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Medical Leasing: Essential Aspects and Peculiarities

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MEDICAL LEASING: ESSENTIAL ASPECTS AND PECULIARITIES

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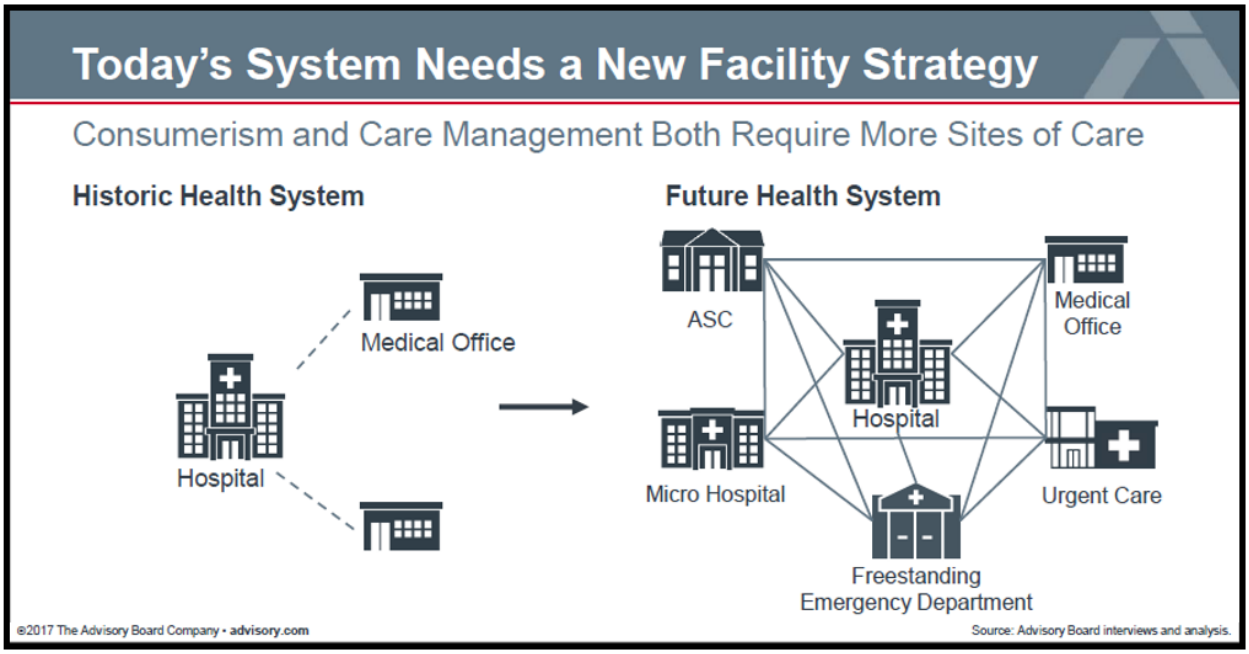
I. INTRODUCTION

As the health care industry evolves to satisfy ever-changing legislation and to ensure profitability for the health care providers in a time of increasing competition, health care real estate must continue to evolve to meet the needs of the health care providers. Hospitals, health care systems and medical providers seek to expand their brand and their ability to serve patients in convenient locations. Health care leasing options have greatly expanded – from traditional hospital campus and medical office buildings to suburban urban care facilities, ambulatory surgery centers, freestanding emergency rooms, and micro-hospitals.



[1]

So the question becomes: Where are these suburban urban care facilities, ambulatory surgery centers, freestanding emergency rooms, and micro-hospitals going to be located? The health care provider is repurposing grocery stores and other "big-box" retail, moving into corners of shopping malls, leasing space within freestanding general office buildings, and providing services from industrial sites.

Spaces previously reserved for typical retail uses or general office use are being leased and utilized for medical purposes. Unintended consequences and issues arise from the difference in the use. This paper will (i) discuss some of the peculiarities in medical or health care leasing,

[1] Presented by Abby Burns and Matt Pesesky, at Advisory Board, Facility Planning Forum, July 13, 2017

considerations that Landlords need to contemplate when leasing to health care providers, and (ii) how the lease documentation may need to be revised to reflect these considerations.

II. REGULATORY ISSUES

For the most part, the health care regulations affect leases to physicians or physician practices where the building is owned by a group of physicians or a hospital that is physician-owned. This is common for medical office buildings; however, a few of the regulations pertain to all medical-related leasing.

A. Stark Law

Stark Law (42 USCS § 1395nn; 42 C.F.R. § 411.35-411.389) applies to landlords which have an ownership structure consisting of physicians or medical providers. It prohibits physicians from making referrals for certain "designated health services" (including both inpatient and outpatient services, with very few exceptions) to entities which the physician has a financial relationship. Stark Law is intended to regulate referral payments, such as rental payments based on per-capita or per-procedure volume. Percentage rent could be prohibited based on Stark Law.

Stark Law is a strict liability law, where intent is not required for a violation. There are civil penalties for violation of Stark Law, such as: denial of payment from Medicare, Medicaid, patients or third-parties; repayment of any payment received; monetary penalties of up to $15,000 per service; monetary penalties of up to $100,000 for circumvention schemes (principal purpose of ensuring referrals to an entity in violation of the law); exclusion from participating in Medicare and Medicaid.

The statute provides for a Safe Harbor for Rental of Office Space (see 42 C.F.R. § 411.357(a)). This applies to the use of office space by a landlord to a tenant if the arrangement meets the following requirements:

1. The Lease arrangement is in writing, signed by the parties and specifies the Premises.
2. The term of the Lease is at least one (1) year. If the Lease is terminated (with or without cause), the parties may not enter into a new lease during the first year of the original term.
3. The Premises does not exceed that which is reasonable and necessary for the legitimate business purpose and is used exclusively by the tenant (i.e., not shared with landlord or its affiliates). This does not prohibit the tenant paying a portion of common area expenses so long as such payments do not exceed tenant's prorata share based on space leased by tenant to the total amount of leasable space in the building.
4. Rental charges over the term are set in advance and are consistent with fair market value.

5. Rentals are not determined: (i) in a manner that takes into account the volume or value of any referrals or other business generated; or (ii) using a formula based on (a) a percentage of revenue raised, earned, billed, collected or otherwise attributable to the services performed or generated in the office space or (b) per-unit of service rental charge, to the extent that such charges reflect services provided to patients referred by lessor to lessee. Be wary of percentage rent based on any method of calculation.

6. The Lease would be commercially reasonable even if no referrals were made between landlord and tenant.

7. If the Lease expires after a term of one year, a holdover satisfies the other requirements of the Safe Harbor if: (i) the Lease satisfied the conditions of the Safe Harbor when the Lease expired; (ii) the holdover is on the same terms and conditions as the immediately preceding arrangement [i.e. no holdover increase]; and (iii) the holdover continues to satisfy the Safe Harbor conditions.

Generally, leases by a hospital to a physician tenant must comply with Stark Law.

B. Anti-Kickback Statute

Anti-Kickback Statute (42 C.F.R. § 1320a-7b), also known as the Medicare and Medicaid Patient Program Protection Act of 1987, also applies to landlords which have an ownership structure consisting of physicians or medical providers. The Anti-Kickback Statute provides that it is a crime to knowingly solicit, offer or receive payment, gift or remuneration in exchange for referrals for services or goods that are reimbursable under Medicare, Medicaid or any other federal health care programs. Landlords need to be mindful of percentage rent or any other rents that vary with the number of patients or referrals. It is intended to force providers of health services which are reimbursable by governmental programs to consider the means and manner of payment.

As opposed to Stark Law, which is a strict liability statute, intent is required for a violation of the Anti-Kickback Statute; however penalties for violation of Anti-Kickback Statute include criminal penalties. Criminal penalties include fines up to $25,000 and a 5-year prison term per kickback; and civil penalties can cost as much as $50,000 per kickback, in addition to three times the amount of damages sustained by the government. In addition, the penalty can be exclusion from federal health care programs.

Like Stark Law, the statute provides for a Safe Harbor (Rental Safe Harbor) (see 42 C.F.R. § 1001.952(b)). There is no violation for a payment made by a tenant to a landlord for the use of space, as long as all of the following are met:

1. The Lease agreement is in writing and signed by the parties.

2. The Lease covers all of the Premises leased between the parties for the term of the Lease and specifies the Premises covered by the Lease.

3. If the Lease is intended to provide the tenant with access to the Premises for certain periodic intervals of time, rather than on a full-time basis for the term of the Lease, the Lease must specify exactly the schedule of such intervals, their precise length and the exact rental for such intervals. This is important for timeshare leases, and the physician tenants need to be careful of working (using the Premises) at times other than those specified in the Lease.

4. Term of the Lease is for not less than one (1) year.

5. The aggregate rental charge is set in advance, is consistent with fair market value in arms-length transactions, and is not determined in a manner that takes into account the volume or value of any referrals or business otherwise generated between the parties for which payment may be made in whole or in part under Medicare, Medicaid or other federal health care programs. Fair Market Value is defined as the value of the rental property for general commercial purposes but shall not be adjusted to reflect the additional value that one party would attribute to the property as a result of its proximity or convenience to sources of referrals or business otherwise generated for which payment would be made in whole or in part under Medicare, Medicaid or other federal health care programs.

6. The aggregate space rented does not exceed that which is reasonably necessary to accomplish the commercially reasonable business purpose.

Generally, leases by a hospital to a physician tenant must comply with Anti-Kickback regulations.

Many of the Safe Harbor requirements for Stark Law and Anti-Kickback Statute are similar; however there are some differences. The chart attached as Exhibit A sets forth what is required to meet each of the Safe Harbors.

C. HIPAA

The Health Insurance Portability and Accounting Act of 1996 provides safeguards as to the confidentiality of protected health information. With respect to leasing space, it is important to note that tenants which are health care providers will be obligated to comply with HIPAA, which means that the tenant may require that landlord's access to the Premises is limited as to certain areas where records are maintained. Consider permitted access so long as a representative of tenant is present to ensure that the tenant is complying with HIPAA. In addition, the landlord may need to educate its staff regarding the limitation on entry and what areas of the Premises landlord's employees are permitted to enter and during what times.

D. Affordable Care Act

Patient Protection and Affordable Care Act of 2010 requires greater efficiencies in the health care sector. This statute does not directly affect medical leasing, but it is one of the reasons

that health care providers are moving into suburbs and other locations to provide more efficient and more effective patient care.

III. FACILITY CHANGES AND CONSTRUCTION ISSUES

A. Tenant Improvements; HVAC and MEP Capacity

Health care tenants in retail spaces may have more expensive tenant improvement requirements. For example, they may need to reinforce walls or floors for equipment weight or protections for radiation and magnetization from X-Rays, MRI Machines, CT Scanners, etc. Health care tenants may require additional HVAC and MEP capacity. For example, a stand-alone emergency center or urgent care facility may be opened 24 hours a day, requiring air-conditioning and heating during hours which are not "normal business hours." Medical equipment may require additional electricity; and medical office space may contain sinks in multiple patient care rooms, which would require plumbing to be supplied in more areas throughout the Premises.

Because of these more robust construction requirements, the tenant may request more tenant improvement allowance than a typical retail tenant whose tenant improvements requirements are limited to painting, new flooring, and some other minor alterations. If the landlord agrees to a larger tenant allowance, the landlord may want to increase the term of the Lease to allow for a longer period of time to amortize the costs of the improvements. Health care tenants will want to use their own architect and contractor, instead of landlord's, because Tenant's design professionals and contractor are familiar with the nuances of medical improvements and construction. In addition, the Lease should cover whether the landlord or tenant will own the tenant improvements at the expiration of the term of the Lease. This is discussed in more detail in the "Surrender" section below.

B. Zoning; Parking; and ADA Compliance

As we know, the City of Houston does not have zoning regulations; however other cities do have zoning and Houston has other ordinances and use restrictions/recorded restrictive covenants which may affect whether medical use is permitted in the retail center or office building. City of Houston Ordinance Chapter 3, together with the Texas Alcohol and Beverage Commission, restrict the proximity of dealers of alcohol and public hospitals to no less than 300 feet between the dealer and the hospital. Keep this in mind when leasing space to any emergency departments, urgent care facilities or micro-hospitals that are associated with a public hospital within the same shopping center as restaurants, bars, liquor stores, or grocery stores that sell beer and wine.

Parking for clinics will likely not be a concern for a retail center because, in Houston, clinics require 3.5 parking spaces per 1,000 gross square feet and general retail requires 4.0 parking spaces per 1,000 gross square feet. Hospitals, however, require 2.2 parking spaces per bed. (See Chapter 26 of the City of Houston Code of Ordinances). Texas Accessibility Standards requires more accessible parking (handicap spaces) for hospitals, rehabilitation facilities that specialize in treating mobility-related conditions, and out-patient physical therapy centers. General retail requires approximately 1-2% of all parking spaces be accessible, with one out of every eight accessible spaces being for van accessibility; however,

hospitals require that 10% of all patient/visitor spaces be accessible, with one of every six accessible spaces being van accessible, and rehabilitation facilities that specialize in treating mobility-related conditions and out-patient physical therapy centers require that 20% of all patient/visitor spaces be accessible, with one of every six accessible spaces being van accessible.

A health care tenant will be more concerned with compliance with the physical requirements of the Americans with Disabilities Act because many of their patrons will have special needs for mobility issues. In addition, medical providers are more likely to receive scrutiny from the ADA compliance officers.

C. Relocation Clauses

Because the tenant improvements are more extensive and more costly than the typical retail tenant's tenant improvements, a medical tenant will not want the landlord to have a right to relocate their premises within the shopping center. It would also be expensive for the landlord to relocate the tenant because the landlord would be obligated to pay for those tenant improvements within the relocated space. If the landlord is not willing to delete the relocation provision, a medical tenant should make sure that the provision requires landlord to pay all costs of relocation, including construction, build-out, and relocation of furnishings and equipment, plus be responsible for the interruption in tenant's business operations (down-time). Keep in mind that if the landlord is physician-owned, relocating a tenant could make the Lease fail to meet the Safe Harbor criteria of Stark Law and Anti-Kickback Statute (i.e. requirement that the Lease specify the premises).

IV. PERMITTED USE ISSUES AFFECTING THE LEASE

A. Exclusive Uses

Exclusive use provisions provide for the right of one tenant to require that the landlord not lease another space in the shopping center or office building to another tenant which uses its space for the same use as the original tenant. In the case of medical or health care use, the tenant of an urgent care center, for example, would not want another medical use (such as a freestanding emergency department) within the shopping center because that other tenant could take away potential patients.

In addition, when leasing space as a health care tenant or as a landlord to a health care tenant, carefully review the exclusive use rights of other tenants in the shopping center to ensure that the medical use is permitted. Some of these prohibited uses may not be a blatant prohibition on medical use. As an example, the existing tenant may be a pharmacy, such as CVS or Walgreens, that has the exclusive use for medical clinics. Also, exclusive use rights may prohibit some of the ancillary uses of the primary medical use. For example, pharmacies, gift shops, or cafés may be prohibited by another tenant's exclusive use rights.

B. Radius Restrictions

A radius restriction prohibits either (1) the tenant from operating another space within a certain radius distance for the same use as the premises within the existing shopping center or

(2) the landlord from leasing space in property owned by landlord within a certain radius distance for the same use as the tenant. The restriction on landlord basically expands an exclusive use right into other shopping centers owned by landlord.

A health care tenant may want to require that the landlord does not lease space within a certain radius to a tenant of the same use or to specific health care providers. Note that this only applies to property owned by the specific *landlord entity*. Consider making sure it applies to landlord and its affiliates. A landlord leasing space to a health care tenant may want to require that the tenant not build another facility within a certain radius in order to prevent competition with the facility in the applicable shopping center. This may be less important to the landlord if no portion of the rent is percentage rent.

C. Prohibited Uses

The landlord may have standard prohibited uses in all of its leases for a specific center. In addition, restrictive covenants or reciprocal easement agreements may define certain uses as prohibited in the shopping center. These could expressly prohibit "medical use." In addition, there may be other, more obscure uses that are prohibited that may prevent or limit the use within the health care facility. Look for uses such as: (i) massage parlors, which could prevent some physical therapy or chiropractic services; or (ii) drug sales or distribution, which could prevent the health care tenant from having a pharmacy or otherwise distributing or administering prescription drugs to their patients.

D. Religious Considerations/Directives

Many hospital systems and health care providers are owned by non-profit religious entities, which require that the physicians and clinics comply with certain faith-based directives. These may affect both the landlord and the tenant in medical office buildings or other facilities that are related to such religion-based hospital systems. Physicians practicing in a medical office building on a campus of a religion-based hospital system may be prohibited from performing certain types of medical procedures; and landlord of those buildings may be prohibited from leasing space to tenants who would perform such procedures. In a retail setting, a tenant owned by a religion-based hospital system may require that the landlord of the shopping center add certain prohibited uses to the list of prohibited uses related to the remainder of the shopping center.

E. Utility Usage; Hours of Operations

As discussed above, health care tenants may need more utility capacity than a typical retail or office tenant. Medical tenants use more water for hand-washing, more electricity to operate the medical machinery, such as MRI and X-Ray machines, more HVAC to property cool such equipment. The Lease Agreement needs to take into account this additional utility usage and either charge tenant more for its usage or separately meter the tenant's premises so that tenant pays for its own use. The landlord should consider whether sufficient utility capacity is available prior to leasing space to the health care provider.

Many facilities will be open longer than the average retail tenant. Freestanding emergency rooms and urgent care centers may be open twenty-four hours a day. The Lease needs to provide for the additional hours and require landlord to operate the shopping center during such times, such as providing utilities after-hours and keeping the parking areas lit overnight. The Lease should also allocate the cost of an outage or cessation of utility service. This is especially important for emergency care facilities. During letter of intent and lease negotiation, landlords and tenants need to discuss which party will be responsible in the event of utility service cessation and whether one the parties should provide a generator for the premises.

F. Medical Office Buildings

In addition to the possibility of compliance with faith-based directives, leasing of medical office buildings usually need to comply with other use requirements of the host hospital system. Many systems require that any physicians leasing in the MOB or practicing medicine in the MOB be in good standing with the hospital and have rights to practice within the hospital. The systems also prohibit the physicians from performing certain procedures, including diagnostic testing, which may compete with the hospitals. Owners of the MOBs will be required to include these use prohibitions and limitations in their leases. For example, many hospitals do not permit surgery, MRI testing, CT scans, or ob/gyn procedures within the MOB. Patients, instead, will need to obtain those services from the hospital.

V. PERSONAL PROPERTY LIENS

Most retail lease forms contain a provision granting the landlord a lien against all personal property located within the Premises. In the realm of health care and medical leasing, a lien against the tenant's personal property can be very fruitful for the landlord if the tenant defaults under the Lease because tenant's personal property may include expensive medical equipment. Sophisticated tenants will request a waiver of this lien, including landlord's contractual lien, statutory lien rights, and constitutional lien rights.

Much of the large medical equipment may not be owned by the tenant, however; therefore, the lien may not be as fruitful as the landlord may think. Health care providers will lease some of the large equipment, which means that the lessor of the equipment will have superior rights to landlord. In addition, if a tenant intends to finance any equipment, its lender will request a subordination of landlord's lien so that the lender's lien rights are superior to landlord's rights to that equipment. Most landlords will agree to the subordination but will require the lender to agree to certain restrictions regarding removal of the equipment and entry into the Premises.

VI. SURRENDER

As discussed, tenant improvements for health care tenants may be more extensive and more costly than the typical retail tenant. A health care tenant may want to negotiate with the landlord before the improvements are made to permit tenant to remove the improvements at the expiration of the term and surrender of the premises. Landlord may permit this but will want the tenant to agree to certain restrictions on time of removal or method of removal and

will want the tenant to fix or pay for any damage caused by such removal. On the other hand, the landlord may want the tenant to remove its improvements so that the landlord has a vacant space that is ready to be leased to many types of tenants and not just medical tenants. Landlord and tenant should agree at the time of construction on the ownership rights of the improvements and the removal obligations and limitations.

VII. TERMINATION RIGHTS

Physician tenants within medical office buildings will want to negotiate for termination of the Lease upon death or disability of the physician or, with respect to a group of physicians, certain physicians within the group. If the landlord agrees to a termination right, consider fair market value determinations when considering termination fees, and keep in mind regulatory and legal compliance. Most landlords will resist termination for death or disability because the tenant's insurance should cover the rental payments under the Lease in such an event.

VIII. HAZARDOUS MATERIALS AND MEDICAL WASTE

The Lease Agreement needs to include a provision that requires medical tenants to comply with all Occupational Safety and Health Administration (OSHA) regarding the handling and disposal of medical waste. In addition, the medical tenant may need to educate the landlord and its employees and property manager regarding how to handle such disposal, and landlord may need to make alterations or improvements to its waste-disposal procedures and trash areas.

IX. SUBLEASE ISSUES; TIME-SHARES

A. Subleases

There may be opportunities for medical tenants to sublease space within a shopping center or office building, such as subleasing from a "big-box" retailer like a grocery store, pharmacy space, or large discount retailer. Below are some important issues to consider with subleasing:

1. The Sublease is always subject to the Prime Lease. Thus, if the Prime Lease is terminated, the Sublease will be as well.
2. If the Prime Lease contains restrictions on use, the space may not be usable for the intended medical use.
3. There may be issues regarding access rights, surrender and removal, and lien rights. As discussed above, these provisions should be matters that are negotiated in connection with medical use but may not have been negotiated in the Prime Lease.
4. Try to obtain a Recognition Agreement from the prime landlord.

B. Time Shares

Time shares are office-sharing arrangements, where a physician works at a certain office only part-time or on certain days. This is becoming more and more prevalent, especially with large

practice groups with multiple offices. Keep in mind the Anti-Kickback Statutory Safe Harbor requirement that the Lease Agreement must specify the exact times and dates of use. A physician can counteract the Safe Harbor compliance by merely coming to the office early or leaving late. Physician practices that have time-share arrangements have come under scrutiny by Medicare and Medicaid; therefore, any time-share arrangements need to be drafted carefully and strictly enforced.

X. RETAIL LEASE BY HOSPITALS (AS LANDLORD)

As "retailization" of the health care industry evolves and expands, patients and other users (medical staff, employees, physicians, etc.) are demanding more retail spaces within the hospital facilities and within medical office buildings. The trend is for a "one-stop-shop". Users want to be able to visit a friend in the hospital, buy a gift, have a snack, and fill a prescription, without leaving the campus of the hospital; and physicians and medical staff want to be able to buy coffee, breakfast, or lunch, workout, buy sundries, and get their dry-cleaning done. at the place of their work. Thus, the hospital system or medical office building developers are acting as landlords in order to provide these retail conveniences to their users. It is MOB developers' typical business to lease space, but a hospital's main mission is to provide health care to the community, not lease retail space. When a hospital system becomes a landlord, it becomes, in essence (and in part), a real estate developer. Hospital systems need to keep in mind most of the issues discussed above, as most apply to retail leases within hospitals and MOBs. In particular, with respect to any hospital system which is owned (in whole or in part) by physicians, the regulations of Stark Law and Anti-Kickback Statute become critical.

EXHIBIT A

CHART OF SAFE HARBORS UNDER STARK LAW AND ANTI-KICKBACK

Safe Harbor Requirement	Stark Law	Anti-Kickback Statute
Lease is in writing, signed by the parties	✓	✓
Lease specifies the Premise it covers	✓	✓
If the Lease is for periodic intervals, the Lease must specify the exact schedule		✓
Duration is at least one year	✓	✓
If the Lease is terminated, the parties may not enter into another Lease for one year	✓	
Space does not exceed that which is reasonable and necessary	✓	✓
Space is used exclusively by the lessee	✓	
Rental charges are set in advance and consistent with fair market value	✓	✓
Rental is not determined in a manner which takes into account the volume or value of referrals or using a formula based on the percentage of revenue earned, or per-unit of service	✓	✓
Lease arrangement would be commercially reasonable even if no referrals were made between Landlord and Tenant	✓	
Restrictions on holdover – must satisfy the statute prior to and after the expiration of the Lease and is on the same terms and conditions (no rent increases)	✓	