

GOVERNMENT LEASING NEWS

A QUARTERLY NEWSLETTER FOR OWNERS, MANAGERS AND DEVELOPERS OF
GOVERNMENT-LEASED PROPERTY

This article by Robert MacKichan of Holland & Knight is a reprint of the original publication that appeared in the Summer 2007 edition of Government Leasing News.

Innovative Financing of Government Leased Real Estate GSA's Securitized Credit Lease

I. INTRODUCTION

For over a decade, the General Services Administration has promised the issuance of a "securitized lease," a lease with terms and conditions more attractive to the nation's mainstream lending institutions. In the absence of such an alternative, the General Clauses of the standard GSA lease have continued to present underwriting concerns for financing facilities with Government tenants. Among the most significant, the customary entitlement of the Government to offset rent for failure in performance and the right to fully terminate for any casualty loss have impacted the cost of financing facilities with Government tenants.

Several years ago, a task force was formed within GSA and tasked with the preparation of alternative lease provisions to provide greater financial appeal of Government leases. The study group issued a substitute set of General Clauses titled "Credit Lease General Clauses" (SF 3517X), but due to the departure of the task force chairman, to date this alternate lease form has not received formal endorsement through

the issuance of an agency instructional letter. Although conceptually the lease provisions have been utilized in several large GSA lease procurements, including the U.S. Patent and Trademark Office and the new Department of Transportation headquarters, the utilization of SF 3517X has seemed to have been fallen into disuse.

As a practitioner in federal real estate, GSA's apparent reluctance to utilize this alternate form seems inconsistent with its mission to acquire first-class office space at the most competitive pricing. A careful analysis of the provisions of the new lease provisions, and GSA's current utilization of the standard lease provisions to address lease administration issues, would support greater utilization of the new lease without compromising the rights of the Government. Use of the new lease provisions would arguably foster more competitive pricing without diminishing GSA's ability to adequately respond to performance deficiencies.

To better understand the provisions of the "Credit Lease," the new provisions

must be compared to the standard provisions of the currently utilized General Clauses.

II. STANDARD GSA LEASE PROVISIONS (SF 3517)

As a general rule, most GSA leases are full-service leases holding the lessor responsible for the operation, maintenance and repair of the facility and, as directed by the Government, the completion of tenant improvements or other alterations. The rent is paid monthly in arrears and is the sum of two components, base rent and operating costs. Base rent is usually fixed for the firm term of the lease and must include base year real estate taxes and insurance. The operating cost component is escalated annually utilizing a specified index. The lessor is entitled annually to a lump sum payment annually for the increase in real estate taxes in excess of the base year taxes, as established utilizing one of two methods specified in the lease. Base year taxes are either (1) the real estate taxes for the first 12-month period coincident with full assessment, or (2) may be an amount negotiated by the parties that reflects an agreed upon base

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for a fully assessed value of the property.

The standard GSA Lease provides broad rights of the Government to offset the payment of rent when lessor has failed to perform in accordance with the terms and conditions of the lease and an entitlement to terminate the lease for default when (1) a failure has remained uncured for 30 days following receipt of a notice to cure, or (2) when there have been repeated and unexcused failure of the lessor to comply with one or more requirement of the lease. Lease termination will also occur if the entire premises have been destroyed by fire or other casualty or at the Government's discretion in the instance of partial destruction or damage such as to render the premises untenable, as determined by the Government.

A standard GSA lease also allows the Government to sublet the premises without the lessor's consent, but the Government shall not be relieved of its obligations under the lease. Assignment requires the consent of the lessor (not to be reasonably withheld), but does relieve the Government of any obligations of the lease.

As noted, the provisions within the currently utilized standard General Clauses most commonly of concern to lenders are as follows:

Fire & Casualty Damage Clause. This clause provides that the lease will immediately terminate if the entire premises are destroyed by fire or other casualty. In the case of partial destruction of the leased premises so as to render the premises untenable, as determined by the Government, the Government may terminate the lease by giving writ-

ten notice to the lessor within fifteen (15) days of the fire or casualty. If the Government so terminates the lease, no rent will accrue under the lease. If the lease is not terminated, the rent will be reduced in proportion to the amount of the leased premises destroyed.

Failure in Performance (Right of Rent Setoff). This clause permits the Government to deduct from its lease payments the cost, including administrative costs to the Government, of any service, utility, maintenance, repair, or replacement required under the lease if the contractor fails to provide the required service. Alternatively, the Government may deduct from any payment under the lease an amount that reflects the reduced value of the contract requirement not performed. Any failure of performance pursuant to any other clause of the lease will trigger the Government's right to offset rent under this clause.

Default in Delivery. This clause requires that the lessor deliver the leased premises, substantially complete, by the delivery date. If the lessor fails to work diligently to ensure timely delivery of substantially complete premises, the Government may terminate the lease and hold the lessor and its sureties jointly and severally liable for any damages to the Government resulting from such termination. The contracting officer may grant a time extension in the event of an excusable delay so long as the lessor notified the contracting officer within ten (10) days from the beginning of any such delay.

Default by Lessor During the Term. This clause permits the Government, by notice to the lessor, to terminate the lease for

default and collect the damages specified in the Default in Delivery discussed above. This clause provides that any of the following shall constitute default by the lessor: failure to maintain, repair, operate, or service the leased premises when and as specified in the lease; failure to perform any other requirement of the lease within thirty (30) days following the lessor's receipt of notice from the contracting officer or his/her authorized representative; and repeated and unexcused failure by the lessor to comply with any requirement of the lease, even if one or all of such failures were cured in a timely fashion.

In contrast, the credit lease addresses these primary concerns as follows:

III. THE GSA CREDIT LEASE (SF 3517X)

Lease Structure. Fundamentally, the Credit Lease divides the lease into two components, the Space Lease and the Service Agreement. The lease defines each as follows:

Space Lease. This is that portion of the lease which addresses (1) the lessor's obligations and covenants to provide the Premises and to provide any and all Capital Repairs and Replacements to the Premises for the entire lease term, and (2) the Government's obligation to pay the Base Rent.

Service Agreement. This is that portion of the lease contract which addresses the lessor's obligations and covenants: (1) to furnish to the Premises all property services, utilities, maintenance, insurance, and Non-capital Repairs and Replacements, (2) to manage the property in the execution of the foregoing, and (3) to pay real estate taxes, as provided in the lease. The "Service Agree-

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ment" also entails the Government's obligation to pay the Service Agreement Rent.

Rent. The Credit Lease deviates from the standard GSA lease by dividing rent into the following:

Base Rent. The portion of rent to be paid by the Government for the Space Lease component of this contract. Base Rent is exclusive of Service Agreement Rent.

Service Agreement Rent. The portion of rent that the Government pays for operating expenses and real estate taxes for the leased premises, and the lessor's management fee. It also includes, in the event of a lessor default, the Service Agreement Reserve. If the lease is for less than 100 percent of the property and other tenants are responsible for contributing fees toward Common Area Maintenance (CAM), then, in the event that lessor defaults by not providing CAM, the Service Agreement Rent will also include an amount equal to the CAM fees for the non-Government leased portion of the property. Service Agreement Rent is exclusive of Base Rent.

In addition to defining these two categories of rent, the Credit Lease establishes a Service Agreement Reserve that provides additional security for the Government as follows:

Service Agreement Reserve. The mechanism that provides additional security for the Government in the event of a lessor default. Beyond the sum of the amounts paid for operating expenses, taxes and the lessor's man-

agement fee, the Service Agreement Reserve is an amount, up to 10 percent of annual Base Rent, by which the Government may withhold or set off rent in the event that a lessor default continues beyond the notice and cure period. Any such set off or withholding by the Government will, in accordance with the terms of this lease, constitute a deduction from Service Agreement Rent, and not from Base Rent. The Government reserves the right to set off Service Agreement Rent, including the full Service Agreement Reserve for each instance of a lessor default. In no event, however, will the Service Agreement Reserve rent offset exceed 10 percent of annual Base Rent during any 12 month period, or an average of 2 percent of annual Base Rent for each of any 5 contiguous lease years. The Government anticipates that its right to offset rent by the Service Agreement Reserve will oblige Lenders to create an escrow account, initially endowed with 10% of the first year's rent. Additionally, provision must be made to add annually to the account at least 2% of any year's Base Rent. If, at the end of each lease year, the lease is performing and there are no defaults, then lessor's Lender may release to the lessor any amounts in the Service Agreement Reserve fund in excess of 10% of the annual Base Rent. If there are any defaults for which the Government has exercised its right to setoff or withhold rent, then the addition to the escrow of an amount equal to 2% of Base Rent each year keeps the escrow full, and thereby protects against any interruption of the cash flow to the lender.

Failure in Performance, Default by Lessor During the Term and Termination

Rights of Lessor. As compared to the standard GSA lease, the Credit Lease essentially eliminates the Government's right to terminate the lease for default due to a Failure in Performance or Delivery. In addressing the lessor's failure to perform, the Credit Lease distinguishes between failures to perform in matters associated with the Space Lease and Service Agreement.

Although the Government may declare the lessor in default for uncured deficiencies relating to the Service Agreement (a failure to provide any service, utility, maintenance, non-capital repair or non-capital replacement required under the lease), the Government's remedies are limited to (1) performing or providing by contract or otherwise the requirement and deducting from any payment or payments of rent, except Base Rent, the cost of performing the requirement, or (2) deducting from any payment of rent, except Base Rent, but including part or all of the Service Agreement Reserve, an amount which reflects the value of the contract requirement not performed, or (3) terminating the Service Agreement portion of this lease. If so terminated, the Government is entitled to collect from the lessor's lender or its assigns all Service Agreement Rent proceeds held in escrow for the payment of real estate taxes, as well as any and all other amounts of Service Agreement Rent collected or held for the payment of operating expenses not yet discharged, including the lessor's management fee retainage, if any, and any escrow established for the Service Agreement Reserve, and the Government will arrange for the provision of all services, maintenance and operations as identified in the

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Service Agreement of the lease.

For deficiencies in the performance of Space Lease matters (any physical element or condition either within or affecting the tenantability of the premises that deteriorates or fails necessitating a capital repair or replacement), should a lessor fail to cure after a 180-day notice period, the Government may, by contract or otherwise, repair or replace the element(s) or cure or correct the condition and deduct the resulting cost to the Government, including administrative costs, from any payment or payments of rent under the lease, including part or all of the Service Agreement Reserve and the lessor's management fee, but excluding Base Rent.

The aforementioned protection afforded the Base Rent is further addressed in the "Non-Interruptability of Base Rent" provision of the Credit Lease, wherein it states in part as follows:

"Notwithstanding any other provision of this lease, except as provided in this clause and in the clause entitled Fire and Other Casualty, the Government may neither terminate the Space Lease portion of this contract nor set off, reduce or terminate Base Rent once the Contracting Officer has accepted the premises as substantially complete and executed a Supplemental Lease Agreement (SLA) to accept the premises as substantially complete."

The Credit Lease also limits the Government's entitlement to terminate the lease for a default in delivery. In the standard GSA lease, with time being of the essence, a lessor's failure to deliver the premises could result in the Govern-

ment's termination of the lease. With the Credit Lease, the Government may either grant a time extension or terminate the lease in the event that the premises are not at least 80% complete. If the premises are 80% complete, the Contracting Officer is required to extend the time for delivery, but lessor is responsible for liquidated damages.

Other traditional provisions of the standard GSA lease providing a right of the Government to terminate the lease, have been eliminated or substantially limited.

The Credit Lease limits the Government's termination right in the event that the premises are destroyed or damaged by fire. Instead, the Credit Lease provides that immediate termination occurs only if the premises cannot be "substantially completed" and reoccupied within 365 days of the destruction, or the date the parties agree upon, whichever is longer. If the premises can be reoccupied and "substantially completed" within 365 days, the lease will not terminate. If the latter transpires, the Government may suspend all payments due under the lease during the time of repair. Further, the Credit Lease stipulates that it is the lessor's sole responsibility to maintain fire and casualty and rent interruption insurance.

Deviating from the standard GSA lease, the Credit Lease adds a requirement that the Government provide the lessor with written notice of the Government's intention to sublet any part of the leased space at least 15 working days prior to subletting, but shall not be relieved from any obligations of the lease. The lessor may only object to such subletting only if it is unlawful or would have a material adverse effect on

the value of the property. Furthermore, the Government may not assign the lease without the express consent of the lessor.

IV. CONCLUSION

With the benefits evident in the new SF 3517X Credit Lease, it seems apparent that lessors and the Government would benefit from greater utilization of the alternate credit lease. However, in all likelihood until GSA formally issues an instructional letter to the contracting staff providing the tools for its broader utilization, building owners and developers are not likely to see the new Credit Lease included in new lease solicitations. As a means of achieving that desired result, this writer would recommend routinely encouraging GSA to use this format. When Solicitations for Offers are issued, ask the Contracting Officer to amend the solicitation to include the Credit Lease. Also forwarding general expressions of support and interest in Credit Lease to GSA's Commissioner of the Public Buildings Service would also be very helpful securing GSA inclusion of the terms.

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