

April 16, 2012

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Health Care

Critical Real Estate Considerations in Health Care Transactions - Leases

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This is Part II of Critical Real Estate Considerations in Health Care Transactions. Part I can be found [here](#).

Real estate leases are critical components of health care operations and are often key considerations in health care transactions – whether as free standing lease arrangements, in connection with the acquisition or disposition of real estate, or as part of the assets in a merger or acquisition. Irrespective of the type of transaction in which a leasing issue arises, there is significant value to undertaking appropriate measures of care and due diligence to fully understand existing lease terms and to appropriately address and implement issues in new leases. This E-Alert is intended to outline some of the major concepts to be considered in entering into leases and revising existing leases, and the pitfalls associated with a failure to do so.

While the practical real estate issues and concepts discussed herein must be reviewed in conjunction with health care-specific regulatory issues, such as compliance with the federal Anti-Kickback Statute, Stark Law, and HIPAA, they must also be handled properly from a real estate perspective if health care providers desire to efficiently develop and use land and facilities to expand to meet the growing need for health care services. A lease is often incorrectly viewed as an ancillary document. However, the importance of the terms of a lease should not be underestimated. Leases are a considerable expense, bind the parties for years and govern in the event of a sale of the property or an assignment by the tenant.

A “new” leasing transaction can take on a number of forms, the most typical of which are: (i) traditional space leases of existing property, (ii) build to suit leases where a land owner/property developer is engaged to construct a specifically designed building/space for a particular tenant who will lease and occupy the building upon completion, and (iii) a sale-lease back, where a real estate owner and user sells a real estate asset to an investor who in turn immediately leases the real estate back to the seller. This last form is a common methodology used to monetize assets without interrupting operations. No matter the leasing context, the following sets forth certain concepts that should be carefully considered – how they are addressed, of course, will depend on whether they are viewed from the perspective of landlord or tenant. The tenant aims for flexibility and the landlord’s goal is certainty.

Ownership

A clear understanding of the ownership of the property may seem elementary, but too often this issue is overlooked. Only a fee simple title owner can directly lease real estate. If the landlord is merely a lessee, the nature of the transaction is characterized as a sublease, and in such cases the underlying prime lease (even if only a ground lease) must be considered and its terms understood to ensure additional obligations are known and appreciated. The consequences of executing a lease with the wrong party or with an entity that is no longer in existence can be fatal to the lease transaction.

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Use

The negotiation of the permitted use provision in a lease is important not only for the immediately contemplated use and user, but for potential uses in the future and assignees of a tenant's interest. A permitted use provision drafted too narrowly can be a significant impediment to a future lease assignment, and, in the case of multi-location providers, the ability of the provider to freely convert building uses and locate and relocate services. Notwithstanding the express terms of a permitted use clause in a lease, applicable zoning laws must be analyzed. An experienced land use attorney should review the applicable governing zoning ordinance as part of the tenant's due diligence. For example, a use change from standard office to medical office may result in the imposition of impact fees as a condition to issuance of the certificate of occupancy for new or newly upfitted premises.

In addition to confirming that the scope of permitted uses do not violate applicable zoning ordinances or add unanticipated costs, and negotiating the permitted use provision in a lease to ensure as much flexibility as possible, it is important for tenants to review restrictive covenants and declarations applicable to the property for use restrictions and related issues, such as signage and parking. Such restrictions or mandatory specifications can be found in subdivision declarations, commercial park owners' association governing documents or other restrictive covenants.

Option Rights; Rights of First Offer; Rights of First Refusal

Among the most valuable terms in a lease, option rights, rights of first offer and rights of first refusal must be crafted with exceptional care to ensure that the negotiated right is fully enforceable in line with the parties' expectations. For example, an option to extend a lease term or to purchase the property may not be enforceable if the material terms of that option are not fixed or capable of being fixed. Language such as "to be determined by the parties" will render these rights illusory.

Maintenance; Repairs

A significant business issue underlying leases is who bears the responsibility for maintenance and repair of the premises. Generally, in multi-tenant buildings, costs attributable to the building structure and grounds are initially borne by the landlord and then passed through to tenants as part of common area maintenance expenses, sometime called "CAM" or "TICAM". Careful thought must be given to the type of expenses that the landlord can pass through to the tenant and exclusions are often negotiated. Such arrangements are known as net or triple net leases. However, even in a net lease, the tenant is often held responsible for maintenance and repairs within the four walls of its premises that are not otherwise related to building structure or mechanical components – precision in drafting these provisions will avoid unnecessary disputes during the term of the lease. In single tenant spaces, the allocation of maintenance and repair responsibilities can vary greatly depending on negotiations. To the extent that a tenant will be held responsible for all or any aspect of such work, a thorough site investigation is highly recommended. In addition, if a tenant is responsible for structural and mechanical components, the existence of warranties and the ability to enforce those warranties (often through the landlord) should be addressed in the lease and consideration should be given to a cap on costs to the tenant.

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Assignment; Subletting

As previously stated, from a tenant's perspective, flexibility is a key consideration. Anticipating and accommodating future transactions, whether the sale of the business operating out of the space, or the ability to sublease the space if the space is no longer desirable, should be at the forefront of a tenant's mind. On the other hand, landlords (and their lenders) often go to great lengths to ensure the financial viability of a tenant and are typically unwilling to provide broad rights to tenants to turn over lease obligations to an unknown party in the future. Through carefully crafted language, there are a number of ways in which these provisions can be structured so as to balance the concerns of landlords and lenders, without losing the necessary flexibility for tenants.

Memorandum of Lease

A memorandum of lease is a summary of the lease identifying the parties to the lease, the property, the term, any options to extend, and, often, any special rights granted to the tenant such as a right to purchase the property. The memorandum of lease does not include economic terms. The failure to record a memorandum of lease will render the lease subordinate to any instrument recorded subsequent to the lease in the local land records and the effect of this is significant. One possible result is that if a lender forecloses on property pursuant to a mortgage or deed of trust recorded after the lease is in place, the purchaser of the property (usually the foreclosing lender) does not have to recognize the lease. Another potential result is that the property is sold by the landlord and the buyer does not honor the lease. Either event can be devastating to the tenant. The memorandum of lease must be recorded in the county in which the property is located.

SNDA

Unless a memorandum of lease is recorded prior to the recording of a mortgage or deed of trust, the lease is junior to the mortgage and can be eliminated in a foreclosure. The risk associated can be huge, especially when the tenant pays significant upfit costs or the strategic value of the location is paramount. A subordination, nondisturbance and attornment agreement ("SNDA") is intended to contractually establish the impact on a lease if the lender forecloses. "Subordination" is the agreement to allow another's interest in certain real property to have priority over one's own interest – in this case, the lender's interest to be superior to the tenant's. "Nondisturbance" means an agreement by the lender to recognize the tenant's rights under the lease after a foreclosure and typically requires that tenant perform its obligations under the lease. "Attornment" is the acknowledgment by tenant to look to a purchaser of the landlord's interest (usually the foreclosing lender) after a foreclosure of the mortgage. Like the memorandum of lease, the SNDA must be recorded.

Title Issues

Depending on the value of the lease and the length of the term, issues related to title and third party reports addressed in [Part I](#) should be considered and pursued. Moreover, to the extent that a purchase option has been negotiated, tenants should treat the lease transaction as if it were a purchase and perform all of the due diligence that is associated with a purchase. Once issues of concern have been disclosed and addressed with the landlord, protections against changes in the status of title to the property caused by landlord or otherwise should be incorporated into the lease document.

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Leasehold Title Insurance

Tenants should consider leasehold title insurance if the term of lease is lengthy, if the specific location is strategically critical, if tenant is responsible for substantial upfit costs, or if the tenant has negotiated an option to purchase the property.

This Alert does not address all provisions in a lease, each of which must be considered in detail both from a real estate and regulatory perspective. Input from a K&L Gates attorney experienced in both leasing and health care for review, negotiation and careful drafting is critical to protect the interest of the leasing party.

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