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Leasing

Possibility of Federal Sequestration Highlights Need for Early Termination Options



By RICHARD J. HAMILTON

Government contractors utilize leased space in order to provide services on behalf of the government and its agencies. It has become customary for some government contractors to negotiate early termination rights in the event that the contract giving rise to the need for the space expires or is cancelled, defunded, or awarded to another party. When tenants are plentiful and vacant space less so, landlords may be generous in the negotiation of early termination rights because the premises, particularly if it is a favorable size in a favorable location, can be quickly backfilled under agreeable terms. Unfortunately, when vacant space is plentiful, as has been the case in many markets since 2009, landlords review early termination rights with a careful eye to ambiguities and potential interpretations that would prevent a tenant from expeditiously vacating the space when needed. Tenants often fail to negotiate clear and specific early termination rights upfront because it is difficult to anticipate each circumstance under which the need to cancel a lease may arise.

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In an almost perfect storm, due to the threat of sequestration after Jan. 1, 2013, which, based on a widely-reported Department of Defense analysis, would immediately give rise to \$500 billion in budget cuts over 10 years, many government contractors are now finding need to exercise early termination rights in markets already flooded with too much space. Even if sequestration were not to occur, it seems clear that government contractors will face a period of reduced or more slowly growing defense spending, making the negotiation of early termination options critically important.

When negotiating early termination options during the initial lease discussions, government contractor tenants should be mindful that the most effective early termination options are neither too vague nor too specific. Early termination options suffer from the classic Goldilocks problem of getting it just right, and careful negotiation at the outset of lease discussions can enable more predictable outcomes once an early termination option is exercised. This article discusses five of the more common pitfalls that arise during the negotiation of early termination options, which can often (but not always) be avoided through careful negotiation at the outset of lease discussions.

References to Specific Award Numbers. It has been common practice to make reference in a lease to the specific contract award giving rise to the need for space, with the results never being as precise as intended. In many instances, following the natural expiration of the original award, similar work continues under bridge contracts or new awards, whereupon the lease is extended but the early termination option is not revisited to clarify the now-outdated reference to the original award.

Anticipating this issue, many tenants and landlords have negotiated language into early termination options expanding the defined contract as both the particular contract giving rise to the need for space as well as any “follow-on award” or “award for similar services.” In actual practice, the qualifying language has proven extremely problematic because, when a tenant attempts to exercise an early termination option based in its failure to be granted a “follow-on award” or “award for similar services,” disputes inevitably arise over the meaning

of the qualifying language. Landlords often take a plain-language view of what constitutes “similar services” while tenants, often more steeped in the nuances of government contracting, take a more technical view of whether an award is truly similar, basing their decisions on a combination of factors: the type of award, the total scope of services, total number of task orders awarded versus anticipated task orders, or the revenues generated by a certain award in contrast to the anticipated revenues. The differences in the landlord’s approach and the tenant’s approach inevitably lead to conflicts, particularly in a market in which the landlord is not able to immediately backfill the space, or with respect to a space that has been modified for laboratory uses or secure compartmented information facilities (SCIFs), which are in some cases expensive to remove.

In the initial lease discussions, the tenant should generally avoid relying on identifying specific contracts, particularly when the references to those contracts are enhanced with vague qualifying language. Instead, the tenant should focus on objective factors relating to the particular contract to justify when an early termination right may be exercised.

Awards That ‘Require’ Tenant’s Presence in the Premises. In the absence of language that frames an early termination option in terms of a particular contract award, some landlords may try to describe the contract as one that “requires” the tenant’s presence in the premises or define the scope of work to be performed under a certain contract as work “required” to be performed within the premises. If reviewed casually, the language of the option may merely be intended to tie, in some way, the performance of the particular contract to the need for leased space. Trouble arises, however, when a tenant has to demonstrate that a contract “requiring” the tenant’s presence in the premises has expired or has not been renewed. More often than not, the contract neither requires the tenant’s occupancy of particular leased space, nor obligates the tenant to perform a particular scope of work in a particular location. Typically, if a contract contains any location restriction at all, the restriction is broadly geographic (e.g., state, county, political subdivision, region), or the performance of the contract is tied to a military or other secure governmental installation or facility.

The tenant should generally avoid negotiating an early termination option that contains problematic stealth requirements that cannot be demonstrated or proven at the time the tenant desires to exercise its early termination option. Instead, as above, the tenant should focus on objective factors relating to the contract that can be easily quantified and demonstrated at the time the tenant desires to exercise its early termination option.

Exercise Periods Based on Specific Dates or Windows. In the negotiation of early termination options, tenants will often attempt to negotiate open-ended early termination options that can be exercised at any time with a short period of advance written notice. Landlords often resist these types of termination options because landlords usually desire a certain guaranteed lease term that is not subject to termination options. This benefits the landlord in its dealings with lenders and in otherwise having a tenant base that is stable for a predictable period of time. The negotiated result, however, is often a problematic termination option that can be exercised

only within a particular window of time and can only be effective as of a particular date certain. In practice, contracts do not often expire as scheduled and new awards to subsequent contractors do not occur in a manner that can be predicted several years in advance. Inevitably, the time frame for a new contract award shifts, and the tenant is granted a contract modification or bridge contract to continue work until the new contract is awarded. In this case, the time frame during which the tenant must exercise its early termination option might become badly out of sync with the reality of the contract award process, resulting in the tenant entirely losing its right to terminate the lease when needed.

With careful planning, the tenant and landlord can negotiate an early termination option that satisfies both parties. At the outset of the lease, the tenant may be able to commit to lease the premises for two years or more during all or a portion of the initial contract period of performance. After the guaranteed term, the tenant may be able to negotiate a more flexible termination option, including, perhaps, an open right to terminate after the guaranteed term, or multiple windows in which to exercise the option combined with multiple scheduled termination opportunities occurring throughout each lease year or the balance of the lease term.

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Termination of the Entire Lease. Typically, it was assumed during initial negotiations that a contract would either fully expire, or be fully awarded to another party in which case the need for the premises would be entirely obviated. Recently, however, many awards, rather than continuing as a single-awardee contract, have been converted into multiple awardee, task order based contracts where work is not guaranteed to exist at the previously existing level. In this case, the tenant often would prefer to downsize the existing space rather than terminate the entire lease, but the tenant’s leverage to negotiate a more favorable arrangement is ultimately tied to the original early termination option, which requires termination of the entire premises. Terminating the entire premises only to renegotiate a partial termination increases costs and reduces predictability.

At the outset, if the original premises is easily demised into multiple spaces and/or suites, the landlord may be willing to permit terminations of portions of the entire premises. In particular, if the tenant is considering a lease of multiple floors to support a particular

award, the landlord may permit partial termination as to whole-floor segments of the premises. The tenant should be mindful when negotiating a partial termination option that it has the ability to exercise the option more than once as to multiple portions of the premises, which might be necessary if the premises is particularly large or covers multiple floors of an entire building or multiple buildings. A landlord often wants predictability in the size and configuration of the space that can be terminated, whether in whole-floor segments or contiguous areas of the premises, so that the space can be more readily backfilled. This can often be accommodated to the benefit of both parties with careful planning upfront.

Restoration Obligations. A major concern of any landlord when a tenant exercises an early termination option is whether the space can be easily leased to another user. In some instances, the space has been modified for specialized uses with laboratory or SCIF space. While laboratory space has always been problematic, landlords were often able to lease SCIF space to subsequent users, particularly in markets heavy with government contracts users. More recently, since the SCIF construction standards have been updated, existing SCIF space is less valuable and cannot be reused. In either the case of laboratory space or outdated SCIF space, landlords often face steep restoration costs to reconfigure the premises into space that is usable for traditional users. In many cases, a landlord's resistance to

the exercise of an early termination option may be ultimately rooted in the costs of restoring the terminated space for reuse.

In many leases, restoration clauses are generalized and do not address highly specialized improvements that could give rise to oversized landlord restoration costs. On one hand, the tenant may argue that the landlord should be careful to anticipate end-of-term costs, particularly when the landlord is aware of the types of specialized tenant improvements that are being made to a space. On the other hand, the tenant might find that the predictability in exercising an early termination right might weigh in favor of agreeing at the outset of lease negotiations to accept some of the cost to remove specialized improvements. Since specialized improvements are often installed in connection with the initial lease improvements, the landlord and tenant are in a good position at that time to agree on a specific list of improvements that the tenant will remove at its expense upon the exercise of the early termination option.

An early termination option can be a valuable tool for a government contractor tenant to manage its needs for leased space as well as to satisfy the more common landlord concerns about tenant commitments, space configuration, and restoration obligations. With careful planning and advance negotiation, many of the pitfalls of early termination options can be avoided, and as a result, an early termination option can be exercised when the need arises with predictability and with the rights and obligations of the parties clearly defined.