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Turning Lemons into Lemonade: Doing Real Estate Business with the Federal Government in These Challenging Economic Times

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The Federal Government is one of the largest real estate players in the United States, owning or leasing a huge portfolio of office buildings and other real estate assets across the country. The Public Building Service (“PBS”), a major division of the General Services Administration (“GSA”), is specifically tasked with providing workplaces for over 1.1 million Federal employees, as well as with the development, leasing and disposition of Federal property. The sheer size of PBS’s real estate needs and holdings means that there are very significant opportunities for the private sector to do business with it. Moreover, the economic and political climate existing during the past few years has resulted in dramatically increased expectations that PBS develop creative solutions to satisfy its real estate goals, with the result that the private sector is being presented with exciting new and diverse opportunities to do business with PBS.

Lemons: The Challenges Facing PBS

PBS owns or leases approximately 9,500 real estate assets comprising about 375 million square feet of workspace for Federal employees.¹ Beyond the everyday demands of managing such a substantial portfolio, PBS recently has been facing numerous special challenges, including:

1. An Aging Inventory with Significant Capital Needs. The average age of GSA-owned buildings is 47 years and GSA has identified a backlog of over \$4 billion in reinvestment needs to repair the aging infrastructure and to reconfigure or replace the Government’s existing properties with more modern and efficient buildings.²

2. Workplace Innovation. Almost all the Departments and Agencies of the Federal Government are looking for effective ways to reduce their overhead and allocate more of their budgets to their core missions. As a consequence, a major effort is being undertaken to rethink the way Government employees are housed at work. Agencies are concluding that their use of numerous large offices is unnecessary and even counterproductive. Instead, cutting edge approaches for collaborative and innovative workplace solutions are being demanded, such as telecommuting and “hoteling.” The co-location of agencies with related missions is expected to increasingly facilitate coordination and efficiency as well.

¹ See <http://www.gsa.gov/portal/content/104444>.

² Eugene Meyer, *Lots of Federal Property to Sell, but It’s Not That Easy*, N.Y. TIMES, April 10, 2013, at B5; Press Release, General Services Administration, *GSA Announces Major Investments in the Nation’s Public Buildings as Part of President’s Budget* (April 10, 2013), available at <http://www.gsa.gov/portal/content/169331>.

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3. Sustainability Requirements. The Obama Administration is highly committed to achieving a more sustainable and energy-efficient Government.³ This sustainability theme is reflected in PBS's evolving development and leasing requirements. For example, since 2010, PBS's minimum requirement for new construction and substantially renovated Federally-owned facilities has been LEED gold, and PBS aspires to LEED gold in new lease build-outs as well. Furthermore, since 2011, its new leases must be located in buildings that have earned the Energy Star label in the most recent year unless there is an applicable exception.⁴ Indeed, PBS's policies are designed to make clear that those who want to do business with it will need to get on the sustainability bandwagon. We can expect enhanced focus on sustainability as the Federal Government considers whether to extend existing leases or move into new space.

4. Budgetary Constraints. PBS's budget has been slashed due to the current political climate and the often-discussed goal of reducing the national deficit. PBS's new construction budget was just \$50 million in fiscal year 2012, down from almost \$750 million in 2009,⁵ an amount which itself was a substantial decrease over the funds made available in earlier years. At the same time, the need for more secure and modern Government facilities is great. Critically-needed repairs must be undertaken and Federal Agencies' need for additional essential space must be addressed. The Administration and Congress are expecting the Government to do "more with less" but it is quite complicated to apply this principle to real estate needs, especially when the roof is leaking.

5. Budget Scorekeeping. The Statutory Pay-As-You-Go Act of 2010 requires that new spending not add to the Federal deficit.⁶ PBS faces two related difficulties based upon the manner in which the Office of Management and Budget ("OMB") scores its spending. First, OMB scores the entire cost of acquiring or constructing a new building in the first year of acquisition or construction. In addition, the Federal Government is required to pay for the full cost of its real estate needs itself, rather than buying and/or constructing with third party financing as is typically done in the private sector. As a consequence, annual budgetary and cost reduction goals discourage increased property ownership by the Federal Government and incentivize leasing.

Second, OMB treats operating leases differently from capital leases for purposes of the annual spending analysis.⁷ If a lease qualifies as an operating lease under the OMB guidelines, it obtains

³ On October 5, 2009 President Obama signed Executive Order 13514, "Federal Leadership in Environmental, Energy and Economic Performance." This Executive Order significantly expanded previous energy reduction and environmental performance requirements and directed Federal agencies to meet aggressive sustainability goals. Furthermore, GSA was appropriated approximately \$5.5 billion under the American Recovery and Reinvestment Act of 2009 primarily for energy efficient retrofits of Federal buildings. Now that those funds have been allocated, additional resources similarly will be required to continue this effort.

⁴ Section 435 of the Energy Independence and Security Act of 2007; Memorandum on Implementation of Energy Savings Projects and Performance-Based Contracting for Energy Savings (December 2, 2011).

⁵ See General Services Administration – Real Property Activities – Federal Buildings Fund – Limitations on Availability of Revenue, *Consolidated Appropriations Act, 2012*, Pub. L. 112-74, 125 Stat. 786, 911 (December 23, 2011); General Services Administration – Real Property Activities – Federal Buildings Fund – Limitations on Availability of Revenue, *Omnibus Appropriations Act, 2009*, Pub. L. 111-8, 123 Stat. 524, 659 (March 11, 2009).

⁶ P.L. 111-139.

⁷ In order to be treated as an operating lease, a lease must meet each of the following criteria: (i) the ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at the end of the term or shortly thereafter; (ii) the Government does not have a purchase option exercisable at a price below the asset's expected fair market value; (iii) the term of the lease does not exceed 75% of the expected economic life of the asset; (iv) the present value of the anticipated lease payments does not exceed 90% of the asset's fair market value at the start of the term; (v) the asset is general purpose (i.e. not usable for a special purpose of the government) and is not built to the

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favorable treatment under the scoring rules, since the rent payments are scored on an annual basis over the term of the lease. However, if a lease does not qualify as an operating lease, it is treated as a capital lease instead, and all outlays under the lease are scored and viewed as expenditures in the first year of its term. Consequently, from a budgetary scoring perspective, capital leases are strongly disfavored. The result is that the incentives for PBS are skewed toward leasing, which often is not the most economically rational outcome, since the Government finds itself making substantial rental payments for many years and does not obtain ownership of the assets at the end of the term.

6. Growth Areas: Need for Specialized Facilities. Even in this era of budget cuts and sequestration, the Government cannot completely halt its expansion in certain areas which have continued to grow in response to the shifting demographics of the nation. For example, the Department of Veterans Affairs (“VA”) has ongoing needs for new facilities in order to meet the increasing demands of an aging U.S. veteran population and to serve our many veterans of the wars in Iraq and Afghanistan.⁸ Other agencies such as the Social Security Administration need new facilities, or offices located in different geographic areas, to serve their evolving constituencies. Similarly, additional and more secure border crossing stations are required both for national security purposes and to facilitate increased trade.

7. Disposing of Excess Property. Congress has expressed its displeasure that GSA has not disposed of sufficient excess real estate in an expedited manner.⁹ One factor which slows down the current process is that Federal law mandates a particular series of priority transferees when the Government seeks to dispose of an owned property once an Agency reports it to PBS as excess to its needs. Before PBS can sell it to the private sector, PBS must first offer the property to other Federal Agencies, then to homeless groups and for other public uses, and also for sale to state and local governments. If those groups all pass on the property, then PBS may dispose of it via a competitive sale to the public.

Congress’s investigative arm, the Government Accountability Office, once again identified the management of Federal property in its 2013 High Risk Reports, asserting that the Federal Government relies heavily on leasing while it continues to own far too much excess property, often in the same markets.¹⁰ President Obama is also strongly committed to rectifying this situation and issued Presidential Memoranda on June 10, 2010 and December 2, 2011 aimed at (i) accelerating the process of disposing of excess Federal properties, (ii) increasing energy efficiency and (iii) placing more Federal employees in existing buildings and renting less space.¹¹ More recently, OMB directed Federal Agencies to submit a plan for not increasing their current total square footage for office and warehouse space.¹² Changes must be implemented in order for the private sector to be able to acquire

unique specifications of the government as lessee; and (vi) there is a private sector market for the asset. See OMB Circular A-11, Appendix B.

⁸ See Adam Bruns, *Serving Those Who Served*, SITE SELECTION, November 2012, <http://www.siteselection.com/LifeSciences/2012/nov/clusters.cfm>. Although the VA has independent authority to construct medical facilities, GSA acquires the real estate for much of the office and records storage space which necessarily expands along with the VA.

⁹ Indeed, the Subcommittee of the House Committee on Transportation and Infrastructure that oversees public buildings recently held a number of “field hearings” in vacant public buildings to focus public attention on the slow speed at which the disposition of such buildings has been occurring. Certain members of Congress individually also have been extremely vocal in voicing their displeasure at the pace of PBS’s disposal of vacant, Federally-owned properties.

¹⁰ See <http://www.gao.gov/highrisk>.

¹¹ Presidential Memorandum on Disposing of Unneeded Federal Real Estate (June 10, 2010); Memorandum on Implementation of Energy Savings Projects and Performance-Based Contracting for energy savings (Dec. 2, 2011).

¹² Office of Management and Budget Memorandum (OMB) M-12-12, *Promoting Efficient Spending to Support Agency Operations*.

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properties on an expedited basis and for the proceeds to be utilized to undertake currently-postponed but greatly needed capital improvement or construction projects.

The Lemonade: Resulting Opportunities for the Private Sector

The existence of these challenges provides a significant opportunity for Congress and the private sector to offer creative solutions to meet the Government's real estate needs in a manner that could be quite profitable as well – a true chance to “do good and do well” at the same time.

1. Leasing to the Federal Government. In response to the budgetary limitations and OMB scoring rules, which incentivize traditional leasing, PBS has leased a substantially increasing portion of its real estate holdings in recent years. In fiscal year 2010, PBS made lease payments to the private sector totaling in excess of \$5.2 billion.¹³ The advantages of having the Federal Government as a tenant are manifest. The Government typically signs long term leases and it is difficult to find a more secure, credit-worthy tenant. Furthermore, once the funds for any construction costs in a lease are fully appropriated, they generally will be paid out, so the risk of non-payment to landlords and contractors is highly remote.¹⁴ This typically enables the developer to more readily obtain the required financing on advantageous terms. Finally, having the Federal Government as a tenant may be attractive to other potential tenants.

PBS can enter into leases of up to 20 years to accommodate new or existing Federal agencies.¹⁵ Importantly, these leases are awarded through a competitive public process. In order to take full advantage of the Government's significant leasing needs, landlords should familiarize themselves with the leasing processes utilized by PBS and effective techniques for showcasing their properties as available for lease by the Federal Government. It is often helpful to seek the assistance of experienced hands familiar with the process.

2. Developing and Constructing for the Federal Government. Even in today's economy, the Federal Government can be expected to always have a variety of real estate needs, even though the types and purposes of the desired facilities might be rather limited. Broadly speaking, the Government's space needs fall into two categories: existing space and built-to-suit. In the former circumstance, the Government may be looking for a build-out or modernization of already constructed space. In the latter, because of the disincentives for the Government to own its real estate, the Government typically seeks a developer to construct a building to its specifications and lease it to the Government. These opportunities will generally be posted on the Federal Business Opportunities website (known as “Fed Biz Opps”) and will be subject to the same competitive bidding and award process. Prospective landlords should be aware that after the lease is awarded to the successful developer, PBS has very specific guidelines regarding the construction and/or build-out process.¹⁶ If one follows these mandates, the opportunities may be substantial.

¹³ *Lease Reform Implementation Report*, available at http://www.gsa.gov/graphics/pbs/GSA_Lease_Reform_Final_Report_April2011-sm508c.pdf.

¹⁴ Note that GSA's blanket authority amount is currently \$2.79 million, meaning that if the anticipated costs of a project (determined based on net annual rent and estimated construction costs, if applicable) exceed that upper limit, GSA must submit a “prospectus” describing the project to Congress which must authorize and, in some cases, appropriate the required funds.

¹⁵ GSA has authority pursuant to 40 U.S.C. 585; PBS carries out this mission on behalf of GSA.

¹⁶ For example, the building shell definition is standardized nationally for PBS leases and cannot be deviated from. There are similar and related rules for everything from inspection rights to change orders, with which landlords should closely

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3. Purchasing Real Property from the Federal Government. Political pressure on PBS to identify and dispose of excess property is mounting.¹⁷ A number of legislative proposals aimed at accelerating the disposition process have also been introduced. A bill calling for the creation of a civilian BRAC,¹⁸ meant to parallel the Department of Defense version and identify a process for determining how to efficiently dispose of unneeded Federal properties, passed the House in 2012 but ultimately was not adopted; however, a House subcommittee reopened discussions in February 2013.¹⁹ Furthermore, other bills have been proposed which stop short of creating a civilian BRAC but which nonetheless are designed to streamline the existing disposal process under guidance from the GSA in consultation with OMB.²⁰ If any of these proposals are adopted, the gates to substantial opportunities for the private sector could open wide.

Since 2010, PBS has sold upwards of 350 assets, totaling approximately \$110 million in sales.²¹ A recent, prominent example of a successful public auction was the sale of the West Heating Plant in a trendy area of the upscale Georgetown neighborhood of Washington, D.C.²² A World War II-era heating plant which sat vacant for over a decade, the building was opened for bidding at \$500,000 in January 2013 and ultimately sold for \$19.5 million. The purchasing group plans to spend more than \$100 million to convert the plant into approximately 80 high-end condominiums. Its unique and central location caused numerous groups to believe they could very profitably develop this parcel. Similar types of opportunities can be expected to arise throughout the country, and a simplification of the disposal procedures or the establishment of a civilian BRAC will multiply the future opportunities. It is also important to note that the financially-strapped United States Postal Service has also launched a plan to close over 200 of its postal processing facilities, resulting in numerous and exciting similar opportunities for the real estate community.²³

4. Public-Private Partnerships. The current budgetary difficulties faced by PBS can be expected to cause it to continue to reevaluate its existing authorities and to undertake new, creative approaches to meeting the Government's space and capital improvement needs. In particular, PBS has the authority to exchange Federal property to acquire interests in real estate, and it may provide cash or other consideration as part of the transaction.²⁴ PBS can enter into leases (including leasebacks), exchanges

familiarize themselves before entering into a build-out or build-to-suit project with the government. See http://www.gsa.gov/graphics/pbs/Pricing_Desk_Guide_4th_Edition.pdf.

¹⁷ GSA has the authority to dispose of excess federal property pursuant to 40 U.S.C. 541 – 574; PBS carries out this mission on behalf of GSA.

¹⁸ Congress created the Base Realignment and Closure Commission (or BRAC) in 1988 (and in five subsequent rounds, most recently in 2005) to dispose of excess military bases in the United States. BRAC was an independent entity authorized by Congress to provide a disinterested, non-partisan review of the list of bases which the Department of Defense recommended be closed. The rationale was to minimize the political aspects of the decision-making and achieve a rational and expedited process.

¹⁹ See H.R. 1734 (112th): Civilian Property Realignment Act, February 7, 2013; <http://www.bizjournals.com/baltimore/news/2013/02/28/house-kicks-off-search-for-federal.html>.

²⁰ See H.R. 328 (113th): Excess Federal Building and Property Disposal Act of 2013, introduced by Rep. Jason Chaffetz and Rep. Mike Quigley on January 22, 2013.

²¹ See <http://online.barrons.com/article/SB50001424052748703889404578442753287274228.html>.

²² See http://www.bizjournals.com/washington/breaking_ground/2013/03/four-seasons-team-awarded-west-heating.html?ana=tw&page=all.

²³ See K&L Gates' prior discussion of these opportunities at <http://www.klgates.com/usps-plan-to-close-hundreds-of-mail-processing-plants-and-retail-post-offices-creates-unique-real-estate-opportunities-07-27-2012/>.

²⁴ PBS exercises GSA's authority given pursuant to 40 U.S.C. 543, 581(C)(1), 3304.

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or other financial arrangements with the private sector to convey real property interests.²⁵ Relying on a combination of these authorities, PBS has presented the private sector with multiple high-profile opportunities in the last year to take advantage of its expanded interest in these kinds of partnerships:

- **Los Angeles Courthouse:** PBS owns an almost 800,000 square foot courthouse in downtown Los Angeles which will not be needed once the construction of a new courthouse is completed in 2016. At the same time, PBS needs a new 175,000 square foot, energy-efficient office building in Los Angeles, but has been unable to construct its own building or enter into a lease that would provide for the Government's ownership of the building at the end of the term given its limited new construction budget and OMB's budget scorekeeping rules for capital leases. In response to this problem, PBS has sought expressions of interest from developers to construct the desired new office facility, in exchange for title to the substantially larger courthouse.²⁶ A developer who has a creative plan for the redevelopment of the old courthouse and who also believes it can construct the new building at an appropriate cost might find this opportunity quite attractive.
- **FBI Building:** The FBI's headquarters in the Hoover Building on Pennsylvania Avenue is located in one of the most highly sought-after areas of downtown Washington; unfortunately, the building itself is inefficient and out-of-date for the FBI's purposes. Seeking to reduce the FBI's operating expenses and space footprint, PBS has proposed exchanging the approximately 6.66 acre site for 2.1 million square feet of new space elsewhere in the D.C. metro area. Earlier this year, PBS presolicited developer interest in constructing just such a new headquarters in the DC metro area, as well as in redeveloping the site of the Hoover Building and its associated prime location. PBS received about 35 expressions of interest and could issue a formal request for proposals this summer.²⁷
- **Federal Triangle South:** Similarly to the FBI Building project, PBS recently received ten responses regarding the proposed redevelopment of a unique 22-acre site known as Federal Triangle South, which is also located in a central area of downtown Washington within easy walking distance of both the National Mall and the revitalized Southwest Waterfront. PBS had proposed selling or trading some of the property in exchange for new buildings. The interest of the real estate community has been sparked by this intriguing opportunity and PBS has received a variety of proposals including outright sales, exchanges, proposals for leasing space and combinations thereof.²⁸
- **Conversion of the Old Post Office:** GSA is reportedly in the final stages of negotiating what is expected to be a 60-year lease with the Trump Hotel Collection and Colony Capital Partners to turn Washington's landmark Old Post Office Building into a 250-room luxury hotel, a project which is intended to maximize the use of the property and its valuable location just blocks from the White House while preserving its historic integrity.²⁹ This long-term lease model for redeveloping the Old Post Office is similar to that which was used to redevelop Washington's Tariff Building

²⁵ PBS exercises GSA's authority given pursuant to Section 412 of the GSA General Provisions, *Consolidated Appropriations Act, 2005*, Pub. L. 108-447, 118 Stat. 2809, 3259 (December 8, 2004).

²⁶ See <http://www.gsa.gov/portal/content/137663>.

²⁷ See http://www.bizjournals.com/washington/breaking_ground/2013/03/gsa-reports-strong-interest-in-new-fbi.html.

²⁸ See http://www.washingtonpost.com/blogs/capital-business/post/gsa-receives-10-responses-for-proposed-redevelopment-of-federal-triangle-south/2013/03/05/fb3ac4de-84e5-11e2-9d71-f0feafdd1394_blog.html.

²⁹ See http://www.bizjournals.com/washington/breaking_ground/2013/03/trump-goes-into-overtime-on-old-post.html; http://www.washingtonpost.com/blogs/capital-business/post/donald-trump-says-deal-is-close-for-old-post-office-pavilion/2013/04/10/3c1fcaea-a1f0-11e2-9c03-6952ff305f35_blog.html.

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into the Hotel Monaco in 2002.³⁰ In contrast to the development proposals above, the redevelopment of the Old Post Office was specifically authorized by Federal law,³¹ but it suggests that partnerships between the Government and private sector are the future of Federal real estate development, although a revised interpretation of OMB's current scoring rules may be needed to facilitate many additional projects.

The economic realities and trends discussed above are generating exciting opportunities for the real estate industry. The rapid expansion of the proportion of Federal real estate that is leased, rather than owned, means that the Government has become one of the largest, most stable tenants in the market today. Those developers with space to lease should focus on this opportunity. At the same time, increased pressure from the President and Congress to accelerate the identification and disposal of excess Federal property should lead to many additional Federal properties becoming available for purchase by the public. Finally, the competing demands of budgetary constraints and capital and space requirements will continue to cause PBS to use its existing and new authorities to structure innovative solutions to meet its needs. Enjoy the refreshing lemonade.

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³⁰ See <http://www.gsa.gov/portal/content/101413>.

³¹ *Old Post Office Building Redevelopment Act of 2008*, Pub. L. 110-359, 122 Stat. 4005 (October 8, 2008).