

HOW YOUR OFFICE LEASE CAN AFFECT THE VALUE OF YOUR DENTAL PRACTICE: A CASE STUDY

We have all heard a colleague or friend declare, “My landlord is the worst!” However, many dentists are unaware that even the best landlord may be waiting for you to sell your dental practice (or attempt to) before showing you what truly lurks in the lease you signed when you began your dental practice. Many dentists that we work with are unaware of the provisions in their leases which can do one of the following: prohibit the sale to a potential buyer, reduce the value of your dental practice, reduce the amount of proceeds you receive from the sale of your dental practice, terminate your lease when you ask for an “assignment” of the lease to your potential buyer, etc. Unfortunately for dentists, these lease provisions are uniquely tailored to businesses which have a large component of the value of their business tied to the location they rent space in. In the case of dental practices, your goodwill (the most important asset you own) is tied to the location of your dental practice. Furthermore, leases are only getting worse, with new provisions inserted in an attempt to further extract money from business sales. Below are two examples of how recent dental practice sales we were involved with will highlight the growing danger of the business asset you signed without investigation.

CASE STUDY #1:

NEGOTIATED PURCHASE PRICE: \$1,200,000

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 closer to his family 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 within a short period of time and the dental 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 needed these assigned to the buyer. Unfortunately for the selling dentist, he failed to have the lease reviewed by an attorney knowledgeable in lease issues which are important to dentists. The options remaining 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 dental practice, the landlord cited the recapture clause contained in the lease and threatened to terminate his lease on the spot 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 was arbitrarily increasing the rent for the office \$1.05 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. This kept the buyer from rescinding his offer and the sale eventually went through. . .at a loss to the seller of \$150,000 because he did not properly review his lease prior to signing.

CASE STUDY #2

NEGOTIATED PURCHASE PRICE: \$650,000

LENDER APPROVAL: YES, WITH CONDITIONS OF HAVING THE LANDLORD GRANT THE BUYER 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, while nice and a good landlord, did not wish to “tie up” his property for a long period of time. He had previously been approached by the federal government build a large social security administration building on his property, lease it 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 to the seller because he did not negotiate a long enough lease to protect a future sale of the dental practice.

I cannot stress how important it is to have your lease reviewed if you ever have an ownership interest in a dental practice. In my firm’s experience, landlords are willing to negotiate these points, provided you know how/what to ask for. Being an owner does not just take excellent clinical skills, it takes being an extraordinary business person as well,

and one of the most important assets you have, your dental office lease, will determine your future success at selling your practice.

Jason P. Wood, B.A., J.D.

Jason is a partner in the law firm of Wood & Delgado, a law firm which specializes in representing dentists for their business transaction needs throughout the United States. Mr. Wood can be reached at (800) 499-1474 or by email at jason@dentalattorneys.com