YOUR LEASE IS AN IMPORTANT ASSET IN A SALE

A problem in the Veterinary industry is that there are far too few members of the legal profession who make their livelihood representing and protecting Veterinarians in connection with their business affairs. Indeed, it seems that the deck is stacked against Veterinarians since the vast majority of attorneys are either bringing malpractice actions against you or represent the developers, landlords and large corporations which you must do business with. Unfortunately, far too many Veterinarians continue to believe that they do not need advisors knowledgeable in the Veterinary industry to conduct their business affairs, and, as such, an increasing number of Veterinarians fail to reach the pinnacle of their careers, being forced to deal with litigation, bad landlords, unprofitable Veterinary practices and other business problems which interfere with them focusing on the practice of veterinary medicine. This article is intended to show you how truly complicated a single facet of your business is: the lease, which can be detrimental not only your Veterinary practice, but your entire career as a Veterinarian. This article will be utilizing case studies, changes in the law and specific provisions in today's "form" leases which are negatively impacting Veterinarians throughout the country. Whether you are currently looking for a new office location, purchasing a Veterinary practice or thinking about selling your practice, this article will provide you with insight on how to protect your business.

1. Leasing Brokers. They are not attorneys and do not profess to be. They do not negotiate points of law or revise sections which may impact the value or transferability of your Veterinary practice to another Veterinarian. The leasing broker's main job is to find you a suitable space, negotiate the rental rate, term and possible tenant improvement allocations and to help facilitate the overall transaction. Due to the many different businesses a commercial broker interacts with, they generally will not understand the value of certain sections as they pertain to Veterinarians. Many Veterinarians believe that by engaging a commercial leasing broker to negotiate their lease they are in fact protecting themselves from many of the issues we will be addressing in this article, but if you read the commercial leasing brokers indemnification section, you will see that the broker clearly states that they are not an attorney and they encourage you to seek legal counsel to review the Lease. The broker understands that every business is unique and, therefore, the lease can impact each business differently. Believe it or not, while rent, tenant improvement allowances and the term of your lease are clearly important to the success of your Veterinary practice, they are not the only provisions of a lease which can cut into the profitability and value of your Veterinary practice.

2. The Newer the Lease, the More Anti-Tenant It Will Be. If you have a lease that was drafted in 1990, chances are the rights and duties of the landlord and the tenant are fairly equal. However, as time progresses members of our profession spend more and more time drafting modifications to form leases to strengthen

their clients' position, with their "client" being the landlord. Over the last ten to fifteen years this trend has generated speed. You can now expect to have between fifteen and twenty-five provisions in the newer leases which have the potential to negatively impact the value of your Veterinary practice, possibly prohibit you from selling it to another Veterinarian or cause you to have your lease terminated when you try to sell it.[1]

3. The Courts: Tenant friendly, but will protect the Law of Contract. For centuries there has been an ongoing battle between the "Law of Contract" and the courts desire to protect the "uninformed." In California, the courts routinely draw lines in the sand in an effort to protect individuals from the repercussions of their signatures on the dotted line. One example of this is that the courts have ruled that covenants not to compete are unenforceable without the transfer of an ownership interest.[2] This is contrary to the majority of states which enforce covenants not to compete against associates even after the employment contract ends. Likewise, courts have stepped in to protect tenants from landlords who attempt to take advantage of the tenant when they go to assign the lease to another party.

   In Ilkhchooyi v. Best[3] the court prohibited a landlord from receiving "excess consideration" during the sale of the tenant's business. In this case, a tenant was attempting to sell their business to a potential buyer. When the seller and buyer agreed upon a purchase price they were required under the lease to request an assignment from the landlord to transfer the lease to the buyer to complete the sale. The landlord then requested $30,000 as consideration for the assignment of the lease as part of the "excess consideration" clause. The deal fell apart and the tenant sued the landlord.[4] The court found it "unconscionable" to attribute the "excess consideration" to the allocation of goodwill of the business.[5] In its findings the court stated that the legislative intent of California Civil Code Section 1995.240 was to allow a landlord to capture the "bonus value" of the lease if the tenant was profiting from undermarket rents[6] and was not intended to include allocations attributed to the business itself.[7] In partial response to this case, the California legislature codified the court's decision in California Civil Code Section 1950.8 which allows a tenant to sue a landlord for "treble damages" if a landlord attempts to receive "excess consideration" in connection with a tenant's business.[8] Unfortunately, landlords in California quickly revised their leases to "get around" the legislature and the court's decision while still receiving profit from a tenant's proposed sale. Section 1950.8 allows a landlord to receive excess consideration if "the amount of payment is stated in the written lease or rental agreement."[9] Therefore, landlords use phrases like "10% of the value of any consideration received by Tenant in connection with or related to any assignment," "upon a requested assignment, Tenant shall pay Landlord $25,000 as consideration for Landlord's granting of an assignment," "as a condition to entering into this Lease, Tenant agrees to pay Landlord $10,000 as consideration for a grant of an assignment of this Lease," etc.

4. Landlords Secret Weapon: Recapture Clauses and Renewal Options Personal to Original Tenant.

Recapture Clause. Many leases now have a "recapture" provision which allows the landlord to terminate a lease if you ask for an assignment or a subletting of your office.[10] In other words, when you find a buyer for your Veterinary practice you must notify the landlord that you wish to assign your lease to the buyer of your Veterinary practice. As soon as you request an assignment of your lease to a potential buyer, the provision "kicks in."[11] At that time, the landlord can either accept the assignment, deny the assignment or terminate your lease! Landlords have increasingly utilized this provision to extort various amounts of money from their tenants. While the numbers vary greatly, there is generally an increase for the "request" of compensation by the Landlord with an increase in the purchase price of the Veterinary practice. Please note, this section is often times used to get around the decision and Section 1950.8 of the California Civil Code discussed above.

a. Personal Options. This section usually makes any option period to extend the lease personal to you, making them useless to any potential buyer. Without at least 7-10 years of a viable lease term (including option periods), many lenders will not lend money to a buyer to purchase your Veterinary practice. This provision is contained in most new form leases [12], since Courts, like those in California, have ruled that in order to prevent a renewal option transferring to a lease assignee, it must be specifically stated in the lease.[13]

b. Case Study. Below is one example the authors recently encountered showing how the above provisions have negatively impacted a client as a result of not modifying or removing these provisions when they entered into their lease. Due to attorney-client privilege the name of the client and the Veterinary practice location is being withheld.

i. Negotiated Purchase Price: $2,000,000
Lender Approval: Yes
The seller was a very successful Veterinarian who had started his Veterinary practice from scratch in a growing community. After steadily increasing production figures, the seller wished to move out of California after a decade of running his practice and had already found another Veterinary practice to purchase. The broker involved in the transaction found a suitable buyer and the Veterinary lender was willing to fund the entire purchase price. . .with one condition. The current lease term only

had 3 years left on the lease but also had two, five year options remaining. The lender requested that these be assigned to the buyer. Unfortunately for the selling Veterinarian, the remaining options were personal to the seller and there was a recapture clause in the lease which allowed the landlord (instead of granting or denying the assignment) to terminate the lease. When the landlord saw how much the doctor was receiving from the sale of his Veterinary practice, the landlord cited the recapture clause in the lease and threatened to terminate his lease if he was not paid a very large portion of the purchase price. The seller decried that the landlord was using extortion tactics to extract money from him and threatened to sue him and report the landlord to the authorities. In our review of the lease it was clear: the landlord had the right to terminate the lease upon a requested assignment. After months of negotiation and threats of lawsuits our client finally concluded that the landlord's position was absolute. He agreed to pay the landlord $100,000 if the sale went through. However, the landlord did not stop there. As part of the condition to allow the sale to go through, the landlord arbitrarily increased the rent for the office $1.00 a square foot to what the landlord determined was fair market value. This caused the lender to reconsider their loan because the overhead percentage increased to a level they were not comfortable with loaning money on. In order for the sale to go through, our client would have to reduce his purchase price an additional $50,000 to cover the increase in rent to the buyer for the next few years. **Total loss: $150,000.**

5. Lease Provisions to Modify. As mentioned above, there are many provisions in a lease which can impact the value of your Veterinary practice. However, knowing what you can possibly modify in a lease and what a landlord will not modify is just as important as negotiating your rent. If you ask for the wrong things (i.e., trying to change a triple net lease to a gross lease) you typically will end up not receiving any of your requested modifications. Below is a sampling of things you may wish to ask for when negotiating your new lease or assignment.
    a. Veterinary Exclusive. If you are in a smaller shopping center or strip mall this provision could be crucial to your business being successful. As mentioned above, landlords have no provisions in their leases prohibiting them from leasing space to another Veterinarian However, when a landlord is courting a new tenant for empty space in their shopping center, this is an excellent time to demand to be the only Veterinarian in the center, and often times the Landlord will grant this request.

b. Damage or Destruction to the Premises. The way this section of a 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. However, a careful review this section reveals that in most leases there are many "outs" for the landlord so they do not have to rebuild in a timely fashion. 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 the Veterinarian has the right to terminate the lease. Generally, our law firm requests 90 days to commence repairs and 180 days to complete repairs.

c. 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.[14] This could mean that you have another 10-15 years of personal liability connected with the lease! Try to be removed from future liability after a valid assignment.

d. Length of Lease Term: Plan for Your Future. Do not accept a five year lease for your Veterinary practice. You are either going to spend $100-$150 a square foot building out your Veterinary practice, or you will be paying a substantial amount of money when you acquire the Veterinary practice. Your patients will be familiar with your location and if you are required to move, your production will decrease in the short run since not all of your patients will follow you. Obtain as long of a lease term as possible without tying you to the location indefinitely. For instance, instead of requesting a 15 year term for your lease, ask for a five year term with two-five year options. Furthermore, know when you want to sell your practice. This will prevent the following from happening to you.

   i. Case Study. Negotiated Purchase Price: $650,000
   Lender Approval: Conditioned upon the buyer receiving an additional five year option.
   The seller had a strong practice with an associate who produced the majority of the production in the office. The seller had utilized veterinary medicine (and the revenue it created) to establish other successful businesses in another state. His other businesses had grown to a level where his involvement and presence at the Veterinary practice was actually costing him more money then he was making from it due to the time away from his other businesses. He decided to sell and found his buyer quickly. . .his associate. Since the associate produced the majority of the work, the Veterinary lender had no problems making a full value loan of $650,000 (plus working capital) to the buyer. The only condition, they needed an additional option to extend the term of the

lease. The seller had previously negotiated the lease with the landlord and had three and a half years remaining on his current lease, with no options remaining. Unfortunately for the seller, the landlord, did not wish to "tie up" his property for a long period of time. He had previously been approached by the federal government to build a new building, with the government as a tenant, lease it to them for 25 years, and then allow the landlord to have the building free. Even though this deal deteriorated, it left the thought of untold riches in the landlord's mind and he wished to keep the property open for any other future offers. Therefore, he was unwilling to grant the buyer an additional option "at this time," but would "entertain" the offer when the current lease expired. This, of course, did nothing for the transition since the lender required a longer term lease to fund the buyer. The seller was desperate and began offering tens of thousands of dollars to the landlord to grant the option. Even after $100,000, the landlord would not budge. The associate became restless and threatened to leave if the seller did not sell him the Veterinary practice at a much-reduced price: $250,000, to cover the cost of a new build out if the landlord would not grant a future option to extend the lease. The seller accepted the associate's offer. . .**at a loss of $400,000**.

The above list is a small sampling of the many issues Veterinarians face in entering into a lease for their Veterinary practice. When counseling a Veterinarian on the many unseen pitfalls in leases, they are usually astounded by the hidden issues, and they should be. As mentioned earlier, the "form" leases have been in the hands of attorneys for years, constantly being perfected and modified so that their clients, landlords, are protected as well as they can be. While the lease is only one component of owning and operating a Veterinary practice, many times it is one of the most important, and the most overlooked. With simple changes to the lease, including the issues mentioned above, the lease can be a valuable asset to you, possibly even increasing the value of your Veterinary practice.

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[1] Based upon the authors' review of approximately 150 dental leases each year.

[2] Herzog v. "A" Co., (1982) 138 CA 3d 656, 188 CR 155

[3] Ilkhchooyi v. Best,, (4th Dist. 1995) 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766

[4] Ilkhchooyi v. Best,, (4th Dist. 1995) 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766

[5] Ilkhchooyi v. Best,, (4tth Dist. 1995) 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766

[6] California Civil Code Section 1955.240

[7] Ilkhchooyi v. Best, 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766 (4th Dist. 1995)

[8] California Civil Code Section 1950.8

[9] California Civil Code Section 1950.8

[10] This is found in most form shopping center leases, medical office leases, but has not yet been drafted into the newest American Industrial Real Estate Association lease form.

[11] Section 17.7 of Westwood Financial Corporation Form Shopping Center Lease states: "**Recapture.** If Tenant requests Landlord's consent to any assignment of this Lease, Landlord shall have the right, to be exercised by giving written notice to tenant within thirty (30) days of receipt by landlord of the information concerning such assignment required by Section 17.1, to terminate this Lease effective as of the date Tenant proposes to assign this Lease, and on such date, Tenant, and all persons acting under or through it, shall vacate and deliver up to Landlord possession of the Premises and the Lease shall terminate, but such rights and obligations of Landlord and Tenant that would have survived the normal expiration or early termination of this Lease shall remain in full force and effect." (underlining by authors)

[12] American Industrial Real Estate Association Lease form , form Shopping Center Leases, form Medical Building Leases, form Retail Office Leases, etc.

[13] Striecher v. Heimburg, 205 Cal. 675, 676-677 272 P. 290 (1928) (Lease ambiguity held against Landord), In Re Circle K. Corp, 127 F.3d 904, 31 Bankr. Ct. Dec. (CRR) 808, 28 Collier Bankr. Cas. 2d (MB) 1445, Bankr. L. Rep. (CCH) Section 7762 (9th Cir. 1997); Standard Oil Co. v. Slye, 164 Cal. 435, 442, 129 P. 589 (1913); Cicinelli v. Iwasaki, 190 Cal. App. 2d 59, 64-65, 338 P.2d, 1005 (2d Dist. 1959) (option assignable unless specifically stated in lease) , Ilkhchooyi v. Best, 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766 (4th Dist. 1995)

[14] American Industrial Real Estate Association (2002), Section 12.2[a]