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Leases involving healthcare providers: A few specific issues to consider

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At this point in the economic cycle, with real estate development and deals slowing, one of the few areas of continued real estate activity may be transactions involving healthcare providers, who are more (though not entirely) insulated from economic downturns than other companies. This articles outlines a few specific issues to consider in leases involving healthcare providers, specifically: federal and state fraud and abuse laws, assignment, default, and termination issues, hours of operation, landlord's access to leased space, and tenant improvements.

Federal and State Fraud and Abuse Laws

Where both parties to an agreement provide healthcare services, federal and state healthcare laws generally prohibit each healthcare provider who refers or is in a position to refer to the other (referred to as a "referral source") from providing any kickback or inducement to influence referrals in that agreement. The federal Anti-Kickback Statute Safe Harbors, and the Stark Law regulatory exceptions, provide for certain contractual arrangements that meet the requirements of the safe harbor for leased space. These requirements include key terms, such as that the lease must be in writing and specify the leased premises; the space may not exceed the reasonable and necessary requirements for the intended use; the lease must be for at least one year; the rent and other charges must be set in advance and may not reflect or take into account the volume or value of referrals, and must be consistent with the fair market value; and the lease would otherwise be commercially reasonable if no referrals were made between the parties. If terminated before the end of the one year term, neither party may enter into another lease with each other for the same premises for the remainder of that year. Note that the Stark Law applies only when certain "designated health services" (such as laboratory and physical therapy services) are provided and that the provisions of the Stark Law govern relationships not only between the providers themselves, but also extend to relationships with members of the immediate family members of the provider.

If a hospital leases office space to a physician group, and the physician group is an actual or potential referral source for patient referrals to the hospital or its affiliates, the hospital must be sure that it charges the physician group the fair market value rent for the space. Fair market value rent must be calculated at the arm's length cost per s/f for comparable office space, without regard to the volume or value of actual or potential referrals from the physician group. If the rent and other charges are below fair market value, the arrangement would not meet the safe harbor exception for leasing arrangements available under the federal Anti-Kickback Statute or the Stark Law, if applicable, exposing both parties to the arrangement to prosecution for violating these laws. It is important to mention that an arrangement subject to the Stark Law that does not meet an applicable exception violates the Stark Law, while the mere fact that a lease does not meet the Anti-Kickback Statute safe harbor does not necessarily mean the parties have violated the Anti-Kickback Statute.

Representations in Lease

To address the above concerns, a healthcare provider should require that the party opposite it in a lease transaction represent that it is not a "referral source." If a healthcare provider is negotiating a lease where its landlord or tenant is a referral source, then the provider should insist on mutual representations that (1) the lease is not intended to influence referrals, (2) rents and other charges under the lease are set in advance and at fair market value, and do not take into account the volume or value of referrals, and (3) any referrals between the parties will be based on the independent judgment of a patient's physician, acting in the best interests of the patient.

Backup Information

Where a healthcare provider is entering into a lease with a referral source, any fair market value representations in the lease should be backed up by evidence that the rental rates and other terms actually reflect fair market value. Typically, a landlord will rely on estimates of fair market value prepared by real estate brokers or appraisers based on leasing rates for similar properties in the same area. Ideally, this information should be maintained on file with the lease so that it is readily available in the event there is an inquiry. In addition, to ensure that the arrangement remains consistent with fair market value, this information should be updated at the time of any renewal terms and the rent and other charges adjusted, if necessary, to reflect the current fair market value.

Relation to Other Agreements

The fair market value analysis in a lease where one, or both, of the parties are a referral source to the other, is not limited to a review of the lease only. All of the agreements between the parties to a lease must be analyzed to confirm that the lease, standing alone and taken together with all agreements between the parties, whether existing at the time the lease is signed or created during the term of the lease, is consistent with fair market value. For example, if a hospital enters into a lease with a physician group which owns the space to be leased, and is also entering into a medical director agreement with the doctors group, then both the lease and medical director agreement will need to pass muster under federal and state fraud and abuse laws.

Assignment, Default and Termination Issues

Relation to Other Agreements Between The Landlord and Tenant

If two healthcare providers are entering into a lease as part of a larger transaction between the two, the parties need to consider how the lease relates to the overall transaction. Consider for example, a hospital that leases medical office space to a physician group and also enters into a separate services agreement with the physician group under which the group will provide specialty services. In this case, the parties will need to agree on the following:

* If there is a default under the services agreement, will this also constitute a default under the lease, and vice versa? Similarly, if the lease terminates after a casualty, will the services agreement also terminate?
* If the physician group renews the services agreement, will the lease automatically renew? If the services agreement is not renewed, may the doctors group renew the lease?
* May the lease be assigned separately from the services agreement?

Medical Records

In a typical lease, the landlord may have the right to re-enter and take possession of the premises in the event that the tenant defaults. The lease should contain specific provisions stating what will be done with medical records left in the leased premises.

Flexibility to Assign & Sublease

From the tenant perspective, as with any lease, a healthcare provider leasing space for its operations should ensure that the lease assignment clause provides the flexibility to allow the tenant to assign and sublease. Landlords typically have little to gain from an assignment or sublease, and are not always responsive to requests for consent to an assignment or sublease. Difficulty or delays in obtaining landlord consent to a proposed assignment is a recurring, critical issue for commercial tenants, as a non-responsive landlord can hold up an assignment that may be needed as part of a sale of the tenant's business or assets.

Consequently, a healthcare tenant should insist on the ability to assign or sublease (without consent, if possible) to entities controlled by or under common control with the tenant, to affiliated joint ventures, and in connection with a merger or sale of the tenant's business or assets. Further, the tenant should insist that the landlord be reasonable in considering requests for consent to an assignment or sublease, and the lease should set forth the standard landlord will follow in reviewing such requests, the fees (if any) that will be charged in reviewing a consent request, and the landlord's time to respond. Finally, as a healthcare tenant will often be assigning its lease as part of a larger transaction, it should insist that landlord rights to terminate the lease and recapture the premises not apply where the tenant is assigning to affiliates, or in connection with a merger, or in connection with a sale of the tenant's business or assets.

Assignment to Competitors

Any time a healthcare provider leasing space to another healthcare provider (even if not part of a larger business deal), the landlord should consider whether there are any competing hospitals or healthcare providers that the hospital would not want leasing its space. If so, this should be spelled out in the assignment clause.

Hours of Operation

A typical office lease might provide that heating and air conditioning is provided to tenants at no extra charge or as an operating expense from 8 a.m. to 6 p.m. Monday through Friday and from 8 a.m. to 1 p.m. on Saturdays, excluding holidays. If services are required outside of these hours, landlords commonly impose an additional "after hours" charge. Medical office or healthcare tenants often have longer hours of operation than typical office tenants. Landlords and tenants need to ensure that the landlord's charge for providing "after hours" heat and air conditioning services to healthcare tenants fairly reflects actual costs. If a healthcare tenant is not careful, after hours HVAC costs could easily exceed all other operating expenses. By way of example, a recently reviewed lease proposed a charge of $13.66 per heating and cooling zone in the premises for after hours HVAC. This 20,000 s/f space had 22 zones, resulting in after-hours HVAC charge of $300.52 per hour. If the tenant used after hours HVAC for three hours per day, Monday through Friday, the charge to the tenant would have been $18,031.20 per month, almost half the monthly rent!

Building Access

On a related note, a healthcare tenant may need to care for patients outside of normal working hours or may have sensitive areas (such as labs or radiology suites) where access needs to be controlled. The tenant should work with the landlord to ensure that janitorial services and landlord's maintenance within the premises is scheduled to avoid interference with operations and damage to equipment or specimens. In addition, such workers need to be trained regarding the confidential nature of the information contained in a medical office.

Tenant Improvements

Healthcare tenants typically require more specialized space and more expensive initial tenant

improvements than office tenants. Â Many of these improvements may require inspection by governmental entities for such matters as clinic licensure, drug control, radiation control, and Clinical Laboratory Improvement Act (CLIA) approvals, and may also require approval of construction plans prior to beginning work. The relationship between tenant improvements and relocation and assignment and subleasing provisions in a lease should not be overlooked. In office leases, landlords commonly include a right to relocate tenants to other space in their building, and these rights often appear in healthcare leases that were adapted from office lease forms. Where a healthcare tenant is making extensive improvements, it should make sure any landlord relocation rights are deleted, as the cost of relocating and interference with patients would make relocation difficult. Further, leases often provide that if a tenant subleases its space, the landlord has the right to receive a portion of the tenant's profits if the sublease rent exceeds the lease rent. Where the tenant is investing in substantial tenant improvements for a space, it should make sure that the cost of these improvements is deducted from any sublease profit.

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