

Understanding Premises Leases

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Why so large cost, having so short a lease, Dost thou upon thy fading mansion spend?

William Shakespeare *Sonnets*

The signing of a lease can represent the largest financial transaction ever made by a prospective tenant. The lease agreement is legally binding and can be enforced on the parties involved. Even though a lease should be reviewed by competent advisors or legal counsel, it is unusual for counsel to actively negotiate its terms; that burden inevitably falls on the prospective tenant. For this reason, a prospective tenant should be aware of the common terms and the usual pitfalls associated with leases. This chapter reviews many of the significant areas that are encountered when negotiating a lease for a professional office.

The person who occupies property owned by another is called a *lessee*. Negotiation of the lease agreement with the owner—the *lessor*—might be limited to the presentation of a contract by the owner, accompanied by the following language: “Enclosed please find your standard lease form. You should sign where indicated, initial each page, and return at your earliest convenience.”

This language may be the first introduction the tenant has to the lease, and even though the term *standard* might seem to imply some degree of conformity or regularity, the only standard aspects of an individual lease are the matters that it addresses. There is no one customary way to address these matters, and they should be viewed as fully negotiable and understood by the prospective tenant.

A lease is a contract binding its signatories to its terms, and the tenant should assume at the inception of the relationship that all terms are also fully enforceable, although negotiable. There are many legal clauses for the novice tenant to appreciate, and written provisions that are perceived to be fair in a lease may lead to difficult financial consequences. Therefore it is important to obtain competent advice before executing a contract such as a lease. The goal in premises lease negotiations is to reach an agreement that is equitable and easily understood.

Prospective tenants should be aware that they are in the best position of negotiation because they will ultimately decide to sign or not sign a negotiated lease agreement. Printed lease forms are sometimes used by landlords to emphasize their power. Prospective tenants should be wary of printed leases and should remain unimpressed by the lease or by how large the law

firm is that may have drafted the lease. Concessions requested by the prospective tenant can always be awarded by a landlord who is interested in realizing occupancy of their space.

NEGOTIATING FOR CONCESSIONS

It can easily be 2 to 3 months after the lease agreement has been signed before the first patient walks through the door. During this period, without the benefit of patient income, the optometrist will be paying for alterations and improvements of the space, ordering instrumentation, shopping for office furniture, and preparing the office for its grand opening. These considerations offer an opportunity for the prospective tenant, the practitioner, to ask the landlord for assistance in the form of concessions before the lease has been signed. Examples of concessions that may be negotiated into the lease agreement include but are not limited to the following:

- Reduction in the rent for the full term of the lease (especially if the rent appears excessive considering the space and location)
- A few months of free rent to help the optometrist reduce overhead expenditures while alterations are being performed on the premises or equipment is being delivered and installed
- Payment by the landlord for all or part of the alterations or improvements to the office space, known as a “buildout allowance” and generally quoted as a fixed dollar amount per square foot
- A “step-up” lease in which rent is paid at a reduced rate for the first 6 to 12 months and gradually increased to the full rate over time

There may be instances when the landlord may refuse to make concessions. The prospective tenant should remember that they are always equally as important in signing the final lease agreement. If the office space is highly desirable and the market for office space is very limited, the prospective tenant might have to be comforted by the knowledge that previous tenants have worked successfully under such leases. In such a case, it is appropriate to check with the other tenants. If the landlord has dealt reasonably and fairly with them, there is a good

likelihood that the prospective tenant will not encounter any extraordinary difficulties. The landlord does have a reputation to protect, and if tenants have been treated unfairly in the past, the landlord's reputation will suffer. In addition, a high turnover rate will drive up the landlord's costs of doing business if rentable space remains unoccupied for significant periods of time.

SELECTING COMPETENT COUNSEL

The best method for selecting competent legal counsel is by soliciting recommendations for real estate attorneys from other health care professionals in the area. Successful professionals are likely to have identified and hired the best attorneys and accountants because physicians, dentists, and other health care providers usually demand good advice and are willing to pay for it. The prospective tenant should not hesitate to schedule an interview with an attorney to obtain information about the attorney's background, philosophy of practice, fees, and experience with real estate. There is normally no charge for this initial interview. The attorney will value the opportunity to discuss matters of mutual interest with a prospective long-term client.

LOCATION

The same type of investigation of local demographic information should be conducted to determine the best locations in which to seek an office. Real estate agents, the staff of the local planning commission, or the local Chamber of Commerce can provide demographic data.

Practice sites should be prominent and readily visible to the public. In addition, the office location should be easily accessible—near public transportation and with adequate parking available.

If an office is highly visible (e.g., next to a bank or across from the post office), the practice will become known immediately. Being in the local "professional building" or in an area with other professional offices is excellent. It is worth some extra cost to obtain a good, visible location; the additional expenditure will be returned many times over. It also is important to obtain adequate space. The consistent rise in net income due to such a practice site usually will compensate for the higher cost of the lease.

SPECIFIC CONTRACT CLAUSES

Several specific clauses of the lease agreement are particularly important. These clauses include identification of the parties, property description, term, rent, tenant mix, assignment, maintenance, warning before eviction, leasehold improvements, broker's fee, exculpation, warranty to practice, and security deposit.

Parties

The parties to the contract must be identified; these are the parties who will be expected to comply with the lease's terms and conditions.

Property Description

The lease should clearly define the property to be rented. If the property is free-standing, it is relatively easy to describe the premises for which maintenance will be performed, taxes assessed, and insurance provided. This description is not as clear when the premises are part of an office complex or shopping center that includes parking facilities, elevators, and other common areas. In these cases, tenants normally pay a percentage of the taxes, insurance, or maintenance that is assessed on the whole building. The percentage to be paid should be negotiated based on the square footage occupied, rent amount, anticipated use of parking and other common areas, and type of business conducted.

Term and Renewal

For a credit-worthy tenant who is successful in a business endeavor, a long lease term can be beneficial to both the tenant and the landlord. Conversely, a long-term lease can be problematic for the optometrist who is less successful. Even though adequate investigation, planning, and market research should minimize that risk, it is always possible for unexpected events to adversely affect anticipated revenues.

Many landlords will not be anxious to lease to an optometrist who wants only a 3-year term. A 5-year term can be more acceptable, even for a new practice. For an already established practice with anticipated revenue based on historical performance, a 10-year lease can be more reasonable. In any case, the optometrist should negotiate for renewal options to be included in the lease. These options are exercised at the discretion of the tenant, and they extend the lease period for a stated number of years. The rent to be paid during the new term should be calculated on a pre-agreed basis.

Whatever the term of the lease, the tenant should request a provision that allows the tenant to stay month-to-month at the prevailing rental charge when the lease expires. Another useful provision is one that provides for possible practice growth by requesting first refusal on adjoining or other space in the building if it becomes available.

Rent

Leases are often characterized as being either "net leases" or "gross leases." A net lease implies that the tenant will pay the landlord rent that includes the "net" cost of all taxes, insurance, and maintenance expenses (i.e., the tenant pays these in addition to rent). A gross lease implies that the landlord pays the expenses for taxes, insurance, and maintenance out of the rent proceeds. A fully negotiated lease should be a compromise between these extremes.

Even though some practitioners live in communities that have experimented with various artificial methods of controlling residential rents, those that advocate such foolishness live in a fantasy world—one where new buildings will be constructed and improved with no regard to profit and where conventional lenders will provide construction loans solely because of their sense of social responsibility. Conversely and realistically, a fair rent should be determined from the

marketplace, which is to say by demand and availability. It is a mistake, however, for the optometrist to use market factors as the only determinant of rent. A pro forma analysis will indicate the maximum rent that will not unreasonably drain the resources of a practice (Figure 12-1). A landlord also should be motivated to ensure that rents are fair and affordable to tenants because a contract to the contrary is an invitation to early vacancy, cessation of rents, and possible litigation.

Most net leases establish a base or fixed rent (often called minimum rent), and additional amounts are added to reimburse the building owner for operating costs, which can include taxes, insurance, and common-area maintenance (e.g., landscaping, janitorial services, elevator maintenance, parking

lot resurfacing, common area lighting). In shopping centers, a percentage rent can be used; this provides a bonus to the owners of the shopping center based on the tenant’s success.

The tenant should attempt to negotiate “caps”—maximums on the reimbursement of operating costs—or, at a minimum, the tenant should expect a guarantee that the total expenses reimbursed to the landlord by all tenants will not exceed 100% of the actual costs incurred. Optometrists who do not wish landlords to perform advertising on their behalf should exclude assessments for advertising. When advertising is to be performed by the landlord, copies of the advertisements should be submitted to the optometrist for approval and to ensure that they conform to applicable state laws.

Bay View Optometry		
Drs. Jones and Smith, Optometrists		
Pro Forma Estimate of Income and Expenses		
Estimated revenue from professional services	\$312,000	
Estimated revenue from materials	290,000	
Estimated refunds	<u>(2,000)</u>	
TOTAL REVENUE		\$600,000
Estimated variable expenses (lab fees, frames, contact lenses)	\$205,000 (34.2%)	
Estimated fixed expenses(% of total revenue)		
Salary (payroll)	116,000 (19.3%)	
Employee benefits	10,000 (1.7%)	
Maximum rent	40,000 (6.7%)	
Insurance	5,000 (0.8%)	
Bank charges	3,000 (0.5%)	
Postage	3,000 (0.5%)	
Travel and entertainment	2,000 (0.3%)	
Continuing education (professional development)	2,000 (0.3%)	
Repairs	4,000 (0.7%)	
Dues and subscriptions	2,000 (0.3%)	
Licenses	1,000 (0.2%)	
Office supplies	6,000 (1.0%)	
Telephone	7,000 (1.2%)	
Utilities	4,000 (0.7%)	
Contributions	1,000 (0.2%)	
Professional fees(CPA)	4,000 (0.7%)	
Marketing	8,000 (1.3%)	
Property tax (equipment and furnishings)	2,000 (0.3%)	
TOTAL EXPENSES		\$425,000 (70.8%)
MINIMUM NET INCOME		\$175,000 (29.2%)

FIGURE 12-1 In this example, Drs. Jones and Smith have determined that the minimum net annual income needed to meet their needs is \$175,000. To satisfy this goal, the maximum rent allowance is \$40,000. Regardless of what the landlord may feel the market rent may be, rent in excess of \$40,000 the first year will put Jones and Smith in a deficit. It would be far more beneficial for both landlord and tenant to structure a rent that ensures both are successful. This may mean a rent that escalates during the initial term of the lease rather than a rent that is held constant.

Even though percentage rents provide some protection to landlords from inflation, a rent based on the number of examinations performed or eyeglasses dispensed might be disagreeable to the optometrist. The negotiation of rent is a business matter, but many optometrists have difficulty reaching business decisions without some regard to practice morals or professional ethics. The decision to pay percentage rents is an individual one, and if it is agreed to, the amount to be paid should be negotiated based on the rents paid by other tenants. A percentage rent requires that monthly accounts of income or profit and loss statements be provided to the landlord. It can be preferable to pay a higher base or fixed rent instead of entering into such an arrangement.

If percentage rents are paid, a fair percentage must be considered in relation to the total amount that the optometrist can budget for rent. A pro forma analysis should identify the maximum available rent the optometrist can pay. Even a 2% percentage rent could increase payment over a fixed rent amount by many thousands of dollars. For example, the tenant would have to pay \$4,000 if the percentage rent applied to all of a \$200,000 gross income but would only pay \$2,000 if it was limited to gross income in excess of \$100,000.

There are other factors that should also be considered, including rental per square foot per year, automatic rent increases, and steps-up in rent.

Rental per Square Foot per Year

The tenant should determine whether the “per-square-foot” cost is in line with what is being charged for comparable offices in the vicinity. The tenant should attempt to have the cost-per-square-foot figure applied only to the office’s actual floor space and should try to avoid payment of a prorated share of the building’s common footage such as halls and lobbies. Economic surveys of established practices that have been performed by the American Optometric Association (AOA) have indicated that rent cost nationally averages nearly 7% of gross earnings. This percentage is similar to that found in other professions. (Some states like California or major urban areas like New York City report significantly higher figures for rent.)

Automatic Increases

Many leases permit a landlord to raise the rent to allow for rises in property taxes, maintenance costs, or the cost-of-living index. If such a clause must be accepted, the tenant should attempt to limit the annual increment to a maximum fixed percentage. Late charges should be clearly stated. If a landlord expects to recover a penalty for any rent payments made late, the amount of the penalty and the date by which the penalty would be incurred need to be carefully described.

Step-Up Rents

When negotiating rents, it can be advantageous to start off a lease term with a low rent that increases over time—hopefully as income also increases. Most accountants should be able to

determine an equitable rent structure. For example, if a landlord is asking for \$1,000 a month for a 4-year term, the tenant can offer \$700 a month for the first year, \$900 a month for the second year, and \$1,230 a month for the last 2 years. Assuming a 6% interest rate, this proposal nets the landlord exactly the same amount as \$1,000 a month during the 4 years. (see Chapter 38).

The attractiveness of many community shopping centers as lease premises lies in the presence of a nationally known anchor tenant: a large department store or supermarket that attracts consumers. Should one of these tenants vacate the shopping center, the optometrist could experience a dramatic loss in revenue, making monthly rent payments a hardship. Thus it certainly would be fair to negotiate a clause that allows for reduced rental payments during the period in which such major tenant vacancies persist.

It also is reasonable to restrict landlords so they may not offer leases or subleases to competitors (other optometrists or opticians) in the part of the facility that is under the landlord’s control.

What should a tenant do if the landlord wants to raise the rent by a tremendous amount at the termination of the current lease? It is difficult to protect against this event except through automatic renewal options that can be asserted by the tenant at stipulated periods. In the absence of such an option, it is probably best to open negotiations for a new lease early (e.g., 4 to 6 months before the lease expires) to prevent this from happening. Another strategy is to ask other tenants about the past history of the landlord before signing the original lease. Has the landlord been reasonable? Have rent increases been reasonable?

Tenant Mix

Landlords can claim that they entered into a lease with individuals who met specific criteria or with careful consideration of tenant mix. Even though some restrictions are appropriate to protect the landlord against the assignment of leases to undesirable tenants, absolute restrictions are unfair. Absolute restrictions on assignment might even prohibit an optometrist from selling the practice.

Assignment

Although many leases prohibit a tenant from assigning or subletting a lease, a prospective tenant needs to weigh these provisions carefully. Without such a right, an optometrist or the optometrist’s heirs might be responsible for lease payments even in the case of death, disability, or lack of economic success. In planning for such an event, the optometrist will want to ensure that the lease could be assigned to another party or perhaps be terminated altogether. In the case of death or disability, it should be possible to terminate the lease when the appropriate notice is given (e.g., 90 days).

The landlord can insist that approval be obtained if the tenant wishes to move before the conclusion of the lease term and to turn the premises over to another tenant. If the landlord

insists on reserving the right to veto any proposed subtenant, the following compromise should be suggested: “The tenant shall not sublet without the landlord’s consent, which consent shall not be withheld unreasonably.” Another proposal is for the optometrist to ask for an automatic end to the lease within 90 days (or within another reasonable period) after a disabling accident or illness has been suffered, the optometrist has been called for military duty, or the optometrist has died. A clause also should be sought that guarantees that a practitioner who buys the practice has the right to continue under the terms of the lease.

It also should be clear what the tenant’s rights are when title to the property being leased reverts to the owner of a mortgage. The lease should clearly state that the rights of a tenant are not subordinated to the interests of a mortgage lender (called a *mortgagee*). This clause would prevent a lender from evicting tenants in the case of a mortgage foreclosure, a situation in which a transfer of ownership is effected from the original landlord to a mortgage lender.

Both parties to a lease should have the right to terminate or cancel the lease should the other significantly default on lease provisions. A reasonable period in which to remedy such a default should be provided.

Some leases obligate a tenant to keep paying rent for the full term even if the building is severely damaged by fire or other casualty or if an essential facility like air conditioning breaks down and the landlord fails to repair it. The lease should allow the tenant to terminate the agreement under such circumstances without penalty or to pay a reduced rent.

Maintenance

Typically, the landlord would like to repair nothing, whereas the tenant would like the landlord to repair everything. Absent other concessions, a fair agreement is somewhere between these two extremes. A possible fair agreement would have the building owner liable for all repairs to the building exterior, including roof and exterior glass, as well as mechanical systems such as central heating and air conditioning, whereas the tenant would be responsible for repairs to plumbing, the electrical system, interior painting, carpeting, and so on. Maintenance provisions are subject to negotiation, and results can vary considerably, depending on the amount of rent paid and the length of the lease term.

Insurance on the building is normally carried by the owner; it is required by the building’s mortgagee. The owner, likewise, should have the burden of rebuilding in the case of destruction by fire or other casualty. The tenant should be properly insured for the replacement of interior leasehold improvements, furniture, equipment, and supplies.

Maintenance of the exterior affects building appearance; thus standards for exterior signage should be established. A professional tenant such as an optometrist should be protected from the garish signs of a retail store or amusement area next door. In fact, the optometrist can request protection from such a tenant being allowed in the same building. Examples of such restrictions include prohibitions on pawn

shops, massage parlors, sex paraphernalia shops, bars, or exotic dancing establishments.

Responsibility for exterior painting and maintenance of sidewalks or parking areas should be covered in the lease. A tenant might be compensated for maintenance violations by a landlord through fair rent reductions, providing that the tenant has appropriately notified the owner of the violation and that adequate time has been given for the defaults to be cured.

Warning Before Eviction

A tenant should ensure that eviction will not result the first time a house rule (e.g., “objectionable conduct”) is broken. The tenant should ask to be given written notice when in violation of a rule and to be allowed an opportunity to correct the error. A flat “no” should be given to any clause that says breaking a rule renders the tenant not only liable to be evicted but also responsible for the payment of the rent for the balance of the lease. If clauses such as these cannot be stricken from the lease in their entirety, then “objectionable conduct” (or other terms) must be clearly defined.

Leasehold Improvements

Seldom will office space vacated by one tenant be acceptable to another without renovation. The payment of office renovation costs (build-out allowances) needs to be negotiated, not only in terms of how the costs are to be borne, the extent of the renovations, and the period involved for them to be performed, but also in terms of the effect of the costs on the rent to be paid by the tenant during the lease term. Options for payment should be considered.

When an owner is highly dependent on full occupancy or when office space has had a long vacancy, a prospective tenant might be able to negotiate for the landlord to pay the renovation costs or—if the tenant pays the costs—for the landlord to provide a period of free or reduced rent as reimbursement to the tenant. When office space is in high demand and rents are fair, it might be unreasonable to expect concessions of this type, but nevertheless there is nothing to lose in requesting a build-out allowance.

It can be strategically advantageous for a tenant to offer a higher rent than requested if, in return, the owner agrees to absorb the cost of renovations. When owners agree to perform renovations for a tenant, provisions should be included in the lease for monetary damages resulting from construction delays.

The landlord might agree to adhere to a tenant’s specifications at the landlord’s expense if the office needs painting, partitioning, or structural changes to suit the tenant’s practice. If not, the tenant can suggest that an improvement allowance be rewarded as a rent rebate.

Alterations and repairs usually should not be initiated until the term of the lease begins. If the office is vacant, written permission should be obtained to start the modifications immediately. Customarily, the tenant is obligated to pay for services

(e.g., electricity, water, and gas) once alterations have begun. The tenant should try not to accept any clause requiring the premises to be restored to their original condition. The cost of recreating a bare rectangle can be expensive. Also, improvements are assets to the landlord and should not have to be removed.

Broker's Fee

A broker's fee is usually due in leasing transactions and is generally payable by the landlord. In a sublease situation, the existing tenant pays the fee. The lease should identify any brokers involved and should clearly establish who is responsible for the broker's fee.

Exculpation

An exculpation clause limits the liability of a landlord to the interest in the property itself. The clause frees the landlord from legal responsibility for certain acts—committed by the tenant—that cause injury to persons on the property. It is not unusual for an owner to attempt to limit personal liability in this way.

Warranty to Practice

The tenant should be sure to include a clause stating that if local zoning laws forbid the practice of optometry on the premises or the operation of a business, the lease is null and void.

Security Deposit

The prepayment of 1 to 2 months of rent will earn the landlord money as long as the deposit is held. Unless local law so requires, the landlord will not offer to pay interest on the deposit. The tenant can ask for payment of the interest on the deposit held by the landlord.

Other Terms

In shopping plazas, leases often state that all tenants must maintain the same hours (e.g., 9 am to 9 pm 6 days per week). A professional tenant usually can have this provision changed, and the change should be written into the lease.

The parking privileges available to staff and patients should be specified. The lease agreement should be examined to determine whether there are any additional costs for parking. The rules and regulations of the landlord regarding availability of parking during the hours the practice is to be open should be checked. Ideally, there should be seven to eight parking spaces for each professional in a building. If the practitioner and the staff do not use the spaces, a minimum of four to five spaces might be adequate.

The tenant should be sure that there are specific rights to erect customary signs—both inside and outside the building—and that these rights are contained in the lease.

CONCLUSION

When considering the rental of office space, other tenants should always be consulted to determine the integrity of a landlord. The law of supply and demand governs a tenant's bargaining position. That bargaining strength depends on how badly the tenant wants the space and how much the tenant is willing to pay for it. If there are two or three other prospective locations and time is not of the essence, a tenant is in a better position to bargain.

In the low-to-moderate rental field, the demand for space usually exceeds the supply. In more expensive areas, the reverse is true. Being a professional is in a tenant's favor when bargaining. Landlords would prefer to have a professional as a tenant, and a young professional should not be afraid to ask the landlord for changes and concessions.

Lease provisions can be looked at this way: a tenant is unlikely to get every clause requested in every instance. However, a prospective tenant can be sure that provisions favoring the tenant will not appear in the landlord's standard contract and that the landlord will not bring up such provisions unless asked to do so. How much compromise a landlord allows will depend on how desirable the space seems and how likely it is that a prospective tenant can find other suitable space in the locality.

From the landlord's viewpoint, professionals are good tenants. They usually pay their rent on time and do not often cause problems; they add prestige to the building and typically sign long-term contracts. These facts should not be forgotten by a young optometrist seeking to negotiate even that very first lease arrangement.

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Website

www.pueblo.gsa.gov.

Website for the Federal Citizen Information Center.