



Property Lease Dangers Part I[©]
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Location is the veterinary practice's most valuable asset after its staff, and unless you own your facility, your commercial lease is the most important factor affecting your location.

So veterinary practice owners need to know what's in their lease when they rent their facility. Increasingly, so do veterinary practice sellers who also own their facility. This is because they often retain ownership of the facility and rent it to the practice buyers--either because the new owners can't afford to buy it, or to create a source of retirement income, or because they don't want to sell in a depressed real estate market.

Unfortunately, commercial leases are probably the most painful document you will need to understand outside of your insurance policies. Perhaps not as painful as root canal, but close. (BTW, you do understand your insurance policies, don't you?)

So in an attempt to reduce lease review trauma, here's a road map of the main areas you need to focus on.

Define the Premises.

Landlords rarely represent and warrant (i.e. promise) to tenants that the Premises are safe, suitable for a veterinary practice, in compliance with all laws, that the HVAC (heating, ventilation and air conditioning) works, or even that the square footage is accurate. Tenants need to examine the Premises carefully of course, but even careful due diligence won't reveal hidden defects, especially leaks occurring only after heavy precipitation. Tenants also need to inspect HVAC, electricity and plumbing. It will be difficult to properly assess the heating in August or the AC in February. Do not count on landlord representing that these systems are functional and adequate, or even that the facility's basic structure is sound and that the roof doesn't leak.

Specify the Term.

Given the cost of moving to another facility and negotiating a new lease, tenants usually want one or more options to renew the contract, and landlords are usually agreeable one or more renewal terms. Veterinary practice leases usually range between 10 and 25 years. The lease parties should therefore prepare (and invest for) a long term relationship. Their association will last longer than many marriages. The lease parties should make sure they have a common understanding of exactly when tenant must give notice to renew the agreement.

The World of Rent, and How Fast it Grows!

Rent is usually the sum of “base rent” and “additional rent.” Base Rent is the amount tenants pay just to occupy the premises. “Additional Rent” comprises all other amounts the agreement requires tenants to pay landlord--mostly facility operating and related. Base Rent can be expressed in various ways. Tenants should be wary of comparing rentals based on dollars per square feet, because the commercial real estate industry uses several different measures of “square feet.” So landlords will quote a dollar/square foot rent using "rentable square feet," but since only a portion of rentable square feet is actually usable by tenant, the true rent is higher.

Base rent is sometimes based on a percentage of tenant’s gross revenues. This will complicate the contract, because the lease parties need to agree on: (a) the method used to calculate the practice’s gross revenues; and (b) a process to resolve disagreements.

Most leases provide for annual increases in rent. The “miracle” (if you are a landlord) or the “curse” (if you are a tenant) of compounding also applies to base rent. So a tenant with a hypothetical 10 year lease with \$ 60,000 flat annual rent lease will pay a total of \$600,000 over the lease term. If the contract has a 3% annual escalation clause, total rent paid by tenant will be \$ 687,832.76, a difference of approximately \$ 87,833.

Most leases also provide for payment of additional rents. All amounts that the lease requires tenant to pay to landlord in addition to base rent fall within the category of “additional rent.” At minimum this would include the security deposit, which ranges between one and three months’ rent. What other items, if any, are included within additional rent, depends on the contract working. For example, in most cases, property taxes are not paid directly to the taxing authority by tenant, but by landlord, who then is reimbursed by tenant. Some leases require tenant to pay landlord’s estimate of property taxes monthly or quarterly in advance, subject to an annual reconciliation mechanism. This "smoothes out" tenant's payments, and also allows landlord to receive a portion of the property tax amount in advance.

The Great CAM Tug of War: Maintenance, Repairs and the other Expenses Tenants Pay.

First, what’s in CAM? In multi-tenant facilities landlord at minimum is responsible for maintaining and repairing the common areas (sidewalks, stairways between tenant premises, parking lots, landscaping, etc.). These costs are called “common area maintenance” or “CAM.” CAM is a misnomer, however, because CAM usually includes other facility costs that landlords pass on to tenants, such as property taxes and insurance.

Unfortunately, there is no commonly accepted exhaustive list or definition of operating expenses. This means that CAM is whatever the lease parties negotiate. It is in landlord’s interest to protect its profits by passing along as many costs and expenses as possible. Tenants of course have every interest in minimizing CAM, but they start out at a disadvantage because landlord’s attorney writes the lease agreement. Accordingly, the typical CAM provision starts like this:

“Tenant will pay its pro rata share of all facility operating costs of whatever nature,

including but not limited to...”

and then there’s a long laundry list of costs that are passed on to tenant.

The “including but not limited to is important” because it allows the landlord to add new categories of expense. The lesson for tenants of course is to change the CAM definition to a limitative list.

What about "trust but verify"? Many leases do not have tenant CAM audit rights. This means that short of going to court, tenant has no way to check CAM charges. When the lease does have audit procedures, they may not be meaningful. For instance, the contract frequently states that tenant has only a 30 day window to perform an audit each year and/or cannot obtain supporting information; and/or that landlords’ numbers are binding on tenant absent “manifest error.”

In contrast to multi-tenant leases that have CAM charges, single tenant leases focus on maintenance and repair issues, which are generally far less contentious. This is because most, if not all of the expenses are paid by tenant directly. So tenant is able to exercise some cost control. Most single tenant facility leases also expressly stipulate that landlord must make all “structural” repairs at its own expense (whereas tenant is responsible for all other repairs and maintenance). This is a marked improvement over multi-facility leases, most of which are silent about whether structural repairs are included in CAM or not.

Balance of article continued in Part II