

Leases: Some Pitfalls For The Unwary

Leases - who wants them? Who needs them? I suppose the answer to those questions is somewhat self-fulfilling. Landlords and dentists want and need them. The purpose of this piece is to give you an outline of certain standard features of a Lease.

I am a Solicitor who has acted for dental clients for many years. Equally, I am able to give the Landlord's perspective, as I am a commercial Landlord myself.

It goes without saying that when you purchase a dental practice, the property element of the purchase, whether this is a Lease or a freehold, will be as important a consideration as the purchase of the goodwill and dental equipment. This piece is written with leasehold property in mind. However, if the freehold is available, you may wish to consider a freehold purchase, as this will take away many of the headaches associated with Leases.

The vast majority of dental purchases involve the assignment of an existing Lease and not the grant of a new Lease. On the assignment of an existing Lease, there will be very little room to re-negotiate its terms. You must bear in mind that you are taking over an existing document, which will have reflected the prevailing economic climate at the time and the relative bargaining strengths of the respective parties to that document.

This will not necessarily be so on the grant of a new Lease - the parties i.e. the prospective Landlord and prospective Tenant will take an active role in negotiating its terms.

Lease features

Length of term, rent and rent review pattern

The vast majority of you will be purchasing a Practice with the assistance of finance, hopefully, from a specialist dental lender. A lender will, nine times out of ten, require a mortgage over that Lease and will require the term of the loan to be no longer than the (remaining) length of the term of the Lease. It goes without saying that, the longer the Lease, the longer the term of the Loan, so the lower your monthly outgoings.

How long do you want? I suppose the answer to this depends on your own particular profile and future ambitions. You must also try to wear the hat of the Landlord for a minute. What does he want? In pure investment terms, the necessary answer to this is that (normally) he will want to maximise his investment for the longest possible period, whilst at the time, having the security that the rent will be paid and that the other Lease covenants are complied with. Dentists are recognised as extremely good Tenants. This in itself will give you some negotiating power. The average length of a new Lease to a dentist is between ten and twenty years.

The amount of rent payable will be determined by the prevailing economic climate. At a given time, the amount payable per square foot in a given location for a given use can be fairly easily determined. Local surveyors will be well versed in the prevailing square footage value. It may be worth seeking advice from a Surveyor, if you sense that the Landlord is "ripping you off". This may cost you now but remember, you will be tied into the Lease for a long time and the potential overall savings could far outweigh the cost of that initial advice.

The market rental value will not stay the same over a period of time. Landlords will therefore want to review the rent (upwards only, of course!) as often as possible. My preferred option is a fifteen or twenty year Lease, with five yearly rent reviews. Invariably, the Landlord will come back and ask for three yearly reviews. We might settle on a sixteen-year Lease, with four yearly reviews. It is often a simple question of mathematics and compromise.

Lease protected by or excluded from the Landlord and Tenant Act 1954?

What does this mean? In simple terms, if a Lease is protected by the Act, this means that you have an automatic right to a new Lease on similar terms when that Lease comes to an end, except under some fairly limited circumstances. Where a Lease is excluded from the Act, there is no such automatic right.

Since everybody, including the Landlord, knows that moving premises means enormous infrastructure costs, planning difficulties and huge loss of goodwill, a contracted out (ie unprotected) Lease is most unappealing. At best, even if he wants you to stay, the Landlord can blackmail you with a very hefty and unjustifiable new rent, if he is to be persuaded to let you have a new Lease at the end of the term of the Lease. There are few good reasons why a Landlord will want a Lease excluded from the Act.

My argument has always been that the location of your premises is fundamentally linked to the value of the goodwill. I have in mind things such as through flow of patients, access to parking and other facilities etc. It obviously depends to a certain extent on the type of dentistry you are carrying out. For example, the acuity of these factors may not be so great for a referral practice, but security of tenure is a crucial issue to the average general dental practice.

Linked to this is how you view your purchase. There are two schools of thought on this. My own personal view is that if you are making a capital payment for your Practice, you should be able to re-sell the Practice for a capital sum at some point in the future. Of course, who knows what will happen to the value of NHS goodwill under the new contract; watch this space for an article on that challenging subject! My instinct is that values will remain fairly stable.

The other school of thought is that you should view your purchase as an investment say over ten or fifteen years, make your money and if, at the end of that time, you can on-sell, that is a bonus but nothing else. Given that the average value of goodwill is now in excess of £200,000.00, I do not subscribe to this view, so a protected Lease (or a freehold) is pretty much a fundamental requirement.

Repair liability and dilapidations

In simple terms, there are two types of repair liability, namely an FRI Lease (full repairing and insuring lease), or a Lease, which is granted subject to a Schedule of Condition.

The repairing clause in an FRI Lease will invariably require you to "keep and maintain the premises in good and substantial repair and condition" and, at the end of the Lease, to "put the premises back into "good and substantial repair and condition".

This has a number of consequences. Firstly, if the premises are not currently in "good and substantial repair and condition", then you are effectively taking on an inherent liability. Who, I hear you ask, can tell me whether the premises are in "good and substantial repair and condition" at any point in time? Obviously, you can use your common sense to a certain extent. For example, if the roof is caving in and you are taking a Lease of the whole building, then you will of course be assuming a somewhat onerous liability. However, only a competent Surveyor carrying out a full structural survey can really assess the true extent of your actual liability.

Secondly, you need to be aware that at any time during the term of the Lease, the Landlord can serve on you an "interim Schedule of Dilapidations," requiring you to carry out certain specified repairs within a given period.

Thirdly, it is common at the end of the term of a Lease, particularly if you are moving out of the premises, that the Landlord will serve on you a "terminal Schedule of Dilapidations", again specifying works to be carried out, or a sum paid in lieu. Of course, dilapidations are to a certain extent negotiable, but that is really beyond the remit of this piece. However, you should have the

words “keep, maintain and put back” at the forefront of your minds, as this may prove a costly exercise.

The second form of repair liability is a Lease granted by reference to what is known as a Schedule of Condition. In my experience, this is a relatively rare phenomenon. I would say that less than 10% of all dental Leases I come across are granted on this basis.

In essence, the Lease will provide that you will be required to keep the premises in “no worse condition” than is evidenced by the Schedule of Condition. The Schedule of Condition itself will normally take the form of annotated photographs of the premises, evidencing the state of repair and condition of the premises at the time that the Lease was granted.

Break Options

What is a break option and why have one? You are a dentist who is about to embark on a new venture. You have just negotiated a new fifteen-year Lease, but have lingering doubts in the back of your mind about the prospect of making the business a success in the future. If the business flops, say after three years, you would still be liable for rent and other overheads for the remaining term of the Lease.

Dentists with this concern may therefore try to negotiate a Tenant only break option after say five and ten years. This means that if the business does not work out, then you would have a “get out of jail” card on those dates.

The other, less appreciated benefit of a break is to avoid continuing to pay excessive rent following a downturn in rental values. Suppose that the rent was reviewed to £30,000.00 per year in 2000. Suppose that the review was in 2005. Suppose that rents have tumbled and the market rent is now £20,000.00. With upward only reviews the norm and no break, the review in 2005 would be that the rent remained at £30,000.00 per year. A Tenant of mine had a break, which was exercisable in September 2005, and his rent was excessive. He simply told me that if I did not reduce (even typing the word really hurts!) the rent at review, he would leave and take a Lease elsewhere at a lower rent. This is of course a hard threat for a dentist to make, though for an office, where location is not an issue, it is a powerful threat indeed.

From a Landlord’s perspective, a break option is not a particularly attractive proposition. Instead of viewing his investment in terms of fifteen years of “watching the money pile up”, his attention will be focussed on the fact that he may have to find a new Tenant after only five years.

Landlords are therefore reluctant to agree to break options. Also, the Landlord may adopt the attitude that if he wants one, I want one too. Of course this would be unthinkable for a dentist and his lender. That said, Landlords (me included!!) are inherently greedy and the carrot that you can offer them for a Tenant only break option is to pay a premium up front or a higher basic rent. This is akin to a one off insurance premium and may give you some comfort.

Having said that, I would not seek or even consider a Tenant’s break, unless I intended to move the Practice at some defined point. The exit, and I’ve seen it done on numerous occasions, is to sell on the Practice, together with the remainder of the fifteen-year Lease. That brings us to Authorised Guarantee Agreements, another legal minefield, and Lease extensions, but I will save those joys for (yet another boring) article.

Conclusions

There are many important areas of Leases, which I have not covered here, such as service charges, rent reviews, alienation provisions and alterations. I will do what I can to sort out the key issues in these areas and bring them to you, at a later date, in the most accessible and helpful way possible.

The bottom line is that when you are taking on a commitment such as a Lease, you need good commercial legal advice. Oh, and if you wish to consider consulting one of my colleagues or myself

on a Lease or dental related matter, we would be delighted to advise you. No nonsense, no frills (or not many), just good solid commercial legal advice, at reasonable (well, fairly reasonable) rates.

Thank you and goodnight!