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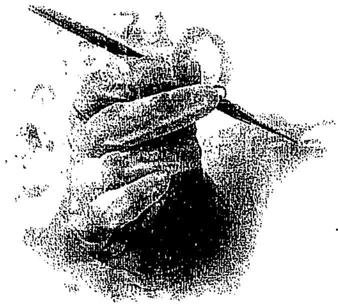

Why Your Lease Is an Important Asset

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ABSTRACT The authors represent more than 3,500 dentists in California and have utilized their experience, knowledge and actual client examples to provide a thorough guide to protecting your future income and sale of your dental practice. This article is intended to provide an in-depth prospective of the value of the lease for your dental practice.

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Most dentists think of attorneys either as patients or as people who may sue others. A problem in the dental industry is that there are far too few members of the legal profession who make their livelihood representing and protecting dentists in connection with their business affairs. Indeed, it seems the deck is stacked against dentists in California since the vast majority of attorneys are either bringing malpractice actions against them or representing the developers, landlords, and large corporations with whom dentists must do business.

Unfortunately, far too many dentists continue to believe they do not need advisers' knowledgeable in the dental industry to conduct their business affairs, and, as such, an increasing number of dentists fail to reach the pinnacle of their careers, being forced to deal with litigation, bad landlords, unprofitable dental practices, and other business problems that interfere with them focusing on the practice of dentistry.

This article focuses on how truly complicated a single facet of owning a dental practice is. The premises lease is often the most overlooked asset of a dentist and this mistake, can be detrimental not only to one's dental practice, but to an entire career of a dentist. This article will utilize case studies, changes in California law, and specific provisions in today's "form" leases, which are negatively impacting dentists throughout California. Whether one currently is looking for a new office location, purchasing a dental practice, or thinking about selling a practice, this article will provide insight on how to protect one's business.

Leasing Brokers

Many dentists believe that a leasing broker acts as their attorney in connection with the lease. However, they are not attorneys and do not profess to be. They do not negotiate points of law or revise sections that may impact the value or transferability of the dental practice to another dentist. The leasing broker's main job is to find a suitable space, negotiate the rental rate, term, and possible tenant with whom a commercial broker interact; they generally will not understand the value of certain sections as they pertain to dentists.

Many dentists believe that by engaging a commercial leasing broker to negotiate their lease they are in fact protecting themselves from many of the issues the authors will be addressing in this article. However, if one reads the commercial leasing brokers indemnification section, one will see the broker clearly states they are not an attorney, and they encourage the dentist to seek legal counsel to review the lease. The broker understands 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 one's lease are clearly important to the success of the dental practice, they not are only provisions of a lease which can cut into the profitability and value of one's dental practice.

The Newer the Lease, the More Anti-tenant It Will Be

If a dentist has a lease that was drafted in 1975, chances are the rights and duties of the landlord and the tenant are fairly equal. However, as time progresses, members of the authors' profession spend more and more time drafting modifications to form leases to strengthen their clients' position, with their "client" being the landlord. Over the past 10 to 15 years, this trend has generated speed. One can now expect to have between 15 and 25 provisions in the newer leases that have the potential to negatively impact the value of the dental practice, possibly prohibit the dentist from selling it to another dentist, or cause one to have one's lease terminated upon selling it.[1]

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California 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 California 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 that 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 vs. Best, the court prohibited a landlord from receiving "excess consideration" during the sale of the tenant's business.[3] 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.[3] The court found it "unconscionable" to attribute the "excess consideration" to the allocation of goodwill of the business.[3]

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 and was not intended to include allocations attributed to the business itself.[4,3] In part as response to this case, the Legislature codified the court's decision in California Civil Code Section 1950.8 that 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.[5]

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."[5] Therefore, landlords use phrases like "10 percent 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.

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

RECAPTURE CLAUSE

Many leases now have a "recapture" provision that allows the landlord to terminate a lease if the dentist asks for an assignment or a subletting of the office.[6] In other words, when the dentist finds a buyer for their practice they must notify the landlord that they wish to assign the lease to the buyer of the dental practice. As soon as the seller requests an assignment of the lease to a potential buyer, the provision "kicks in."[7] At that time, the landlord can either accept the assignment, deny the assignment, or terminate the 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 dental practice. Please note, this section is often times used to get around the decision and Section 1950.8 of the California Civil Code discussed previously.

Personal Options

This section usually makes any option period to extend the lease personal to the dentist, making them useless to any potential buyer. Without at least seven to 10 years of a viable lease term (including option periods), many lenders will not lend money to a buyer to purchase your dental practice. This provision is contained in most new form leases since California courts have ruled that in order to prevent a renewal option transferring to a lease assignee, it must be specifically stated in the lease.[8,9]

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 dental practice location is being withheld.

KNOWING WHAT ONE can possibly modify in a lease and what a landlord will not modify is just as important as negotiating the rent.

NEGOTIATED PURCHASE PRICE: $1,175,000

Lender Approval: Yes

The seller was a very successful dentist who had started his dental 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 dental practice to purchase. The broker involved in the transaction found a suitable buyer and the dental lender was willing to fund the entire purchase price ... with one condition. The current lease term only had three 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 dentist, the remaining options were personal to the seller and there was a recapture clause in the lease that allowed the landlord (instead of granting or denying the assignment) to terminate the lease.

When the landlord saw how much the dentist was receiving from the sale of his dental 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 the authors' 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 the authors' 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 a square foot to what the landlord determined was fair market value. This caused the lender to reconsider the loan because the overhead percentage increased to a level to which they were not comfortable with loaning the money. In order for the sale to go through, the authors' 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.

Lease Provisions to Modify

As mentioned previously, there are many provisions in a lease that can impact the value of one's dental practice. However, knowing what one can possibly modify in a lease and what a landlord will not modify is just as important as negotiating the rent. If one asks for the wrong things (i.e., trying to change a triple net lease to a gross lease), one typically will end up not receiving any of the requested

modifications. Following is a sampling of things one may wish to ask for when negotiating a new lease or assignment.

Dental Exclusive

If located in a smaller shopping center or strip mall, this provision could be crucial to one's business being successful. As mentioned previously, landlords have no provisions in their leases prohibiting them from leasing space to another dentist However, when a landlord is courting a new tenant for an empty space in their shopping center, this is an excellent time to demand to be the only dentist in the center; often times the landlord will grant this request.

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, the authors suggest asking for time frames for repairs to commence and to be completed; failing that, the dentist has the right to terminate the lease. Generally, the authors' law firm requests 90 days to commence repairs and 180 days to complete repairs.

Release of Liability

If one is lucky enough to have their lease assigned to the buyer, the dentist will still be on the hook for the length of the lease, including any option periods left.[10] This could mean that one could have another 10 to 15 years of personal liability connected with the lease. The authors recommend that the dentist try to be removed from future liability after a valid assignment.

Length of Lease Term: Plan for Your Future

Do not accept a five-year lease for your dental practice. One is either going to spend $100 to $150 a square foot building out one's dental practice, or will be paying a substantial amount of money when one acquires the dental practice. Patients will be familiar with the location and if one is required to move, production will decrease in the short run since not all of one's patients will follow. Obtain as long of a lease term as possible without tying one to the location indefinitely. For instance, instead of requesting a 15-year term for a lease, ask for a five-year term with two five-year options. Furthermore, know when you want to sell the practice. This will prevent the following from happening.

OBTAIN AS LONG of a lease term as possible without tying one to the location indefinitely.

Case Study

NEGOTIATED PURCHASE PRICE: $650,000
Lender Approval: Conditioned Upon the Buyer Receiving an Additional Five-year Option

The seller had a strong HMO practice with an associate who produced the majority of the production in the office. The seller had utilized dentistry (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 dental practice was actually costing him more money than 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 dental 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 dental 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 scenarios are a small sampling of the many issues dentists

face in entering into a lease for their dental practice. When counseling a dentist 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 dental practice, many times it is one of the most important and the most overlooked. With simple changes to the lease, including the issues mentioned in this article, the lease could be a valuable asset to the dentist, possibly even increasing the value of the dental practice. ■■■■

TO REQUEST A PRINTED COPY OF THIS ARTICLE, PLEASE CONTACT Jason P. Wood, JD, 20 Pacifica, Suite 320, Irvine, Calif., 92618.

REFERENCES

1. Based upon the authors' review of approximately 150 dental leases each year.
2. Herzog vs. "A" Co., 138 CA 3d 656, 188 CR 155, (1982).
3. Ilkhchooyi vs. Best, (4th Dist.) 37 Cal. App. 4th 295, 405 and 407, 45 Cal. Rptr. 2nd 766, (1995).
4. California Civil Code Section 1955.240.
5. California Civil Code Section 1950.8.
6. This is found in most form shopping center leases, medical office leases, but has not yet been drafted in to the newest American Industrial Real Estate Association lease form.
7. 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).
8. American Industrial Real Estate Association Lease form, form shopping center leases, form medical building leases, form retail office leases, etc.
9. Striecher vs. Heimburg, 205 Cal. 675, 676-677 272 P. 290 (1928) (Lease ambiguity held against landlord), 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. vs. Slye, 164 Cal. 435, 442, 129 P. 589 (1913); Cicinelli vs. Iwasaki, 190 Cal. App. 2d 59, 64-65, 338 P.2d, 1005 (2d Dist. 1959) (option assignable unless specifically stated in lease), Ilkhchooyi vs. Best, 37 Cal. App. 4th 395, 405 and 407, 45 Cal. Rptr. 2nd, 766 (4th Dist. 1995).
10. American Industrial Real Estate Association, Section 12.2(a), 2002.