

Operating Cost Increases in Government Leases: How to Avoid Being Left Out in the Cold

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Operating costs make up a substantial portion of the costs of owning and leasing real property. This is true whether you lease to private or public sector tenants. Leases with the U.S. General Services Administration (the "Government") are certainly no different in this regard. However, Government leases do differ from commercial leases in the way that a lessor is compensated for operating costs and increases (or, less commonly, decreases) in operating costs.

Because of the volatility of energy prices over the past several years, many lessors have found that the Consumer Price Index ("CPI") adjustments prescribed by Government leases often fall dramatically short of the actual cost increases that they face. Recently, in addition to the inherent inaccuracy of CPI adjustments as a measure of increases in operating costs, the Government has been further burdening lessors by adding equipment not contemplated by the lease and by increasing the schedule of use of the leased space. This article will briefly discuss how Government operating cost provisions typically work and how lessors can pursue additional compensation for the costs associated with the Government's unanticipated or non-disclosed additional uses in the leased space.

The Operating Cost Adjustment Clause:

In almost all Government leases, the operating cost clause works the same: a base operating cost is established at the beginning of the lease term and it is adjusted annually based on changes in the CPI during the lease term. As part of the lessor's offer to lease space (using

GSA Forms 1217 and 1364), the lessor provides for an operating cost base that will be included in the offered rental rate for the leased space. According to most Government leases, once the operating cost base is established, the lessor will be entitled to adjustments to the operating cost base only to the extent that the CPI varies from the base year CPI, less any deductions for previous year CPI adjustments. The Government has endorsed this approach as an administrative convenience for the purpose of fairly compensating the lessor for costs associated with the operation of the building.

The typical operating cost adjustment clause in a Government lease provides that the CPI adjustment is calculated each year by comparing the CPI in the month immediately preceding the lease commencement date with the CPI in the month preceding the anniversary date of the lease to determine the percentage change from the base year.* This percentage change is then multiplied by the operating cost base to determine the gross increase in operating costs over the operating cost base.

After the first CPI adjustment during the lease term,** the amount paid by the Government for CPI adjustments in previous years of the lease term will be deducted from the gross increase in operating costs for the current year to determine the net increase in operating costs for the current year. Such net amount will then be added to the annual rental rate and carried forward from year to year. Therefore, except for in rare cases such as 2009 where the CPI decreases year over year, the lessor will receive compounded increases in rent

over the term of its lease. Unfortunately for lessors, the increases in operating costs reflected by the CPI adjustments tend to quickly fall behind the actual increases in operating costs experienced by the lessor. Additionally, the Government's actions can compound the problem by further increasing the lessor's actual operating costs.

Government Actions Can Increase Operating Costs:

Government actions that will generally cause increases in operating costs typically fall into two categories: (1) installation of special equipment or other equipment that was not contemplated in the lease; and (2) increasing the schedule of use of the leased space beyond what is provided for in the lease. In each of these instances, the Government's actions cause a substantial increase in the actual costs of operating the leased space, a cost that the Government often expects the lessor to bear without recompense. At a minimum, the lessor will have to bear the burden of carrying the increased costs until it is able to obtain a remedy as discussed below, which could dramatically raise the costs to the lessor of having the Government as a tenant. However, lessors are not without means to avoid such a situation, and if a lessor finds itself in such a situation, it is not without remedies.

Avoiding Bearing the Burden of Increases Due to Government Actions:

To avoid the carrying costs of dramatic increases in operating costs, lessors should seek modifications to the operating cost adjustment clause when responding to a solicitation for offers ("SFO"). In particular, the lessor should

*As provided in the August 2008 version of the Operating Costs clause.

**The Government typically makes the first CPI adjustment on the anniversary of the lease commencement date.

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seek to include language in the Standard Form 2 ("SF-2") of its lease that provides that the Government will be responsible for all costs related to installation of special or additional equipment beyond any existing after completion of the building shell and tenant improvements, including, but not limited to, increases in operating costs.

Additionally, the lessor should seek to include language in the SF-2 that provides the lessor with a specific remedy if the Government increases the normal hours of its use of the leased space or requires 24/7 service to certain parts of the leased space. Finally, the lessor should price in the expected increases in operating costs over the term of the lease when submitting a rental rate in its offer to the Government.

While the Government will not always agree to include these types of clauses, we have had success negotiating at least some variation of these clauses to provide the lessor with some protection against actions by the Government that will lead to increases in the actual costs to the lessor of operating the leased space. If the Government will not agree to any such language, or if you do not have such language in your lease and the Government has taken actions that have increased the operating costs of the leased space, there remain formal and informal avenues that you can pursue to require the Government to provide compensation for such increases.

Lessor Is Entitled to Relief under the Changes Clause from Government Actions that Increase Operating Costs:

Government leases routinely contain what is referred to as a "changes clause," such as the GSA Acquisition Manual's changes clause, 552.270-14. Pursuant to the changes clause, the

contracting officer is allowed to make changes within the scope of the lease and to appropriately compensate the lessor therefor. The contracting officer may issue a change order directing the lessor to make a change with or without the lessor's consent. Alternatively, the contracting officer may request that the lessor submit a proposal for accomplishing the change. This proposal may lead to a bilateral supplemental lease agreement that reflects the change to be made at a price negotiated by the parties. The changes clause thus gives the Government flexibility to meet the needs of the tenant agency and improve performance under an existing lease. For example, the Government could issue a change order directing the lessor to install equipment not contemplated in the lease or extend the leased premises' hours of use, as discussed above, in exchange for a reasonable equitable adjustment to compensate the lessor for the lessor's increased performance costs.

Addressing Government-Imposed Constructive Changes:

However, the Government often fails to strictly follow the changes clause when requiring a change under a lease, instituting changes without the knowledge of the lessor. In those instances, when the Government informally imposes a change in requirements that affects the lessor's cost of performance under the lease, that change is regarded as a "constructive change," and the lessor is entitled to relief just as if the Government made the change formally. The key elements of a constructive change include:

- (1) a change occurring as a result of Government action or inaction;
- (2) the lessor not intentionally and voluntarily performing the change free of charge; and
- (3) the change having an impact on the

cost of performance.

Once the lessor realizes that a constructive change has increased its costs of performance, the lessor should provide notice to the contracting officer describing the change and the cost impact of that change. The lessor should also request relief in the form of one or more of the following:

- (1) an equitable adjustment in the rental rate;
- (2) a lump sum equitable adjustment; or
- (3) an equitable adjustment of the annual operating costs per usable square foot.

Ordinarily, where there has been a Government-imposed constructive change, a contracting officer will either (i) formalize the change by means of a change order or supplemental lease agreement, or (ii) correct the situation by undoing the change so that the Government complies with the lease. If the change is formalized, the Government must compensate the lessor retroactively and prospectively to account for the lessor's increased performance costs. If the Government instead undoes the change, corrects itself, and conforms to the lease going forward, then the lessor is entitled to retroactive relief only.

Resolving constructive changes issues is often challenging because of the disconnect between the Government, which is responsible for enforcing the lease—to include coordinating changes with the lessor—and the tenant agency, which is primarily concerned with accomplishing its mission in the leased space. This disconnect may result in constructive changes going unaddressed by the Government. For example, if the tenant agency increases its staffing or hours of operation or expands its computer capacity, then increased heating, ventilation, and air conditioning requirements and higher

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operating costs are almost assured. Until the lease is amended to reflect the new operating conditions, the rental rate will be too low.

It could also be difficult for the lessor or the Government to realize that the tenant agency has made such a change, much less specifically identify the change. Moreover, quantifying the operating cost impacts of the change may be very difficult and may require expert analysis. Further, the Government may resist upwardly adjusting the rent where the tenant agency, and not the Government, imposed a constructive change.

Unfortunately, lessors are not always successful in informally resolving such issues with the Government. Therefore, an aggrieved lessor may need to pursue a more formal means of obtaining relief.

Pursuing a Formal Claim for Relief:

Government leases are subject to the Contract Disputes Act of 1978, 41 U.S.C. §§ 601-613 (the "CDA"). The CDA allows a lessor to make a written demand to the contracting officer for relief as a matter of right. Such written demand is known in Government contract parlance as a "claim." There is no mandatory format for a claim, but the CDA requires that the claim seek the payment of a sum-certain amount of money, the adjustment or interpretation of contract terms, or other relief relating to the lease. Constructive changes are not always self-evident—they can be difficult to detect and hard to explain to a contracting officer who may not be well versed in the intricacies of

technical matters relating to the administration of the lease. Unless the issues are clearly delineated and convincingly demonstrated, the Government may dispute the lessor's entitlement to relief or disagree with the quantum of relief sought by the lessor. To best ensure success of the lessor's claim, the lessor should include relevant documentary proof, such as invoices, in support of the claim that demonstrates the changes and their cost impacts. Notably, any claim for more than \$100,000 must be certified by an authorized person to have been made in good faith, upon supporting data that are accurate and complete to the best of the lessor's knowledge and belief, and for an amount that accurately reflects the adjustment for which the lessor believes the Government is liable.

Once a claim is received, the contracting officer has 60 days to render a written final decision that explains the rationale for the contracting officer's decision. This final decision may grant the relief sought in whole or in part, or deny the claim altogether. If the contracting officer fails to issue a final decision within the 60-day timeframe, then the lessor may treat the claim as deemed denied. In any event, the lessor must continue to diligently perform its obligations under the lease pending resolution of its claim.

Lessors are often disappointed and surprised by a contracting officer's final decision that seems unsupportable based on the evidence at hand. If the lessor is dissatisfied with the contracting officer's final decision, the lessor

may appeal the final decision to the Civilian Board of Contract Appeals or the U.S. Court of Federal Claims. Although the Government is required to pursue resolution of a claim by mutual agreement if possible, appealing a claim is commonly required to achieve an acceptable resolution of a matter. Although not the preferred approach, litigation may be one of the lessor's most effective tools in reaching a fair resolution with the Government.

Conclusion

While the operating cost adjustment clause in Government leases is not the most lessor favorable, lessors are not without means of ensuring that operating costs do not make leasing to the Government untenable. By pricing in expected operating cost increases and including language in the SF2 that protects the lessor against sharply rising operating costs resulting from Government actions, the lessor can minimize its downside risk.

If you are a lessor under an existing lease with the Government, you are not without options if the Government is increasing your operating costs. You can begin by seeking an informal resolution with the Government and, if that approach is not successful, you can next seek formal resolution through the claims process. Ultimately, whether you are a prospective lessor or an existing lessor, being aware of the impact of operating costs on your bottom line and what you can do to minimize that impact will be vital to making your lease with the Government a successful endeavor.

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