Medical Facility Leasing (Including Ground Leases and Medical Space Leases)

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I. Introduction

Historically, commercial real estate has been divided into four major asset classes: office, industrial, retail and multi-family. However, during the past couple of decades, healthcare real estate has evolved into a major real estate asset class of its own. In fact, the healthcare real estate market is already larger than the industrial market and now rivals the retail real estate market in sheer size and scope. While many have viewed this new asset class narrowly as comprised of only medical office buildings ("MOB's"), the healthcare real estate asset class is actually much broader, including many different types of facilities along the so-called "continuum of care" (such as, for example, wellness/fitness centers, community clinics, ambulatory surgery centers, rehabilitation hospitals, long-term acute care hospitals, assisted living facilities and the like).

A developing trend among hospitals, health systems and other healthcare providers is the outsourcing of the real estate ownership and management of healthcare facilities, which allows the providers to free up capital resources for use toward their core mission. This trend has attracted the interest of traditional real estate developers and has spurred the creation of many healthcare real estate specific developers and investors. A natural result of this trend is a proliferation of healthcare real estate transactions in general and leases in particular. Because healthcare continues to be one of the fastest growing sectors of our economy, the continued growth in outpatient delivery of healthcare services (and the need for capital by the providers of these services) will continue to drive massive real estate development and investment in the healthcare sector.

Another emerging trend has medical uses now showing up in historically non-medical environments (e.g. retail shopping centers and mixed-use developments). This can create issues not only for the provider tenant, but also for the landlord and other non-medical tenants in the development. As a result, any real estate or health care attorney will benefit from understanding how medical use leases differ from traditional office, industrial or retail leases.

The future remains bright for real estate professionals in the healthcare industry, since healthcare spending is expected to reach 20% of the United States gross domestic product by the year 2015. For those able to navigate the pitfalls, medical facility development and leasing can provide opportunities, even in difficult economic times. This webinar is intended as an introduction to medical facility lease transactions, with particular emphasis being placed on ground leases from hospitals or hospital systems to third party developers/investors and space leases in MOB's and other facilities involving medical uses.

II. Issues Affecting Healthcare Leases

A. Who are the players (provider vs. developer/investor)?

1. Provider:

   a. Historically, the provider side of this equation has been the individual physician or physician group

   b. More recently, the hospitals and the systems are taking a larger share of occupancy primarily due to (i) physician employment and (ii) master lease structures.

2. Developer/Investor: The nature of the developer/investor will vary based on product type, location and hospital/system sponsorship.

   a. Large Market/On-Campus/Hospital Sponsored – Healthcare REIT
   b. Small Market/Off-Campus/Unsponsored – Local investor

B. What are their motivations (profit vs. convenience/utility)?

1. Provider:

   a. Physician Alignment
   b. Convenience
   c. Control
   d. Flexibility
   e. Historically not profit driven

2. Developer/Investor:

   a. Profit
   b. Stability
   c. Capital – through physician investment

C. What is the environment (on campus vs. off campus, office vs. retail, etc.)?

D. Regulatory Issues (a very basic primer on Stark and Anti-Kickback issues)

III. Healthcare Industry Trends Affecting Leasing – Population Health Management

A. Third Party Ownership. Pressures on profitability and the demand for capital are driving some healthcare systems and hospitals to look at third party ownership (whether through third party development of new facilities or monetizing existing real estate assets) at an accelerated rate.

1. Advantages to Third Party Ownership.

   a. The redeployment of capital to core business uses
   b. The reduction of on balance sheet debt and depreciation on income statement
   c. The elimination of real estate risk from the hospital's financial statement
   d. The reduction of risk of non-compliance with certain regulatory issues (fraud & abuse laws)
   e. The addition of expert management and development from real estate professionals
   f. The opportunity for the hospitals/systems physicians to invest in real estate

2. Forms of Third Party Ownership.

   a. Direct Sale
      (i) Monetization
      (ii) Sale-Leaseback
      (iii) Ground Lease
   b. Joint Venture with Investor
   c. Physician Ownership

B. **Vertical Integration**. Community Based Healthcare shifts the delivery of healthcare services from the central hospital campus to the community where the patients reside.

1. Driven by healthcare reform/population health management
2. Relieves stress on emergency rooms
3. Changing paradigm for healthcare delivery – See Blockbuster or Borders

C. **Declining Reimbursement Rates from Medicare, Medicaid and Private Insurance**

1. Forcing providers to be more efficient
2. Forcing providers to look at allocation of space

D. **Evolution of Medical Technology and Procedures**

1. Allows more to be done in an out-patient environment
2. May change space requirements

E. **Physician Employment by Hospitals**

1. Making hospitals/systems larger tenants in buildings
2. Positive impact on credit profile of building
3. Creating "orphaned" real estate

F. Aging Facilities

IV. Types of Medical Leases

A. Ground Leases

1. Structure. The use of a ground lease can be an effective way to structure a medical real estate transaction to accomplish the parties' goals and objectives. For example, if a hospital desires to have a third party developer develop a new MOB on the hospital campus, the hospital may ground lease the land to the developer so that the hospital retains ownership of the underlying real estate as ground lessor.

   The most critical benefit of a ground lease for property owned by healthcare systems or hospitals within a campus is that the ground lease allows those entities to maintain control over the operation of the campus. Through the ground lease document, the ground lessor can ensure uniform, consistent operation of the campus.

2. Integration.

   a. Systems Integration. Ground leases on hospital campuses should also address considerations for integration of security, health and life safety systems among various buildings and properties on campus.

   b. Physical Integration. Additionally, there may be physical integration issues to consider in a ground leased property; rights and obligations regarding shared walls and skybridges between hospital-owned buildings and ground leased properties can be complex and must be carefully delineated, potentially through an additional agreement.

   c. Central Plant Integration. Finally, large, closely-integrated campuses can have additional shared facilities plants managing distribution of chilled water and the like which should also be addressed, either in the ground lease or an additional agreement.

3. Revenue Generation. A ground lease can help to generate new capital for future projects and capital expenditures such as facility repairs and improvements.

4. Cost Savings. Because the operations cost of owning and managing real estate can be significant, a ground lessor can realize substantial savings in both time and manpower, and can carefully select its ground lessee on the basis of its expertise in either development of medical facilities or in management of such facilities.

5. Assistance with Regulatory Issues. Ground leases can also provide lessors with a greater ability to avoid the regulatory pitfalls detailed above regarding the Stark and Anti-Kickback Laws.

6. Reversionary Interest. In most cases, ownership of the improvements on the land revert to the ground lessor at the end of the term as well, often at little or no additional cost to the ground lessor.

7. Hospital Control Features

   a. Right of First Refusal. A right of first refusal on space within the building or the entire building if the improvements are sold, enabling the ground lessor to access additional space and ensure assets aren't sold to third parties;

   b. Leasing Restrictions. Requirements that ground lessee and its tenants, if any, comply with campus and/or hospital rules, including restrictions on certain services and requirements that leasing physicians be non-competing and/or have staff privileges;

   c. Limitations on Transfer. Requirement that the manager engaged by ground lessee is satisfactory to ground lessor, possibly including a minimum holding period requirement for the owner or manager and limitations on transfer to only pre-qualified transferees;

      Example:

      (i) For first ___ years, buyer must be private or public REIT of a specified size with a health care focus, and development capability.

      (ii) After ___ years, buyer must have substantial experience in ownership and operation of comparable MOBs.

      (iii) Sale cannot be to a competitor of Hospital System.

      (iv) Change in control transactions not prohibited; however, Hospital System has right to repurchase at fair market value if it occurs within first 5 years.

      (v) Notice to Hospital System before MOB Owner intends to market MOB for sale; Right of first offer/right of first refusal on sale.

      (vi) Properties on a Campus must be owned by same entity (or its affiliates)

d. Cure Rights. rights to cure defaults on behalf of ground lessee.

e. Parking

(i) Hospital maintains ownership and control over all parking via recorded Parking Agreement.
(ii) Centralized and coordinated parking scheme for campus.

f. Use Restrictions.

(i) Must be medical use
(ii) May not compete with procedures offered by the hospital

g. Exclusivity of Relationship Between Hospital System and MOB Owner (Optional)

(i) MOB Owner given first right to negotiate for development of additional Hospital System MOBs or sale of additional MOBs during first ___ years.

(ii) During first ___ Years, MOB Owner will not acquire, own, develop or manage any healthcare property in Hospital System service region (except with Hospital System) (Purchaser's existing properties are grandfathered).

h. Lender Issues. Future MOB Owner mortgage financing requires entering into tri-party agreement with Hospital System (cash purchase); Hospital System has approval rights over Lender if not an Institutional Lender.

i. Maintenance. MOB maintenance standard (comparable MOBs; consistent with hospital accreditation organization requirements) – generally set forth in MOE Agreement.

j. Alterations. Hospital System approval required for alterations (exterior; affect campus systems).

k. Conclusion. Ground leases can have significant benefits, especially for healthcare systems and hospitals within an integrated campus structure. Campus considerations can also cause some issues, however, so the pros and cons of implementing ground leases should be considered carefully. In either case, a ground lease enables the ground lessor to retain ultimate ownership of the land subject to the lease and to generate revenue through lease payments on the land.

B. Medical Office Buildings

One of the largest shifts in healthcare over the past several years has been from in-patient treatment at hospitals to outpatient facilities located in MOB's or other healthcare specialty facilities (such as ambulatory surgery centers). MOBs are attractive to investors because the leases are typically long term (although that is changing), with stable tenants and very little turnover. Space leases in MOBs have traditionally been structured as gross leases (similar to typical office leases), but a trend has developed toward structuring MOB space leases as triple net leases.

There are a variety of issues that developers or investors should be aware of when evaluating an existing MOB or MOB design, and that potential tenants should look for and take into account when evaluating an MOB. Construction costs for MOBs can be twice as expensive as conventional office buildings. Some of the factors contributing to that increased cost are greater parking requirements (e.g., 5 spaces/1,000sf for medical office vs. 2-3 spaces/1,000sf for general office); higher plumbing costs (sinks with hot/cold water in nearly every room); need for thicker walls and/or floors (x-ray, increased wiring and air circulation needs, heavy equipment such as MRIs). Potential tenants should evaluate the existence or lack of these features in evaluating potential office space.

Many physicians and physician groups have been active in investing in ownership opportunities in MOBs as a means to supplement their practice incomes. As mentioned above, it is critical to evaluate the Stark and Anti-Kickback Laws before entering into any new medical leases or MOB investment opportunities. Some specific facilities – such as ambulatory surgery centers – are, for the time being, specifically carved out in the exceptions and safe harbors to these laws. However, given the rapid evolution of the law in this area, regular contact with an attorney knowledgeable regarding these issues is a wise approach.

C. Retail Centers

Another fast growing trend in medical real estate is the presence of medical facilities and offices in retail shopping centers. Such centers have long been home to eye doctors and dentists, but a wider variety of medical users – such as urgent care facilities and imaging centers - are now locating in these centers, and they require some careful planning and creative thinking to accommodate. First and foremost, landlords of retail centers may not be accustomed to medical tenants, so communication and education regarding the potential issues and needs related to these tenants is critical. Likewise, medical tenants will need to understand and appreciate some unique aspects of retail center leasing that they may not have encountered in the past. A standard landlord form lease will likely not contemplate many of the issues that medical tenants raise, many of which issues will be discussed in Article V below. In addition, many retail landlords should expect to encounter resistance from traditional retail tenants related to the leasing of retail space to medical use tenants. Issues related to parking and tenant mix, in particular, are likely to be raised.

D. Medical Office Condominiums

As physicians continue to see their income stream limited by government regulations and insurance companies, they will likewise continue to look for alternative sources of revenue and cost cutting measures. In recent years, owning a medical office condominium has become a viable alternative for physicians and physician groups to leasing space in an MOB. While such condominium structures can be complex and expensive to set up, they should nevertheless be evaluated during the structuring phase of the transaction, as they may best address the objectives of the parties involved. For example, a condominium structure can be combined with an underlying ground lease to provide the ground lessor with the same control mechanism mentioned earlier, while still enabling physicians and practices to own real estate interests – potentially tying them more closely to the ground lessor hospital or healthcare system.

V. Unique Issues in Medical Leases

A. Operational Cooperation – Campus Lease

1. Impossible to anticipate all issues
2. Essentially – good faith and fair dealings

B. Naming Rights

1. Significant source of revenue
2. Landlord may not have control (may be controlled by hospital through the ground lease)

C. Special Medical Related Prohibited Uses

1. If the hospital sponsor is a faith-based organization, it may impose restrictions related to elective abortions or stem cell harvesting, etc.
2. Limited leasing to physicians that have staff privileges
   a. What happens if privileges are lost?
3. May limit to "medical use" only a carve out for restaurants and pharmacies, etc.
4. May preclude leasing to tenants who appear on the government list of parties excluded from Federal Procurement Programs (such as Medicaid and Medicare)
5. All of these allow the hospital to control occupancy of buildings located on its campus

D. Exclusive Use for Specialties

1. Similar to Retail scenario
2. Tenant mix is important
3. Limits competition and encourages general practice doctors to refer patients to that tenant

E. Parking

1. Ego issue for doctors
2. Control issue for hospital

F. Hospital Controls on Tenant Construction and Maintenance

1. Integration of campus-wide systems
2. Health care accreditation issues

G. Hospital Closure

1. Tenant should require control issues to become null and void if hospital closes
2. At that point, all bets are off

VI. Applicability of Standard Office Lease Provisions to Medical Uses

Many standard lease provisions can create unique challenges when applied in a medical office context. Therefore, landlords and tenants should carefully consider the nature of the tenancy when negotiating the standard lease form. This section will analyze the applicability of certain standard lease provisions to medical use leases.

A. Compliance with Laws/Americans with Disabilities Act (ADA)

Patients visiting medical facilities are more likely than the general public to have special needs relating to accessibility. For those same reasons, medical facilities may be subject to increased scrutiny regarding compliance with laws in general and the Americans with Disabilities Act and state accessibility laws in particular. Landlords and tenants should, accordingly, pay special attention to the compliance with laws provisions of the medical facility lease. A variety of improvements to the premises and building may be required, especially when incorporating a medical office use into a retail or standard office building, including accessible restrooms, ramps, parking spaces, drinking fountains, as well as devices designed to assist vision-impaired individuals. The landlord should ensure that the lease contains explicit language requiring the tenant to be responsible for construction and maintenance of its individual premises in accordance with ADA and any state-specific requirements. The tenant will want to ensure that the lease provides that it is the landlord's responsibility to perform all required accessibility work to the common areas (and preferably, not charge such costs back to the tenant as a common area maintenance charge), but landlords will often argue that if the improvements are required solely because of tenant's use as a medical facility, this cost should be borne by tenant. A landlord will want to make sure that its buildings or centers are ADA compliant and that any tenant improvements are designed and constructed by parties knowledgeable regarding the most up-to-date ADA and corresponding state requirements. The landlord may require its tenant to use an accessibility consultant which is familiar with the building in the process of preparing its tenant improvement plans to ensure that any necessary accessibility improvements are properly identified. See Appendix 1 for a sample provision. Accessibility laws allow for interpretations to be made and a landlord often desires for its tenants to utilize a landlord-designated

accessibility consultant who is familiar with the building to ensure consistent interpretations of accessibility guidelines are made from lease to lease.

In addition, the landlord will want to include a provision requiring that the tenant and all services provided by the tenant be conducted in compliance with all applicable laws and regulations. See Appendix 2 for a sample provision.

B. Confidentiality and Records Security

HIPAA and other federal and state laws regulating confidentiality of medical records and personal health data may necessitate modifications to some typical clauses in many standard office leases. Particularly, a medical tenant will want to limit access to areas of the premises that may contain patient records or computer systems with access to such records. Standard office leases typically provide for unlimited landlord access to the premises for janitorial or repair/alteration work – these access provisions should be adapted to satisfy any patient record confidentiality requirements. In addition, these confidentiality requirements should be a consideration in a landlord's exercise of particular remedies – such as the right to enter the premises and remove personal property in the event of a tenant default. A landlord should be especially careful, if locking a medical tenant out of its premises, that the landlord makes special provisions regarding patient records. The landlord may even consider requiring the tenant to provide extra locks or security for record storage areas, in order to defend against possible claims of confidentiality violations from the tenant or its patients. Finally, a tenant may want to negotiate to provide its own janitorial service, and a corresponding reduction in its liability to pay common area maintenance expenses for janitorial services, out of a concern for patient records confidentiality.

C. Medical and/or Hazardous Waste Usage and Disposal

Medical tenants frequently utilize materials and generate waste (such as immunotherapy and chemotherapy agents, biological specimens, and the like) which require appropriate disposal to comply with applicable federal and state environmental and waste disposal laws. Therefore, absolute prohibitions on the utilization of such materials in the lease is not appropriate, although this is often the approach taken in a landlord's form office lease. Medical tenants will want to have Material Safety Data Sheets ("MSDS") for any hazardous materials ready and available for pre-approval by landlords. A landlord's form lease should expand the hazardous materials section to address the appropriate handling and disposal of medical and biological waste, including any necessary registration and reporting requirements, and indemnification responsibilities related thereto. Such disposal may be part of the basic services provided by the landlord. Additionally, federal law requires disclosure by tenant of any radioactive materials used in the premises. A sample hazardous material provision which addresses medical and biological waste is included in Appendix 3.

D. Relocation Provisions

Many landlord form office leases provide that the landlord has the right to move a tenant to a comparable alternative premises during the term of the lease. The tenant will have likely expended a significant amount of its own funds to finish out its space and will want to ensure

that it does not lose this value. If the landlord will not agree to delete the relocation provision, the medical tenant will want to ensure that any substitute premises will be finished to the same level as the existing premises at the landlord's expense, that the landlord will pay for the moving and installation of the tenant's equipment in the new premises and that the tenant will not be required to close during this process. It is also not unusual for the landlord to reimburse the tenant for other expenses related to the move, such as new business cards and stationery for the tenant.

E. Right of Entry

As mentioned above, typical landlord form office leases contain broad rights, often without prior notice, to enter the premises to conduct inspections, make repairs or show space to potential purchasers or subsequent tenants. Tenants with on-site records storage should negotiate limited access to those areas to preserve confidentiality of patient records. In addition to the typical tenant request that any landlord access not unreasonably interfere with the tenant's business operations, any landlord access should also take into account that patient care is being provided in the premises and thus limit access to exam rooms during operating hours. The parties may want to designate open, private or supervised visitation areas on the floor plans from the outset to help minimize conflict. See Appendix 4 for a sample provision.

F. Utilities/Supplemental Air Conditioning

Medical tenants often have higher utility usage than standard office tenants because many such tenants have sinks in each examining room and operate X-ray, MRI and other equipment that utilize more electricity than standard office equipment. Such equipment sometimes necessitates supplemental air conditioning equipment to maintain the desired temperature in the premises. Landlords will want to retain flexibility in the lease to separately meter the premises in order to charge tenants equitably if there are significant variations in utility usage among the tenant base. The landlord will also want controls over the type and amount of equipment installed in the premises so that any necessary supplemental air conditioning or other equipment is properly identified and installed.

From the tenant's perspective, a typical landlord lease form may cause significant uncertainty related to utility usage. Provisions that limit electrical consumption to a certain number of watts per square foot or to that of a typical office tenant may not be sufficient. The medical tenant should provide the landlord with the specifications of its planned equipment in the premises and obtain confirmation from the landlord that the building design and the lease document allows for the electrical usage demand of such equipment. Additionally, the medical office tenant will need to ensure that any supplemental air conditioning needs are addressed in the tenant improvement plans and that any landlord approvals required by the lease are obtained prior to entering into the lease.

G. Landlord Remedies

Medical tenants often have a significant amount of expensive equipment located on the premises which are essential to the physician's daily practice. Therefore, the tenant will want to ensure that any landlord remedy contained in the lease or effective by state statute, granting the

landlord a lien or security interest in the tenant's personal property, is waived or subordinated to any lien rights of a tenant lender providing financing for such equipment. The medical tenant will also want the lease to expressly set forth the parties' intent that any such equipment remain the personal property of tenant, rather than become part of the real property as a fixture. An example of language carving out "special equipment" from a landlord's lien is included in Appendix 5.

Another problematic landlord remedy in a medical office lease is the lockout remedy, which can substantially interfere with the tenant's ability to provide essential medical services and access necessary medical records. Therefore, the landlord would be well advised to consider the potential adverse consequences before exercising this right, not only because of patient care concerns, but also due to the potential damage claim for unlawful exercise.

H. Use; Prohibited Use; and Operating Hours Provisions

A landlord will want to tightly draft the medical lease use clause in order to control tenant mix. The tenant will want to ensure that the use clause allows for broad medical use, or if not, for its specific use as well as for any ancillary services it provides. The broader the use allowed, the more flexibility the tenant has to sublease the premises or assign the lease.

In addition, standard "prohibited uses," "noxious uses" and rules and regulations in a typical landlord's form office or retail lease can be inconsistent with the operations of a medical office tenant; therefore, these provisions should be carefully reviewed and any issues specifically addressed in the lease negotiation process. In fact, many retail lease prohibited uses contain an outright prohibition on certain medical uses. In such event, the tenant should require the landlord to obtain any necessary waivers from other tenants or owners which have imposed such restrictions in order to allow for the proposed medical tenant's use and operation. A landlord will also want to ensure that the tenant's medical equipment does not interfere with communication equipment of other tenants in the building. See Appendix 6 for a sample provision addressing this issue.

In a retail setting, the landlord's form lease provision regarding operating hours may not line up with the operating hours of certain medical tenants. In such cases, the parties will want to address a medical tenant's hours of operation explicitly in the lease, for example, if a physician or emergency clinic tenant will be open to accommodate patients during nights and weekends.

I. Assignments and Subleases

Tenants under medical office leases often are more sensitive to assignment and subleasing rights than tenants in other types of leases. Therefore, landlords and tenants should ensure that the lease adequately addresses a physician group tenant's needs to admit new partners into the practice from time to time, as well as accommodating retiring physicians exiting the practice.

Conversely, landlords will want to know that their tenants are of a consistent quality and reputation, and unfettered assignment rights can disrupt the tenant mix of a medical office building or otherwise saddle a landlord with an assignee which it deems undesirable. Requiring the landlord's consent not to be unreasonably withheld, and establishing criteria for

circumstances in which the landlord is required to provide consent, or alternatively, has the right to withhold consent, may be sufficient to address these issues. These criteria can include that key principals remain in the practice and the type of practice and experience level of new physicians.

J. Parking

Medical office tenants often require more parking than standard office or retail tenants. The medical office tenant will want reserved parking spaces for its physicians as well as sufficient parking for patients. The tenant will often want designated parking spaces for its patients conveniently located to the premises. Medical office tenants may need a higher percentage of such spaces to be handicap accessible. The tenant will need to understand how the parking for the medical office building is managed, including whether its patients will incur a parking charge for parking in a conveniently located parking facility. The medical office tenant may insist that the landlord make adequate accessible parking available for the tenant and its patients throughout the lease term.

VII. Regulatory Issues

The laws surrounding leasing of medical facilities are constantly evolving. A variety of issues affecting doctors, hospitals, other medical service providers and investor owners are in flux at any given time. While this paper will touch on some of the recent, important changes relating to leasing of medical facilities, it is critical to continuously consult with a legal professional who specializes in this area to keep up to date with the latest changes. For example, physician-owned hospitals remain an extremely hot topic, with a continuing push by more traditional hospital systems to ban these newer hospital formats. As recently as February 2009, a ban on physician-owned hospitals was very nearly included in the State Children's Health Insurance Program ("SCHIP") bill signed into law by President Obama. The ban was included in the version of the bill that passed the House of Representatives, but not in the Senate version or final bill.

A. Anti-kickback Law

The federal Anti-Kickback Law was enacted in 1972 and prohibits the solicitation, receipt or payment of "any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind":

1. in return for referring an individual for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under a Federal health care program, or

2. in return for purchasing, leasing, ordering, or arranging for or recommending purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under a Federal health care program.

42 U.S.C. § 1320a-7b(b)(1)(A) & (B). Penalties for violation of the Anti-Kickback Law are severe. Violation of the Anti-Kickback Law is a felony punishable with a fine of not more

than $25,000 and imprisonment for not more than five years, or both. "Remuneration" is interpreted broadly, as is the term "financial relationship" under the Stark Law (described below), therefore, any economic benefit received in a transaction between parties who may have a potential referral relationship may trigger applicability of the statute. A medical facility lease between parties capable of federal health care program referrals, such as hospitals and physician groups, would come under the purview of the statute. The statute contains an express detailed safe harbor provision allowing certain leases between such parties as further described in Section III.D. below.

B. Stark Law (Federal Physician Self-Referral Law)

Section 1877 of the Social Security Act is also known as the Stark Law or the physician self-referral law. The Stark Law became effective on January 1, 1995. The Stark Law prohibits physicians from making Medicare or Medicaid referrals to an entity with which they, or an immediate family member, have a financial relationship for certain specified "designated health services" ("DHS"). DHS is defined as any of the following services: (1) clinical laboratory services; (2) physical therapy, occupational therapy, and speech-language pathology services; (3) radiology and certain other imaging services; (4) radiation therapy services and supplies; (5) durable medical equipment and supplies; (6) parenteral and enteral nutrients, equipment, and supplies; (7) prosthetics, orthotics, and prosthetic devices and supplies; (8) home health services; (9) outpatient prescription drugs; and (10) Inpatient and outpatient hospital services. At first blush, medical facility leases between physicians and DHS providers would lead to Stark Law violations if there were any Medicare or Medicaid referrals between the parties. However, the Stark Law statute provides for a number of specific exceptions and authorizes the Secretary of Health and Human Services to create additional exceptions. An exception applies to rental of office space if it complies with certain requirements that are described in more detail in Section III.D below. Regulations interpreting the Stark Law are constantly evolving, with Phase III of the Regulations finalized as of August 19, 2008.

C. Stark and Anti-Kickback Laws Compared

There are several important distinctions between the Stark and Anti-Kickback statutes. The Anti-Kickback Law is the broader of the two as it covers any entity that engages in business with a federal health care program, whereas the Stark Law pertains only to physicians making referrals for the listed "designated health services" which are reimbursed by Medicaid or Medicare. Penalties for violation differ dramatically. Violation of the Anti-Kickback Law is punishable by civil monetary penalties and criminal penalties (fines and jail time) and can result in exclusion from federal health care programs, whereas violation of the Stark Law is punishable only by civil monetary penalties. As a criminal statute, the Anti-Kickback Law requires proof of a specific intent to violate the prohibited acts under the statute. The Stark Law, on the other hand, is a strict liability statute; "good intent" does not except the physician or practice group from liability. The Stark Law sets out prohibited activities that only become permissible in the event that the transaction falls within one of the enumerated exceptions. The Anti-Kickback Law's "safe harbors" instead describe financial relationships that, while they may tend to induce referrals, do not necessarily violate the law. If a given transaction does not fall within one of the Anti-Kickback Law's safe harbors, however, it still may not violate the Anti-Kickback Law, but

should be carefully evaluated and entered into only with full knowledge of the potential consequences.

D. Leasing Requirements under Anti-Kickback and Stark Laws

If the following requirements are satisfied, payment for the use of office space made by a tenant to a landlord under a lease agreement is not considered a "financial relationship" under the Stark Law:

1. The agreement is set out in writing, is signed by the parties, and specifies the premises it covers.

2. The term of the agreement is at least 1 year. To meet this requirement, if the agreement is terminated during the term with or without cause, the parties may not enter into a new agreement during the first year of the original term of the agreement.

3. The space rented or leased does not exceed that which is reasonable and necessary for the legitimate business purposes of the lease or rental and is used exclusively by the lessee when being used by the lessee (and is not shared with or used by the lessor or any person or entity related to the lessor), except that the lessee may make payments for the use of space consisting of common areas if the payments do not exceed the lessee's pro rata share of expenses for the space based upon the ratio of the space used exclusively by the lessee to the total amount of space (other than common areas) occupied by all persons using the common areas.

4. The rental charges over the term of the agreement are set in advance and are consistent with fair market value.

5. The rental charges over the term of the agreement are not determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties.

6. The agreement would be commercially reasonable even if no referrals were made between the lessee and the lessor.

7. A holdover month-to-month rental for up to 6 months immediately following an agreement of at least 1 year that met the conditions of this paragraph (a) will satisfy this paragraph (a), provided the holdover rental is on the same terms and conditions as the immediately preceding agreement.

42 CFR 411.357(a). Requirements for compliance with the safe harbor exception for leases under the Anti-Kickback Law are very similar. The Anti-Kickback Law safe harbor exception defines "fair market value" as the "value of the rental property for general commercial purposes, but shall not be adjusted to reflect the additional value that one party (either the prospective lessee or lessor) would attribute to the property as a result of its proximity or

convenience to sources of referrals or business otherwise generated for which payment may be made in whole or in part under Medicare, Medicaid and all other Federal health care programs." The Stark Law formulation of fair market value is similar. An appraiser's rental valuation for the premises, taking into account this definition of "fair market value," may be helpful in evidencing compliance with this prong of the exception.

A variety of pitfalls can ensnare landlords and tenants under these laws because of how rapidly requirements can change. For example, in the Stark III regulations that went into effect December 4, 2007, The Center for Medicare and Medicaid Services ("CMS") noted that parties to a lease may not subsequently amend that lease during any portion of the lease term to change the rental rate. Doing so, CMS determined at the time, would violate the "set in advance" exception. Additionally, CMS commented that amendments to the lease that would have a significant impact to the rental rate – such as a change in the size of the premises – may also be prohibited. Instead of amending the lease, parties wishing to so alter the rental rate or related provisions of the lease would be required to terminate the existing lease and enter into a new lease. In its official commentary to the 2009 Medicare Inpatient Prospective Payment System Final Rule, however, CMS reversed this position and stated that an amendment to an agreement between a DHS entity and a physician (or physician organization) during the term of the agreement is consistent with the "set in advance" requirement provided that:

> (1) all of the requirements of an applicable exception are satisfied; (2) the amended rental charges or other compensation (or the formula for the amended rental charges or other compensation) is determined before the amendment is implemented and the formula is sufficiently detailed so that it can be verified objectively; (3) the formula for the amended rental charges does not take into account the volume or value of referrals or other business generated by the referring physician; and (4) the amended rental charges or compensation (or the formula for the new rental charges or compensation) remain in place for at least 1 year from the date of the amendment.

Department of Health and Human Services, Centers for Medicare and Medicaid Services, Medicare Inpatient Prospective Payment System Final Rules, at 1005-1006 (August 19, 2008), available at http://www.cms.hhs.gov/AcuteInpatientPPS/downloads/CMS-1390-F.pdf (last visited February 17, 2009).

The 2009 Medicare Inpatient Prospective Payment System Final Rule also contained several other changes that were relevant and important to medical facility leasing. First, these new regulations prohibit per-use or per-unit-of-service rental charges for space leases between physicians where the extent of such charges reflect services referred between the parties. Under the previous rule, such per-use or time-based leases were permitted, even though such rental was calculated based upon DHS referrals, provided that the payment at the beginning of the lease term was at a fair market rate and did not change during the term of the lease in order to take into account the value or volume of DHS referrals (the "per click" exception). CMS expressed concern that the previous arrangement could result in the overutilization of services, that it could incentivize referrals to the leased space or equipment rather than to another space or facility that may be more effective or appropriate, and that such arrangements might promote anti-competitive behavior. The new rule takes effect October 9, 2009 and contains no provision for

the grandfathering of existing leases, so physicians would be advised to review their leases if they have any such arrangements in place that would extend past the effective date of the new rule and restructure those arrangements accordingly.

The latest Stark Regulations also prohibit the use of percentage-based compensation formulae for determining rent for office space leases, where, for example, rent is based on a percentage of the revenue generated by the lessee. CMS based this new rule on the concern that such leases create an impermissible incentive for lessors to provide referrals to lessees and that percentage-based arrangements may not reflect fair market value. The prohibition on percentage-based leases likewise contains no grandfathering provision and goes into effect on October 1, 2009 in order to give parties adequate time to adjust their existing leases.

Any investment by a medical tenant in the landlord venture in conjunction with the medical office lease should also be evaluated to determine that it is not a violation of the Stark Law or the Anti-Kickback Law.

E. Other Regulatory Issues

Other laws which affect general office leasing may have a greater impact in medical facility leasing, such as environmental laws, privacy laws and accessibility laws, as discussed in Article V below. Leasing of specialized healthcare facilities, such as nursing homes, assisted living facilities and continuing care retirement communities, bring into play myriad federal and state statutes and regulations governing these facilities specifically. A landlord in a net lease of such a facility will need to require the tenant and/or its operator/manager to comply with the specific laws governing the applicable type of facility, as well as all requirements of federal health care programs and the Fair Housing Act (including reasonable accommodation of persons with disabilities and the Housing for Older Persons exception), to name a few. Such landlord will want the ability to terminate the lease or replace the operator/manager in the event of noncompliance, and will need to understand the transition issues involved in any such replacement, including keeping in place at all times a licensed operator, as well as understand potential successor liability issues.

VIII. Conclusion

As the population ages and healthcare reform continues to take hold, the demand for medical real estate will continue to grow. However, as this presentation has shown, significant differences exist between healthcare real estate and other asset classes. The tenants and their needs are unique, complex issues relating to the location on a hospital campus exist, and a complex web of regulations apply. However, for the professional willing to make the investment in time and resources to understand these issues, it can be extremely rewarding.

APPENDIX

SAMPLE PROVISIONS

APPENDIX 1 – Accessibility Consultant Provision

Tenant acknowledges that, depending upon the scope of the alterations, the Texas Department of Licensing and Regulation may require a review ("Accessibility Review") of the Premises, the Building and the Campus for compliance with the Americans with Disabilities Act and the Texas Elimination of Architectural Barriers Act ("Accessibility Laws"). Tenant further acknowledges that the Accessibility Laws do not provide detailed guidance as to their application and therefore professional judgment is necessary to determine compliance. To provide for uniformity for the Campus, Landlord has designated an accessibility consultant ("Campus Accessibility Consultant") that is familiar with the Campus for use by the tenants of Buildings within the Campus for any necessary Accessibility Review. IF AN ACCESSIBILITY REVIEW IS REQUIRED IN CONNECTION WITH ANY ALTERATIONS, TENANT SHALL RETAIN, AT TENANT'S SOLE COST AND EXPENSE, THE CAMPUS ACCESSIBILITY CONSULTANT TO PERFORM THE ACCESSIBILITY REVIEW. Tenant also may request Landlord to instead allow Tenant to use an accessibility consultant other than the Campus Accessibility Consultant for the Accessibility Review provided that Tenant demonstrates to Landlord that such accessibility consultant has appropriate experience, reputation and qualifications. Tenant may use such alternative accessibility consultant for the Accessibility Review with Landlord's prior written approval thereof. In the event that Tenant retains an accessibility consultant other than the Campus Accessibility Consultant for the Accessibility Review without Landlord's prior written approval, the same shall be a default under the Lease, and Tenant acknowledges that Landlord may need to retain the Campus Accessibility Consultant, its architect or other professionals to confirm whether or not any modifications to the Premises, the Building or the Campus are necessary to comply with Accessibility Laws and administrative hearings or other proceedings may be necessary to ultimately determine whether or not any such modifications are required. In the event of such default Tenant shall reimburse Landlord for any costs incurred by Landlord as a result thereof, including any costs incurred by Landlord to hire the Campus Accessibility Consultant, its architect or other professionals and costs incurred in connection with such administrative hearings or other proceedings.

APPENDIX 2 – Compliance with Laws Provision

Compliance with Hospital and Regulatory Requirements. Tenant shall ensure that all services provided by Tenant or any other persons or entities in the Tenant premises are conducted in compliance with all applicable laws and regulations. All persons or entities providing physician services in the Tenant premises must provide medical services reasonably related to a service line of a Hospital and be either (a) a physician that holds medical active or courtesy staff privileges at a Hospital who: (1) has an unrestricted and

unlimited license to practice medicine in the State of [_____], (2) is not, and has not been within the previous ten (10) years, an Excluded Person (as defined below), and (3) has not been convicted of any felony; or (b) a physician group practice that is a partnership, professional corporation, professional limited liability company, or other entity whose employed or contracted physicians providing services at the Improvements each satisfy the requirements of an individual physician pursuant to subsection (a) above. An "Excluded Person" shall mean a health care provider who, in the previous 10 years, has been identified on the List of Parties Excluded from Federal Procurement and Nonprocurement Programs ("EPLS", located at http://epls.arnet.gov/) by designation of the U.S. Department of Health and Human Services (or its successor agency) or other federal agency declaring that the Person is excluded from receiving Federal contracts or certain types of Federal financial and nonfinancial assistance and benefits in any federal health care program including Medicare, Medicaid, CHAMPUS, and any other plan or program that provides health benefits, either directly or through insurance, or otherwise is funded directly in whole or in part by the United States government or a state health care program. Tenant will comply with all current and future federal, state, municipal and other laws, ordinances, rules and regulations applicable to the Tenant's premises, including without limitation, all environmental laws and regulations.

APPENDIX 3 - Medical Waste Inserts to Hazardous Substances Provision

Tenant shall not cause or permit the use, generation, release, manufacture, refining, production, processing, storage or disposal of any Hazardous Substances on, under or about the Leased Premises, or the transportation to or from the Leased Premises of any Hazardous Substances, except as necessary and appropriate for its Permitted Use in which case the use, storage or disposal of such Hazardous Substances shall be performed in compliance with the Environmental Laws.

Hazardous Substances shall also include Medical Waste (as hereinafter defined). As used herein, the term "Medical Waste" shall mean and include those wastes which are generated in the diagnosis, treatment or immunization of humans or related research, or in the preparation and administration of chemotherapy agents, together with all such other wastes which are defined pursuant to any medical or biological waste regulations which have been or may hereafter be promulgated by any governmental agency or authority with jurisdiction over the Premises or the Tenant's use thereof or business conducted therein, and as further set forth in any laws now or hereafter applicable to the Tenant or the Premises.

APPENDIX 4 - Electricity/Supplemental Air Conditioning:

Insert to Landlord Right of Entry Provision:
Landlord will be responsible in making any entry under this Lease in a manner so as not to unreasonably impair Tenant's use and enjoyment of the Leased Premises (Landlord

acknowledging that patient care may be conducted in the Leased Premises and will respect the privacy rights of patients).

Landlord shall furnish to Tenant at all times the following utilities and other services, to the extent reasonably necessary for Tenant's use of the Leased Premises for the Permitted Use, or as may be required by law or directed by governmental authority: Electrical current necessary to meet Tenant's electricity needs for the operation of Tenant's business as Tenant initially contemplates, as described in the Approved CD's ("Initial Electrical Requirement"). In the event that Tenant desires to utilize equipment which requires electrical capacity in excess of the Initial Electrical Requirements: (a) if such additional electrical requirements necessitate an upgrade to the electrical infrastructure serving the Leased Premises, if so requested by Tenant, Landlord shall install such upgrade (and Tenant shall reimburse Landlord the cost thereof); and (b) if Tenant's electricity usage exceeds the Initial Electrical Requirements, then Tenant shall reimburse Landlord from time to time throughout the Lease Term the cost of such excess electricity to the extent Tenant's electricity usage exceeds the Initial Electrical Requirements, provided that in connection with any such demand for reimbursement Landlord shall provide Tenant with documentation reasonably supporting its calculation thereof. Landlord shall have the right, at Tenant's cost and expense, to require that any additional equipment not shown in the Approved CD's be separately metered, in which case, Tenant shall pay the cost of such additional electricity consumed in excess of the Initial Electrical Requirement in connection with such additional equipment.

If any lights, density of staff, machines or equipment used by Tenant in the Leased Premises changes after the construction of the Tenant Improvements and after the initial equipping and commencement of Tenant's operations in the Leased Premises as initially contemplated by Tenant in the Approved CD's (with respect to machines or equipment) in a manner which would materially affect the temperature otherwise maintained by the Building's air-conditioning system or generate substantially more heat in the Leased Premises, then Landlord shall have the right to install any machinery or equipment that Landlord considers reasonably necessary in order to restore the temperature balance between the Leased Premises and the rest of the Building, including, without limitation, equipment that modifies the Building's air-conditioning system. All costs expended by Landlord to install any such machinery and equipment and any additional costs of operation and maintenance in connection therewith shall be borne by Tenant, who shall reimburse Landlord for the same as provided in this Section.

APPENDIX 5 – Landlord's Lien

LANDLORD'S LIEN. Tenant hereby grants to Landlord a lien and security interest in all property of Tenant now or hereafter placed in or upon the Premises for payment of all Rent due under this Lease; provided, however, Landlord specifically waives any lien or security interest in the Special Equipment and further agrees to subordinate its security interest in any other property of Tenant to the security interest of any other lender or equipment lessor of Tenant. Landlord will execute a waiver or subordination confirming the foregoing on terms reasonably acceptable to Landlord. No security agreement or

equipment lease with respect to the Special Equipment or any other property of Tenant shall allow such creditor access to the Premises unless such creditor has entered into such an agreement with Landlord. Such lien and security interest will constitute a security agreement under and subject to the "Uniform Commercial Code", as enacted in the State in which the Premises are located, and shall be in addition to and cumulative of Landlord's liens and rights otherwise provided by law or by other terms and provisions of this Lease. Landlord may enforce this Landlord's lien and security interest immediately upon a breach of this Lease by Tenant, or if Tenant vacates or is threatening to or in the process of vacating the Premises. All costs incurred by Landlord in the removal, storage, and disposition of such property shall be deducted from the proceeds of any sale, and if such proceeds are not sufficient to cover such costs and all other sums due from Tenant to Landlord hereunder, Tenant will reimburse Landlord for any deficiency upon demand. Landlord will not be liable for trespass or conversion or any other claim for damages or constructive eviction by Tenant in connection with any such entry onto the Premises to exercise its rights granted hereunder. Tenant agrees to execute, as debtor, such financing statement or statements as Landlord may now or hereafter request. Tenant hereby authorizes Landlord to file any such financing statement without the necessity of Tenant's signature if Landlord so desires. Such property shall not be removed from the Premises without the prior written consent of Landlord, other than in the ordinary course of Tenant's business, until all unpaid Rent shall first have been paid and all the covenants, agreements, and conditions of this Lease have been fully complied with and performed by Tenant.

APPENDIX 6 - Special Equipment

No x-ray machines or other electrical, electronic, electromagnetic or other similar medical equipment, including equipment utilized for imaging services (the "Special Equipment"), shall be installed or used in the Premises except in strict accordance with the terms hereof. All Special Equipment shall be installed by Tenant at Tenant's sole cost and expense. All Special Equipment shall be electrically filtered and insulated so that there is no interference in the Building with telephonic, video, fiber optic, data processing, radio, television or other similar communication, transmission or reception currently or hereafter used in the Building. Landlord and Tenant acknowledge and agree that regardless of the manner of attachment of the Special Equipment to the Premises, the Special Equipment shall remain the personal property of Tenant.