tenant agency's space requirement and conduct market research to determine whether full and open competition of the lease will produce savings that are greater than the costs avoided by staying in place.[1] If staying put is determined to be the cheaper option, then GSA will enter into negotiations with the existing lessor over the terms of a "succeeding lease," including rent, necessary improvements, and any required changes in square footage. These negotiations will be informed by a detailed program of requirements from the tenant agency, which in an ideal world would be formulated early in the renewal process. If the annual rental amount for the lease will exceed the prospectus threshold, which for the last several years has been \$2.79 million, then GSA must submit a prospectus for approval by the House Committee on Transportation and Infrastructure and the Senate Committee on Environment and Public Works. Under ideal circumstances, this entire process would be completed, with a full program of requirements, an approved prospectus and an executed succeeding lease, before the expiration of the existing lease term.

While renewals in place are historically more common, agencies of course do need to move from time to time, often because of changing space needs, a desire

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to consolidate offices or security considerations. Even in the case of a successfully planned move, it is often necessary to negotiate and execute a short-term extension of the existing lease. In many cases, extensions are required to line up the lease terms of consolidating offices or allow time for construction of new facilities. Again, the goal is to complete negotiations over the terms of the extension well in advance of the expiration of the existing lease.

Politics Getting in the Way?

While GSA has taken great pains in recent years to ensure that more succeeding leases, and extensions when necessary, are successfully negotiated under the timelines described above, political forces are threatening to make the planning, negotiation and approval process much more difficult. This difficulty begins with the shrinking of agency budgets and the manner in which they are being cut. With the contentious budget process subject to a series of unpredictable continuing resolutions, and with basic budgetary needs now subject to increased scrutiny and potential cuts, it becomes very difficult for federal agencies to know how much money they will have. If they do not know how much space they can afford or how many people they can employ from year to year, they will not be able to meaningfully plan for space needs or engage with lessors through the GSA. The result will be delay in the negotiation of leases.

While this uncertainty hinders planning for agencies wishing to remain in place, the result is even worse for agencies that need to move. As part of the effort to reduce budgets, both Congress and the Obama administration are applying pressure to reduce square footage and increase space utilization rates. As President Obama stated in 2010, federal agencies must “take immediate steps to make better use of remaining real property assets as measured by utilization and occupancy rates.”[2] In somewhat stronger terms, Rep. Jeff Denham, Chairman of the House subcommittee which

oversees GSA leasing, has stated that “[g]iven the financial crisis facing our country, we simply must reduce the amount of money we spend to house Federal employees.... And agencies will have to house more people in less space.”[3] Ironically, however, budget cuts may be depriving these agencies of the upfront cash needed to undertake these long-term cost saving measures. Because it is often difficult or impossible to convert floor plans in currently leased buildings to accommodate new utilization targets, many agencies must move to new space in order to meet these demands for efficiency. Such moves require funds not only for relocation costs, but also large investments in new technologies necessary for effective downsizing. In many cases, these funds are simply not available.

Similarly, some agencies seeking to move and consolidate are finding that budget cuts have imperiled or delayed the projects to which they had planned to relocate. An example is the planned headquarters for the Department of Homeland Security at the St. Elizabeth's campus in southeast D.C. With \$500 million needed to complete the project and only \$89 million allocated in the President's proposed 2013 budget, the inevitable completion delays will force DHS employees under literally dozens of leases to stay in place.

Thus, while the push for more efficient space usage eventually may lead to an increase in agencies seeking new space, the confluence of this downsizing pressure with current budget austerity may have the opposite effect in the short term. Agencies that are faced with the need to move in order to become more efficient, but which have no money to do so, could be incentivized simply to wait and see what the next budget battle brings, hoping that their budgetary situation will improve. While such agencies wait, the expiration date of their leases will approach, increasing the risk of holdovers.

Finally, these problems are exacerbated for larger leases, which require express congressional approval for renewals and new leases alike. Even for agencies

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that are able to work out their space needs, each prospectus has now become a political football on Capitol Hill. As of mid-March 2012, less than half of the FY 2011 prospectus-level leases had been approved by Congress, and none of the FY 2012 leases had been approved. Indeed, the congressional committees charged with overseeing federal leasing are holding up prospectus approvals in an effort to force further reductions in the size of leases, and have otherwise been preoccupied with the Civilian Property Realignment Act in the hopes of disposing of excess federal assets. Without prospectus approval, these leases will not be executed, and thus the likelihood of leases expiring without any renewal in place is increased. This issue is of particular concern for the National Capitol Region, where approximately 60% of GSA's leased square footage is subject to prospectus approval. Indeed, in the words of Bob Peck, Commissioner of the Public Building Service, if prospectuses are not approved, "these leases . . . will fall into holdover, costing taxpayers far more, adding unnecessary administrative complexity and burden to business transactions, and negatively affecting private sector landlords with whom we must negotiate." [4]

Federal Holdover Tenancy

Holdover tenancies are a fairly common problem in all leasing contexts, including those involving private sector tenants. However, the normal commercial lease typically imposes penalties on holdover tenants, usually 150 to 200% of the normal monthly rent. In addition, landlords generally have remedies under state law, such as actions for unlawful detainer, which allow landlords to evict holdover tenants. None of these lessor protections apply to GSA leases. Indeed the standard GSA lease forms, including the revised versions proposed in GSA's ongoing lease reform process, do not include any holdover penalties or even mention the concept. Moreover, state causes of action such as unlawful detainer are not available against the federal

government, which cannot be evicted. Thus, if the federal government is not prepared to leave the premises, it simply does not have to.

The threat of holdover tenancy represents perhaps the most challenging aspect of leasing space to the federal government for four key reasons. First, holdovers prevent a landlord from successfully planning the leasing of its building. Indeed, if the government is holding over past the end of its lease, the landlord cannot effectively market the space to new tenants, or may be unable to deliver promised space to a replacement tenant, who then may have a claim for damages under its lease when the government fails to vacate. Second, holdover tenancies can cripple an owner's efforts to refinance. Since loan terms are usually tied to the term of the lease, loans are generally due at the end of the lease term. If the landlord has not entered into a new long term lease by that time, the landlord will have difficulty refinancing the loan. While landlords can attempt to negotiate an extension of the existing loan's maturity date, loan extensions are difficult when no one knows how long the holdover tenancy will last. In the worst case scenario, a lessor who is unable to refinance could be forced into a default at the end of the term of its existing loan. Third, a holdover tenancy can hinder an owner's ability to market its property for sale, and could potentially derail ongoing sale negotiations. Finally, even a small holdover tenancy in an inopportune location can delay the redevelopment of a building or even an entire assemblage of parcels.

Importantly, holdover tenancies can be very costly for the government as well. While GSA's stated internal policy is to continue paying rent during a holdover tenancy at the same rate that was in effect in the final month of the lease term, [5] GSA can be required to pay considerably more. If the government remains beyond the term of its lease, it is technically in breach of its contract with the lessor. [6] In such circumstances, lessors are generally entitled to market rent for the holdover period, which often is greater than the lease rent

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negotiated years earlier. In addition, lessors may seek consequential damages resulting from lost leases, failed refinancings or payments owed to tenants waiting to move in. However, such consequential damages are generally more difficult to obtain. The government can be expected to assert that, as a matter of law, it is not liable for such damages, and even if that argument fails, the lessor must establish that the damages were foreseeable at the time the lease was signed (rather than at the commencement of the holdover). All actions must be brought in accordance with the provisions of the Contract Disputes Act[7] and the applicable provisions of the Federal Acquisition Regulation. [8] Lessors may bring an action before the Civilian Board of Contract Appeals or the Court of Federal Claims, and the procedures and timelines for such actions vary considerably. Of course, the process can be costly and time consuming.

In general, it behooves both the government and the lessor to continue cooperating and negotiating in good faith if the lease is about to fall into holdover status or if it is already there. In many cases, by negotiating and executing a short term extension, the parties can buy time until a succeeding lease can be approved and executed or until the tenant agency is able to move to a new location in an orderly fashion. Such extensions, while generally disfavored by both GSA and lessors, can be an effective way to avoid holdover altogether or, if the term has already expired, to bring a holdover tenancy to an end and thereby provide some certainty to both parties (even if only in the short term). Importantly for lessors, upon the eventual execution of a succeeding lease or extension, the GSA typically agrees to pay the newly negotiated rent retroactively to the date on which the prior lease expired and a holdover began. Of course, while cooperation by all parties is usually the best way to avoid or escape the holdover situation, this does not always work, and the lease could then enter the realm of condemnation.

Leasehold Condemnation

The Fifth Amendment of the United States Constitution provides the federal government with the power to take private property for public use. GSA has been delegated this power to condemn property by Congress.[9] While the classic form of taking involves the condemnation of a fee interest in land, GSA also has the power to condemn a leasehold interest in real property. When the government takes property, it must provide the owner with “just compensation.”

The concept of leasehold condemnation can come into play in two ways. In the first scenario, the GSA, often in a holdover situation, may determine that negotiations will not lead to an acceptable extension or succeeding lease, and thus will institute formal condemnation proceedings. In such proceedings, GSA is guided by federal statutes and its own set of regulations.[10] The first step in the process is an appraisal, which must be conducted according to federal guidelines. If the government cannot negotiate a lease after offering to pay rent at a rate equal to or greater than the rate set forth in the appraisal, then the Department of Justice may commence condemnation proceedings by filing a petition in federal district court. With this petition, the government files a declaration of taking, which states the government’s estimate of just compensation. Upon filing this declaration, title to the leasehold estate vests immediately in the government, and title to the compensation vests immediately in the owner.

Leasehold condemnation may also be raised in the first instance by the owner, who may claim in the Court of Federal Claims that the government has effected a temporary taking of its property. If the government is holding over after the end of the lease, then the government has “taken” a leasehold interest, and the owner can sue for just compensation. Importantly, regardless of who raises the issue of leasehold condemnation, there is no guaranty to the owner that rents deemed to be just compensation under the condemned leasehold will be higher than those under the prior

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lease. Indeed, it is technically possible that just compensation could be set at *less* than the prior rent, a phenomenon that has occurred in the last several years, particularly outside of the National Capital Region.

Leasehold condemnation is usually in nobody's best interest, and it is an action of last resort for the government. Given the considerable cost and delay associated with this contentious process, it is not surprising that it is a rare occurrence in GSA leasing. However, condemnation is a technical possibility whenever a lessor and the government simply cannot agree, and thus it is an important consideration as parties approach lease negotiations during, or in anticipation of, holdover tenancies.

Conclusion: Troubling, but Manageable

While the ingredients are present for an increase in holdover tenancies in GSA leases, there is reason to view these developments as a manageable problem rather than a gathering storm. First, Commissioner Peck and others at the GSA have prioritized the reduction and prevention of holdover tenancies, and have cut the total number of holdover leases in the National Capital Region by more than half since 2009. Thus, GSA comes to the problem with significant positive momentum. In addition, a cost-conscious Congress is showing signs of understanding that delaying prospectuses actually threatens to increase costs to the tax-

payer, and has begun to move prospectuses through the approval process. Indeed, on March 8, 2012, the House Committee on Transportation & Infrastructure approved eleven prospectuses and mandated a lease consolidation for another (see page 31—*Ed.*). While current political and economic forces are unlikely to cause a sea change in GSA leasing, they are still a cause for concern, and threaten to stymie further progress in addressing the problem of holdover tenancies. Fortunately, if the GSA, tenant agencies and lessors all keep these forces in mind as they approach space planning and lease negotiation, the chances are good that the federal leasing community can continue to navigate the lease renewal and extension process with minimal increased pain from holdover tenancies.

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Footnotes:

1. PBS Leasing Desk Guide, 5-4 - 5-12; 41 U.S.C. §3304; 48 C.F.R. §6.302-1.
2. Presidential Memorandum--Disposing of Unneeded Federal Real Estate, June 10, 2010.
3. Cutting Spending and Consolidating Federal Office Space: GSA's Capital Investment and Leasing Program, House Transportation and Infrastructure Committee (March 10, 2011).
4. One Year Later: Still Sitting on Our Assets, House Transportation and Infrastructure Committee (Feb. 9, 2012).
5. PBS Leasing Desk Guide, 10-3.
6. See *Prudential Ins. Co. of America v. U.S.*, 801 F.2d 1295 (Fed. Cir. 1985).
7. 41 U.S.C.A. § 7101 *et seq.*
8. 48 C.F.R. §§ 33.201 *et seq.*, 52.233-1.
9. 40 U.S.C. § 581(c)(1).
10. 40 U.S.C. §§ 3114, 4651; 41 C.F.R. §§ 102-73.260 - 73.290.