Veterinarian Office Lease Issues

This article is intended to provide an overview of some of the issues we frequently encounter at Wood & Delgado when negotiating leases on behalf of our clients. It is not intended to be comprehensive in nature, nor is it intended to replace the advice that your lawyer may give you on a specific lease.

It is a common misconception for many professionals (veterinarians, doctors, dentists, etc.) that the most important issue facing the professional is the negotiation over rent and the length of the lease term. Once this is established, there is no need to haggle over the "body" of the lease. However, there are many issues inside a lease that can significantly impact the value of your veterinary practice and your ability to resell it.

In lease negotiations, your landlord is not your friend! Rather, the landlord is trying to maximize their return on investments and minimize the risk. The lease that you are holding in your hand has been perfected over the years by attorneys who represent landlords, becoming one of the most effective weapons a landlord can have. However, in our experience, landlords are generally ready, willing and able to change areas of the lease as long as they feel like they are still protected. The following is a small list of some of the areas within a lease which can negatively impact the value of your veterinary practice or restrict you from selling it to another veterinarian.

1. Damage to the Veterinary Practice. The way this section of the lease is written appears to be innocuous. The section appears to be stating the obvious: the landlord has a duty to repair within a reasonable amount of time. No problem, next section. But wait. If you review this section carefully you will see that in most leases there are many "outs" for the landlord so he/she does not have to rebuild in a timely fashion. Unfortunately, our law firm has seen landlords use this section of the lease to force veterinarians to come back to their old office and start paying rent two, three or even four years after the building was initially damaged or destroyed! In order to combat the landlord's "outs" in rebuilding, we suggest asking for time frames for repairs to commence and to be completed, failing which you should have the right to terminate the lease. Generally, our law firm requests 90 days to commence repairs and 180 days to complete repairs.

2. Recapture Provision. Most leases now have a "recapture" provision which allows the landlord to terminate your leasehold interest if you ask for an assignment or a subletting of your office. In other words, when you find a buyer for your veterinary practice you must notify the landlord that you wish to assign your property interest (known as a leasehold interest) to the buyer of your veterinary practice. At that time, the landlord can either accept the assignment or terminate your lease, leaving you with an established veterinary practice in need of a new home.

3. Personal Options. This section usually makes any option periods to extend the lease personal to you, making them useless to any potential buyer. Without at least five plus years of a viable lease term (including option periods), many lenders will not want to lend money to buyers to purchase your veterinary practice.

4. Transfer Premiums. Many leases have provisions which allow the landlord to receive a "transfer premium" allowing the landlord to arbitrarily decide the value of the leasehold interest and demand a percentage from you when you sell your practice! Some of these premiums are in excess of 50% of your sale price! Say goodbye to most of the goodwill you have accumulated, it's the landlord's now. If you limit this section to subletting (the original intent of this section), you can avoid having to pay the transfer premium.

5. Release of Liability. If you are lucky enough to have your lease assigned to your buyer, you will still be "on the hook" for the length of the lease, including any option periods left. This could mean that you have another 10-15 years of personal liability connected with the lease! So much for playing bridge, spoiling the grandkids and taking that vacation to Europe. Try to be removed from future liability after a valid assignment.

6. Rent Increases. Nearly all leases have rent escalation clauses which are either contractual in nature or which are tied to an index, usually the Consumer Price Index ("C.P.I.") published by the U.S. Department of Labor. Contractual increases are what you and the landlord bargain for over the life of the term. More common is a cost of living adjustment tied to the C.P.I. In recent years, the C.P.I. increases have averaged approximately 2% per year. However, historically the C.P.I has had periods of great fluctuation. For instance, during the four-year period between 1978 and 1982, C.P.I. increases averaged over 10% a year! You should have a "ceiling" on C.P.I. increases to protect them from unusual rent increases. However, the landlord will likely insist on a minimum C.P.I. increase as well.

7. Rent During Option Period. When initially negotiating your lease, you want an option to renew your lease which is very specific as to rent. If you are using the typical standard forms, you will usually find one of two standards: (1) an increase tied to the C.P.I. increase over the last adjustment date; (2) or an adjustment to prevailing market rent in the area, but in no event will the rent be allowed to go down if the prevailing market rent has fallen, and this is the big trap, as the landlord can keep the rent artificially high for the vet, knowing it would simply be too expensive to move and have to build out a new office.

Therefore, you may want to consider an adjustment to market rent, provided that it reflects a true adjustment to market rent, and not one that restricts the rent from being reduced in a soft rental market. Also, in order to ensure that a real market rate adjustment will occur, it is recommended that an arbitration procedure be inserted whereby the parties each choose one appraiser, and together the two appraisers choose a third appraiser, with the two closest appraisals being averaged to determine the fair market rent. Although this procedure is rarely used, it offers protection to a veterinarian who has an arbitrary landlord unwilling to negotiate fairly.

8. Lease Assignment Upon Sale of Practice. Recently, we had a client whose lease was negotiated many years ago and the lease rate was substantially below market, provided that the current tenant remains liable for the entire term plus any options, and allowed the landlord to receive any rent payable by the buyer to the seller in excess of the amount being paid by the seller to the landlord. The lease also provided that the landlord could deny the assignment if it upset the tenant mix in the building. The landlord disapproved the assignment even though the buyer had the same financial net worth as the seller when he signed the lease. The landlord also

claimed the new doctor's operation of the veterinary practice would upset the tenant mix in the building, even though there were no other veterinarians in the building, but said that he would permit the assignment if there was a 100% increase in the rent. The landlord also sought to retain a portion of the purchase price, saying that $50,000 of the purchase price represented the difference between market rent and what the seller was currently paying.

Finally, I recommend you build some "teeth" into the assignment language to allow you greater flexibility when selling your practice. I strongly suggest you try to incorporate the following into each assignment clause: that the landlord cannot unreasonably withhold its consent to the assignment; that the landlord must consent if the buyer has substantially the same net worth and credit history as the seller at the time of signing the lease; that the landlord cannot deny an assignment based on tenant mix or tenant exclusives if the assignee is a veterinarian; that the selling veterinarian be released from liability at the expiration of the existing term; that the landlord have no right to adjust the rent to market upon assignment; and that the landlord have no right to claim a part of the sale proceeds upon the sale of the business.

9. Eminent Domain. All standard form leases contain condemnation clauses usually labeled "eminent domain" and pertaining to the government condemning the building where the veterinary office is located. Unfortunately, most of these clauses severely restricted the award the veterinarian would otherwise be entitled to by operation of law.

Recently, a client whose lease we negotiated was able to receive in excess of $100,000 from a condemning authority which was widening the street where the client's office was located, and needed to use the property as part of the street widening. We had drafted into his lease provisions allowing him to claim loss of goodwill, the unamortized value of tenant improvements, and moving costs. These clauses are particularly important when the office is located in older urban areas and redevelopment areas.

10. Deaths and Disability. What happens to the lease if the veterinarian dies or becomes disabled? No standard form lease I am familiar with permits the veterinarian or his estate to be relieved of liability under these instances. Therefore, I always attempt to negotiate a release if the veterinarian dies or becomes disabled, in exchange for payment of several months rent following the date the veterinarian becomes disabled.

11. Relocation. Many leases contain relocation rights whereby the landlord may move the tenant to another location within a building. Special care must be given in drafting these terms so that the tenant is not moved to an inferior location, so that all costs of the move are paid for by the landlord, and ensure that the landlord build out nearly identical office space prior to the date of relocation.

12. Subordination. Every lease has a subordination clause requiring that the tenant's lease be in a junior position to the lender on the property. They usually state that the tenant will be bound by the lease terms if a new owner acquires the property, typically through a foreclosure sale. However (and this is the trap for the tenant who has paid for substantial tenant improvements), these clauses do not require the new owner to honor the lease and, thus, the tenant faces the

potential loss of the lease and all tenant improvements following a foreclosure. Careful lease drafting prevents this result.

13. Summary**.** A prospective tenant should always remember that the lease the landlord presents to him was drafted by the landlord or his attorney. The reader should use a qualified attorney to review the lease and make necessary changes, otherwise you will end up with a one-sided lease containing few protections that benefit you. Entering into a landlord/tenant relationship is a little bit like getting married, and the relationship is likely to last a long time "for better or for worse." A careful review of your lease documents before signing will ensure a better relationship between you and the landlord should troubles arise.

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