

Chapter 14

NEGOTIATING YOUR FACILITY LEASE

You need a place to practice and negotiation of your facility lease is critical; whether the landlord is a third party, another doctor selling you his or her practice, or the seller's family member, often the spouse.

Purchaser Due Diligence

If you are acquiring your practice and planning to lease the premises where the seller's practice is located, assess the facility in terms of the current or new lease prior to the acquisition. This is a form of purchaser due diligence. Before entering into any lease, assess the feasibility of owning the facility rather than leasing. You may find that the cost of ownership is surprisingly close to your rental payment.

Bargaining Position

To the extent that you have the ability to relocate your practice, you hold additional bargaining power with the landlord. Nevertheless, if moving is not feasible, due to cost factors for plumbing, electrical, carpentry, and decorating, you may be forced to accept unfavorable lease terms.

Measure the Facility

Measure the useable and actual square footage against the number of square feet specified in the proposed lease. Occasionally, mistakes are made in this area. It is not uncommon for a landlord to include a portion or all of the adjacent or exterior walls/structure or certain common areas, e.g., restrooms, utility area, hallways or the distance between the exterior wall and outside of the building.

Leasehold Improvement Costs

The landlord, and not your practice, typically owns the leasehold improvements. Therefore, consider negotiating a higher rental amount if your practice is required to pay those costs. This assumes that your practice does not own the leasehold improvements and that the landlord benefits in making them. The rent will be currently deductible and not amortizable over 39.5 years, as are leasehold improvements.

Lease Considerations

The lease for your practice facility typically involves the situation where the landlord, in exchange for rental payments, undertakes to perform specified obligations, e.g., to provide the

space, heating and air conditioning, cleaning services, security, and maintain operation of common areas of the building, such as the lobbies and corridors. Such a lease between you and the landlord is known as a "gross lease" because the rentals paid by the tenant are intended to cover not only the ultimate profit retained by the landlord, but also the landlord's operating expenses and long-term maintenance of the building as well.

In many instances, the landlord seeks to disassociate entirely from the operating responsibilities, maintenance and expenses of the property. Instead, the landlord would play a purely passive investment role, collecting rent as owner of the property while another individual or entity would assume all responsibility for operation of the property. The lease between you and a passive owner-landlord is known as a net lease because the rental amount represent the landlord's only profit while you are responsible for all operating expenses in addition to the net rental. Sometimes a distinction is made between a net lease, a net-net lease, and a net-net-net lease, or "triple net lease". Under a net lease, you pay all operating expenses, but not the real estate taxes or insurance premiums; under a net-net lease, you pay the operating expenses and the insurance premiums but not real estate taxes; and under a triple net lease, you pay the operating expenses, the insurance premiums and the real estate taxes.

Generally, you will be presented with a standardized lease form prepared by the landlord or landlord's legal counsel. You should not feel bound by the standardized provisions contained in the proposed lease. Leases are subject to negotiation, particularly where you have not already leased the space and other options are available. If there are ambiguities contained in the lease, many jurisdictions construe such ambiguities contained strictly against the party who drafted it, usually the landlord. Therefore, to the extent that a dispute arises between a landlord and tenant with respect to ambiguous terms contained in a lease, courts generally, although not always, rule in favor of the tenant.

The general tone and/or disposition of a potential landlord is often an accurate indication of how the landlord will treat you during the term of a lease. If you find resistance or unreasonableness on the part of a potential landlord, you may be better served to search for alternate space rather than have potential long-term aggravation. In many cases, cost per square foot is not the most important factor to be considered.

Some of the key provisions with which you should be familiar when reviewing a facility lease are as follows.

Lease Term. Lease terms for dental practices usually range anywhere from one to five years. The length of the term desired by you depends upon a number of factors. For example, favorably low rental terms may justify a longer term, whereas a new practice may justify a shorter term. It is typically advisable to base the lease term on your practice goals and objectives. Renewal options are usually at a high rate per square foot than the previous rental term and based upon increases in the consumer price index.

Payment Terms. An important provision in any lease relates to the payment of rent. There are several methods of determining rent. Most rental provisions fit into one or a combination of the following categories:

1. Fixed rental for the term of the lease, flat rental;
2. Fixed rental with provision for specific increases or decreases, step-up or step-down rental;
3. Fixed rental with adjustment for increased real estate taxes or for increased operating expenses, or for both, escalation rental;
4. Fixed rental with adjustment to reflect changes in cost of living, cost-of-living rental;
5. Fixed rental with adjustments to reflect reappraisals of the property which is not common to practice facilities; or
6. Percentage rental based upon your practice revenues, which is also not common for practice facilities due to concerns over fee splitting.

The flat rental option provides you with the greatest stability since you have the ability to predict the rental obligations over the term of the lease. For example, a step-up or step-down rental may be desirable, from your perspective, if you are unable to pay the landlord a \$3,000 per month flat rental for five years. However, you may be able to afford \$1,800 per month in year one, \$2,200 in year two, \$2,600 in year three, \$3,200 in year four and \$3,200 per month in year five.

In one specific instance, a landlord may also agree to a step-down rental. If the landlord is able to obtain favorable mortgage financing for improvements to the property, primarily because of your high credit standing, and provided that you can show when the initial mortgage is paid off, the cash flow to the landlord will increase substantially, the landlord may agree to a step-down rental at that time. Such provisions are understandably rare, since a tenant is normally not made privy to the financial information of the landlord. Nevertheless, if you are shopping in a "tenant's market", you may find surprisingly favorable lease terms.

Items 3 and 4, above, are fairly common, with the landlord typically providing monthly or quarterly statements to the tenant for charges relating to landscaping, snow removal, real estate taxes and other operating expenses. The cost-of-living adjustment is typically made annually and is based on a nationally published consumer price index. Since cost-of-living adjustments are unpredictable, it is often preferable to insist upon definite payment terms and renegotiate them at the end of each term. However, from the tenant's perspective, it may be advisable to negotiate the cost of living based upon the initial rental rate for later rental periods in order to minimize any future cost-of-living increases.

Security Deposits. Most leases provide for a security deposit to be paid at the time the lease is executed. A security deposit equal to one or two months' rent is not uncommon. The security deposit is typically intended to cover the failure to pay rent or for damage during the lease term. Many times the landlord will agree to waive the security deposit, provided that the lease is signed individually, rather than by a corporate entity, or guaranteed by a third party. A tenant with sufficient working capital may prefer to assume personal liability rather than paying a

deposit. You should also negotiate that any security deposit may be assigned to a new owner in the event that the landlord sells the premises. You may also request in advance that the security deposit be applied against the last month's rent during the lease term.

Recording the Lease. Under certain circumstances, the tenant should negotiate the right to record the lease or a short form of the lease, a statement of the lease terms other than rent. This is particularly important for leases with a long term or in situations where the tenant makes extensive leasehold improvements, so that such tenant is protected from the possibility that the landlord will sell or encumber the premises in the future. In most states, the effect of recording a lease serves as notice to any and all third parties that a lease exists and any purchaser or lienholder, unless otherwise agreed, must purchase or receive an interest in such property, subject to or subordinate to the lease.

Landlord Responsibilities. You, as tenant, would normally expect to be free of any maintenance responsibilities. At the same time, it is important that the building be well maintained for you comfort, your employees and patients. Consequently, you should seek provisions in the lease that impose specific obligations on the part of the landlord to appropriately maintain the building. Generally, you should obtain a specific schedule and frequency of cleaning services, including window washing, etc. You should also negotiate to obtain the right to perform certain maintenance services, in the event that the landlord fails to do so on a timely basis, and deduct those expenditures from your rent, if necessary.

Repair Costs. A common way of allocating the repair burden between the landlord and tenant is by distinguishing between structural and nonstructural repairs, the former being the duty of the landlord and the latter that of the tenant. Since repair costs can be considerable over the term of a lease, landlords and tenants frequently dispute the definition of the terms "structural" and "non-structural." If you are particularly concerned about responsibility for a given repair, provisions should be drafted or clarified to reflect your and the landlord's understanding of these issues. One method of resolving this matter is to itemize specific anticipated repairs, as well as the party responsible for the repairs. These provisions should be incorporated into the lease. You would specifically exclude repairs which would be paid by the landlord in the lease. Another method of addressing this matter is for the landlord to establish a sinking fund, whereby you pay a portion of future anticipated repairs each month during the lease term.

Understand your responsibility under the lease for payment of water, electricity, taxes, snow removal and cleaning expenses. Consider such expenses in your overall occupancy costs as compared to renting another facility. In addition, understand your practice's responsibility for repairs, e.g., interior portions of the premises, doors, windows, heating units, air conditioning units and interior plumbing/sewer. One of the most prevalent facility problems is inefficient heating, ventilation and air conditioning. Yet, the landlord will typically require the lessee to maintain such units in good repair, ordinary wear and tear excepted. If your practice is responsible for interior repair, the lease should specify the party responsible for any sewer backups below the floor and for plumbing problems originating outside the facility. Additionally, make sure your facility is equipped with a water solenoid system and specify in your practice operating procedure the responsible individual for turning off the switch each day.

Improvements or Alterations. If the lease allows for either you or the landlord to make improvements, the lease should incorporate the plans and specifications, as well as the completion dates, the party responsible for the payment of the improvements and the party who obtains building permits and additional insurances. Typically where you have the ability to make improvements, the landlord is often insistent that you obtain consent in advance of making those improvements. However, this is a subject of negotiation and you should strive to include a provision in the lease that the landlord will not unreasonably withhold consent in these matters.

The ownership of leasehold improvements, including cabinetry, and the removal of these improvements should be considered in the lease. Generally, the landlord would allow you to remove cabinetry, provided that the facility was restored to a condition where no damage was suffered by the removal.

Use and Occupancy. You should not only negotiate a lease which permits the operation of the practice, but also insist upon a lease which authorizes subletting. If you leave the premises, a subletting tenant should be able to carry on his or her business on the premises. Additionally, in the event that the property is rezoned for a different use during the lease term without any "grandfather" allowance permitting continued historical uses, or if the property is condemned or claimed by eminent domain, you should have the ability to cancel the lease. You should also attempt to negotiate a provision restricting the landlord from leasing premises any other space in the building or complex to another dentist or specialty practitioner who would directly compete with you.

Adequate Parking. Your parking should be compatible for the growth of your practice. Assuming parking availability not only for your patients, but for staff members. Consequently, you should negotiate a provision that specifically considers parking. Where a landlord provides a parking lot to be utilized by several tenants, you may negotiate a portion of the lot specifically allotted for your practice. Additionally, if parking near the entrance to the practice is limited, consider requiring employees of the practice park farthest from the entrance and leave available spaces closest to the entrance for patients. You should ensure that snow plowing, striping, lighting, and general maintenance of the parking area and landscaping are specifically considered in the lease.

Subletting or Assignment. You should negotiate the ability to completely assign or sublet the premises to another tenant in the event that you leave the practice, hire an associate or share space. A provision should be included in the lease whereby the landlord can not "unreasonably withhold consent" from the assignment or sublease. One question which should be considered is whether you will be responsible for the assignee's or subletting tenant's obligations in the event of default. Resolution of this issue is simply a matter of negotiation.

Default Provisions. Defaults by a tenant normally are classified as a failure to pay rent or other money due or failure to comply with any other obligations or promises under the lease. In the case of monetary defaults, a lease should only permit the landlord to declare a default after a cure period, typically a specified number of days, e.g., 10 or 15, after the due date and after providing written notice to you that the money has not been paid. The landlord should only be permitted to seek remedies against you after the cure period has passed and after

appropriate written notice has been provided. Further, the landlord should not have the ability to evict you without a court order.

Options to Renew. A lease provision dealing with the right to extend or renew upon the expiration of the original term should explain the manner in which the election or option must be exercised. The move to another location once your practice has become established and successful is costly in terms of inconvenience and leasehold improvement costs. Therefore, you only want to move should you choose to, not because you have to.

In negotiating a renewal provision, the following points should be considered:

1. Renewal Term. You may be given an option for a single renewal term or a series of terms.
2. Renewal Rental. The rental for the renewal term or terms should be specified in the lease. It may be a predetermined, a fixed amount or based upon a consumer price index adjusted to current rental. From your perspective, any price index adjustment should be based upon the initial term of the lease.
3. No Default Condition. Most leases provide that a tenant in default under any provision of the lease cannot exercise an option to renew. This type of provision is not unreasonable. You should cure any defaults prior to the exercise of the option.
4. Manner of Giving Notice of Renewal. You normally must give notice of the intention to renew at a designated time prior to the end of the initial lease term. While landlords may seek a period as long as six months in advance so that the landlord will have adequate time to find a new tenant if notice is not given, you may prefer to make your decision as near to the lease expiration date as possible, e.g., 60 days. Occasionally, the lease renewal provision will provide that a renewal will be automatic unless notice to the contrary is delivered to the landlord by you within a specified time prior to expiration of the initial term. Such provisions are undesirable from your perspective, as the burden to terminate the lease is upon you.
5. Option to Cancel. A lease with an option to cancel early can be a solution for a tenant who is faced with having to sign a long term lease, but who may wish to later relocate. Consider a situation where your practice and income are hindered by an undersized facility. Your schedule may be filled so far in advance that you may not be able to generate additional revenue without additional square footage and a more efficient facility design. Facing such a prospect of being tied into a long term lease, you may wish to have an option to cancel the lease early, at a price. Such an arrangement would

involve: (i) providing the landlord advanced notice; and (ii) a declining cancellation fee calculated to reimburse the landlord for the portion of the investment which would not have been recouped due to the shortened term.

You should also consider negotiating a provision providing an option to cancel the lease in the event of death or permanent disability. Such a provision could prove invaluable to a doctor practicing alone, as it would be unlikely that you would have a buy-sell agreement in effect with another doctor for the purchase of the practice. However, such an arrangement is recommended in the event of a catastrophe.