

Health Care Real Estate Leasing: Navigating Regulatory Risk and Transactional Tension

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Agenda

- Introduction to Health Care Real Estate Leasing
- Leasing Compliance Pitfalls
- Ground Lease and Facility Lease Practical Considerations



Introduction to Health Care Real Estate Leasing

Complexity and Importance



Complex Lease Structures

Health care real estate leases involve intricate structures due to regulatory compliance and market dynamics, requiring specialized knowledge.

Compliance Challenges

Navigating compliance challenges is crucial; any oversight can lead to significant regulatory risks in healthcare transactions.

Key Lease Provisions

Identifying key lease provisions can significantly influence the success of a transaction or the risk of non-compliance.

Complex Lease Structures



Health care real estate leases often involve operational nuances that are not found in other commercial real estate leases.

- **Specialized Buildouts**
- **Unique Building Features**
- **Stronger Investment Potential**



Leasing Compliance Pitfalls

Which Laws Apply?

- Largely dictated by who the parties are to the lease

The Anti-Kickback Statute

- **Bottom line:** No payment in exchange for referrals
- Aimed at preventing providers from referring for monetary consideration rather than in the interest of the patient
- Civil and criminal penalties
 - Up to 10 years in prison
 - Up to \$100,000 in fines per violation
 - Up to \$100,000 in civil penalties
 - Exclusion from participation in Medicare, Medicaid, or other federal health care programs
- Requires mental intent showing



The Anti-Kickback Statute

- **Key Question**: Are there referrals between the parties payable by the federal government?
- **Elements: Whoever**
 - Knowingly and willfully
 - Offers, solicits, pays, or receives
 - Remuneration
 - In return for referring an individual to a person/entity for items or services payable by federal health care programs



The Anti-Kickback Statute

- Safe Harbors
- Space Rental Safe Harbor
 - Lease is in writing and signed by parties
 - Specifically describes the leased premises
 - The aggregate space rented does not exceed what is reasonably necessary to accomplish the commercially reasonable business purpose of the lease
 - Term is not less than one year
 - Rent is:
 - (1) set out in advance;
 - (2) consistent with fair market value in arms-length transactions; and
 - (3) not determined in a manner that takes into account the volume or value of any referrals between the parties payable in whole or in part by Medicare, Medicaid, or other Federal health care programs
 - If the lease is on a time-share basis, the lease specifies: the schedule of such intervals, their precise length, and the exact rent for such intervals.



The Stark Law

- Similarly aimed at referrals between providers, but specifically involves a physician or physician owned entity
- Civil, not criminal, statute
- Strict liability statute



The Stark Law

- **Key Question**: Is one of the parties a physician or an entity with physician ownership?
- Elements
 - A physician cannot
 - Make a referral
 - To an entity
 - For the furnishing of “designated health services” that may be payable by Medicare or Medicaid
 - If the physician (or an immediately family member of the physician)
 - Has a direct or indirect financial relationship with the entity
 - Unless an exception to the Stark law applies.



The Stark Law

- Rental of Office Space Exception Elements
 - Lease written and signed by parties
 - Specifies the premises leased
 - Term is at least one year
 - If the lease is terminated in the first year of the term, the parties may not enter into a new lease for the same space



The Stark Law

- Rental of Office Space Exception Elements (*continued*)
 - The space leased
 - Does not exceed that which is reasonable and necessary for the legitimate business purposes of the lease; and
 - is used exclusively by the lessee when being used by the lessee
 - Rent is:
 - (1) set out in advance;
 - (2) consistent with fair market value in arms-length transactions; and
 - (3) not determined in a manner that takes into account volume/value of referrals
 - The terms of the lease are commercially reasonable



The Stark Law

Timeshare Arrangements Exception

- 1) The arrangement is set out in writing, signed by the parties, and specifies the premises, equipment, personnel, items, supplies, and services covered by the arrangement.
- 2) The arrangement is between a physician (or the physician organization in whose shoes the physician stands under § 411.354(c) and—:
 - i. A hospital; or;
 - ii. Physician organization of which the physician is not an owner, employee, or contractor.
- 3) The premises, equipment, personnel, items, supplies, and services covered by the arrangement are used—
 - i. Predominantly for the provision of evaluation and management services to patients; and
 - ii. On the same schedule



The Stark Law

Timeshare Arrangements Exception (continued)

- 4) The **equipment** covered by the arrangement is:
- i. Located in the same building where the evaluation and management services are furnished;
 - ii. Not used to furnish designated health services other than those incidental to the evaluation and management services furnished at the time of the patient's evaluation and management visit; and
 - iii. Not advanced imaging equipment, radiation therapy equipment, or clinical or pathology laboratory equipment (other than equipment used to perform CLIA-waived laboratory tests).
- 5) The arrangement is **not conditioned on the referral of patients** by the physician who is a party to the arrangement to the hospital or physician organization of which the physician is not an owner, employee, or contractor.



The Stark Law

Timeshare Arrangements Exception (continued)

- 6) The compensation over the term of the arrangement is set in advance, consistent with fair market value, and not determined—
 - i. In a manner that takes into account (directly or indirectly) the volume or value of referrals or other business generated between the parties; or
 - ii. Using a formula based on—
 - i. The arrangement is not conditioned on the referral of patients by the physician who is a party to the arrangement to the hospital or physician organization of which the physician is not an owner, employee, or contractor.
 - ii. A percentage of the revenue raised, earned, billed, collected, or otherwise attributable to the services provided while using the premises, equipment, personnel, items, supplies, or services covered by the arrangement; or
 - iii. Per-unit of service fees that are not time-based, to the extent that such fees reflect services provided to patients referred by the party granting permission to use the premises, equipment, personnel, items, supplies, or services covered by the arrangement to the party to which the permission is granted.
- 7) The arrangement would be commercially reasonable even if no referrals were made between the parties.
- 8) The arrangement does not violate the anti-kickback statute (section 1128B(b) of the Act) or any Federal or State law or regulation governing billing or claims submission.
- 9) The arrangement does not convey a possessory leasehold interest in the office space that is the subject of the arrangement.



Stark, AKS Violations

- Sampling of Real Estate Qui Tam Lawsuits Brought under the False Claims Act

Alleged Violation	Law(s) Implicated	Settlement Amount
Free office space, employees, and supplies; Sham real estate arrangements for unnecessary space	Stark, AKS	\$72,300,000
Office space leased at below fair market value rates	Stark	\$15,117,516
Hospital provided free office space to a local physician group	Stark, AKS	\$93,500,000
Provider only required a physician to pay half of the rent as an inducement for patient referrals	Stark, AKS	\$425,000
Lease of office space to physicians for free or at a below market rate	Stark, AKS	\$84,500,000
Office lease arrangements that did not comply with Stark	Stark	\$4,000,000
Hospital paid above-market rent to lease space from physicians	Stark, AKS	\$42,000,000

Putting It All Together

- **Step 1**: Is the other party to the lease a health care provider?
- **Step 2**: If yes to #1, then are there any referrals between the parties or likelihood of referrals during the term of the agreement?
- **Step 3**: If yes to #2, then:
 - What types of referrals are made between the parties?
 - Is the other party a physician or a physician organization?



Practical Applications

Fair Market Value

- Element of the AKS space rental safe harbor and the Stark exception for rental of office space (and timeshare exception)
 - *Fair market value* means with respect to the rental of office space, **the value in an arms-length transaction of rental property for general commercial purposes** (not taking into account its intended use), without adjustment to reflect the additional value the prospective lessee or lessor would attribute to the **proximity** or **convenience** to the lessor where the lessor is a potential source of patient referrals to the lessee, and **consistent with the general market value** of the subject transaction.
 - *General market value* means with respect to the rental of equipment or the rental of office space, the price that rental property would bring **at the time** the parties enter into the rental arrangement as the result of bona fide bargaining between a well-informed lessor and lessee that are not otherwise in a position to generate business for each other.
- **Key questions:**
 - How to determine FMV?
 - What rentable square footage is used for application of rate?



Timeshares

- **Regulatory:**
 - Review 2021 guidance/regulatory landscape
 - Per-click guidance
 - FMV rental rates
- **Practical:**
 - Making better use of unused medical office space
 - Monitoring/administering for regulatory compliance
 - Dealing with last-minute changes vs. scheduled absences

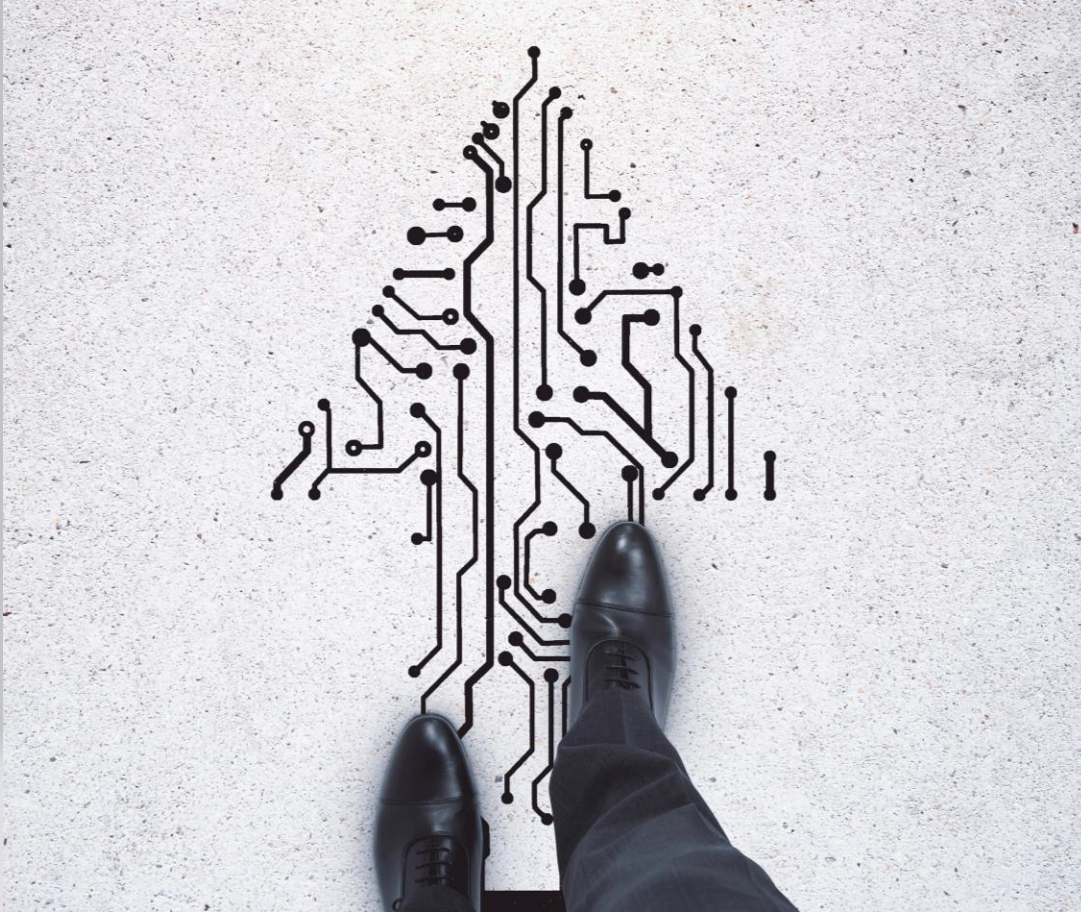


Hospital Outpatient Department (HOPD) Leases



- **Background on Provider-Based Billing and HOPD**
- **Public Awareness**
 - Patients must be aware when they enter facility that they are being treated as hospital patients
- **Demising/Exclusive Use**
- **Entry/Exit Considerations**
- **Signage**

Commercial Reasonableness



Regulatory Definition:

- Arrangement furthers a legitimate business purpose of the parties to the arrangement and is sensible, considering the characteristics of the parties, including their size, type, scope, and specialty.
- An arrangement may be commercially reasonable even if it does not result in profit for one or more of the parties.

Bond-Financed Space



- Private Use
- Lease Administration Best Practices



Health System Leasing Policies/Procedures

Primary Elements of a Compliance Program

1. High-Level Oversight
2. Policies and Procedures
3. Auditing and Monitoring
4. Education and Training
5. Lines of Communication
6. Response and Prevention
7. Enforcement and Discipline



Health Care Leasing

Practical Considerations

- Ground Leasing
- Credit-Tenant Leasing
- Specific Provisions:
- Assignment & Subletting;
ROFO, ROFR & Purchase
Option Rights;
Subordination and
Estoppels;
Renewal and Holdover;
Surrender Obligations

Ground Leases vs. Facility Leases

- **Real Estate = Land + Improvements**
- **A Ground Lease is a legal mechanism to sever the legal interest in the Land from the legal interest in the Improvements**

Basic Mechanics

- Ground Leases are often used to facilitate a development or leasing arrangement with a third-party developer or landlord
- In a health care Ground Lease, during the term of the Ground Lease, the health care provider retains long-term ownership of the Land, with a reversionary interest in the Improvements at the end of the Ground Lease term, and the third-party developer or landlord of the Improvements has ownership of the Improvements during the Ground Lease term.
 - ❖ Health care provider holds Fee Interest in the Land; third-party developer or landlord will hold a Leasehold Interest in the Land and Fee Interest in the Improvements.



General Characteristics of a Ground Lease

- Long term. Usually, a base term of 50 years or longer, with renewals, with total term between 75 and 100 years. Consider state and local laws related to leasing that may trigger a “transfer” for tax purposes.
- Health Care provider retains an end-of-term reversionary interest at \$0 or nominal cost.
- NNN Rent Structure.
- Leasehold Financing (not fee) Permitted.



Ground Lease Legal and Business Considerations

- **Footprint** – carefully define the Ground Lease footprint
- **Rent** – FMV by appraisal, annual escalator and operating expenses, commencement in the context of new construction
- **Maintenance Standard** – maintain to a Class A standard; right to replace property manager
- **Retained Rights** – design approval, exterior modifications, naming and signage rights, ROFR/ROFO to purchase and lease, Option to Purchase
- **Use Restrictions** – use of Improvements must remain compatible with health care provider's policies and practices. Consider prohibited services and restrictions on use and identity of both tenants and owner.



Ground Lease Financing Provisions

The Ground Lease Structure allows the owner of the Improvements to finance the Improvements (as a separate leasehold estate) separate from the fee estate in the Land, which is retained by the health care provider.

- Ground lessor to enter into a new lease with lender following lender's foreclosure
- Non-applicability of ground lessor's ROFR to purchase during foreclosure
- Inability of sheriff or lender to sell to prohibited class of purchasers (e.g., competitors of ground lessor) during and after foreclosure proceedings
- Right of ground lessor to cure ground lessee defaults in leasehold financing
- Right of ground lessor to pay off or assume debt in context of ground lessor's acquisition of ground lessee's interest (purchase or termination due to default)
- Ground lessor's right to terminate ground lease following lender's failure to cure



Credit Tenant Leasing (“CTL”)

It all starts with the Lease:

- NAIC Schedule D (Bond) treatment
- Not a real estate loan (but equivalent due diligence to a real estate loan)
- Priced like a bond rather than a mortgage usually (some premium for structure)
- **Underwriting analysis looks at Tenant’s credit rating and ability to pay rent as primary concern rather than “go-dark” value of real estate**



CTL Basic Legal and Structural Considerations

- A. Must be a true Bond Lease (Tenant must pay “come hell or high water”)
- B. Typically Triple Net (although, does not have to be)
- C. Tenant Termination Events – carefully scrutinized by the CTL Lender
- D. Credit Support Provider – either Tenant or a Guarantor
- E. Subordination to Leasehold Financing – often misunderstood; but NAIC guidelines require a “first lien” mortgage, so very important
- F. Other Common Issues: Assignment, Change of Control and Subleasing; Maintenance and Alterations; Essentiality of Use; Financial Statements



Specific Lease Provisions

Important Lease Provisions that Should Always be Considered Carefully in Health Care Leasing:

- Assignment, Change in Control, Subletting
- ROFO, ROFR and Purchase Option Rights
- Subordination and Estoppels
- Renewal and Holdover
- Surrender Obligations



Assignment, Change In Control, and Subletting

- Health care providers must retain flexibility to assign, transfer or sublet
- Final terms will depend, in part, on credit profile of health care tenant and/or guarantor;
- But, generally speaking, we strive for:
 1. Permitted Subtenants: No restrictions on subletting so long as use is permitted.
 2. Permitted Transfers:
 - To any affiliate or related entity that controls Tenant, is controlled by Tenant, or is under common control with Tenant;
 - To Tenant's successor by merger, consolidation, or acquisition of stock or membership interests, or
 - To any purchaser of substantially all of Tenant's assets, provided the transferee assume lease obligations in writing and notifies the Landlord within an agreed upon timeframe *following* the transfer.



ROFO, ROFR, and Purchase Option Rights

- **ROFO** = Right of First Opportunity to Purchase or Lease Available Space
 - Before a Landlord can sell the building or lease available space in the building, the Landlord first has to offer the building or the space to the Tenant
- **ROFR** = Right of First Refusal to Purchase or Lease Available Space
 - Landlord receives a third-party offer to purchase the building or to lease available space in the building, and Tenant has the first right to purchase or lease on the same terms offered by the third party
- **Purchase Option** = Right to Purchase the Leased Premises on certain terms and at certain times during the Lease term
 - Tenant has a negotiated right to purchase the real estate from the Landlord



ROFO & ROFR Considerations

1. Similarities (ROFO & ROFR)

- Timing – how much time, realistically, will the health care organization need to evaluate a proposal to sell or lease? If the health care Tenant does not exercise its option in time, the Landlord is free to market, sell or lease to the open market on *substantially the same terms (or on the same terms in the case of a ROFR)*.
- One-time right or ongoing?
- If Tenant waives, but Landlord fails to sell or lease, or terms materially change, the Landlord should have an obligation to come back to Tenant before proceeding with another buyer or tenant

2. Differences (ROFO & ROFR)

- ROFOs are, generally speaking, more Landlord-friendly; ROFRs less so.
- As a Tenant, include both. As a Landlord, ROFO only preferred.



Purchase Option Considerations

1. One-time right or ongoing?

- Not unusual to see multiple exercise windows in a longer term Lease

2. Purchase Price

- Negotiated by parties;
- By “competing” appraisals;
- Pre-determined based on negotiated return to Landlord.

3. Include Detailed Closing Requirements – purchase agreement, diligence period, title insurance, transfer tax.



Other Practical Leasing Considerations

1. Subordination and Estoppels

- Timing – how long does your organization need to respond to a request for a SNDA or an estoppel?
- Essential terms

2. Renewal and Holdover

- Timing – realistically, when can your organization decide on a renewal in the context of an existing lease? Be careful with timelines.
- Consider *permissive* rather than mandatory holdover rent when acting as the Landlord; negotiate “tiered” holdover rent when acting as Tenant but only if not permissive.

3. Surrender Obligations

- As a Tenant, the obligation should be to surrender the premises in the condition required by the Lease, wear and tear excepted not in the same condition that existed at the beginning of the term. Alterations should not be required to be removed at surrender if acting as Tenant.



Questions



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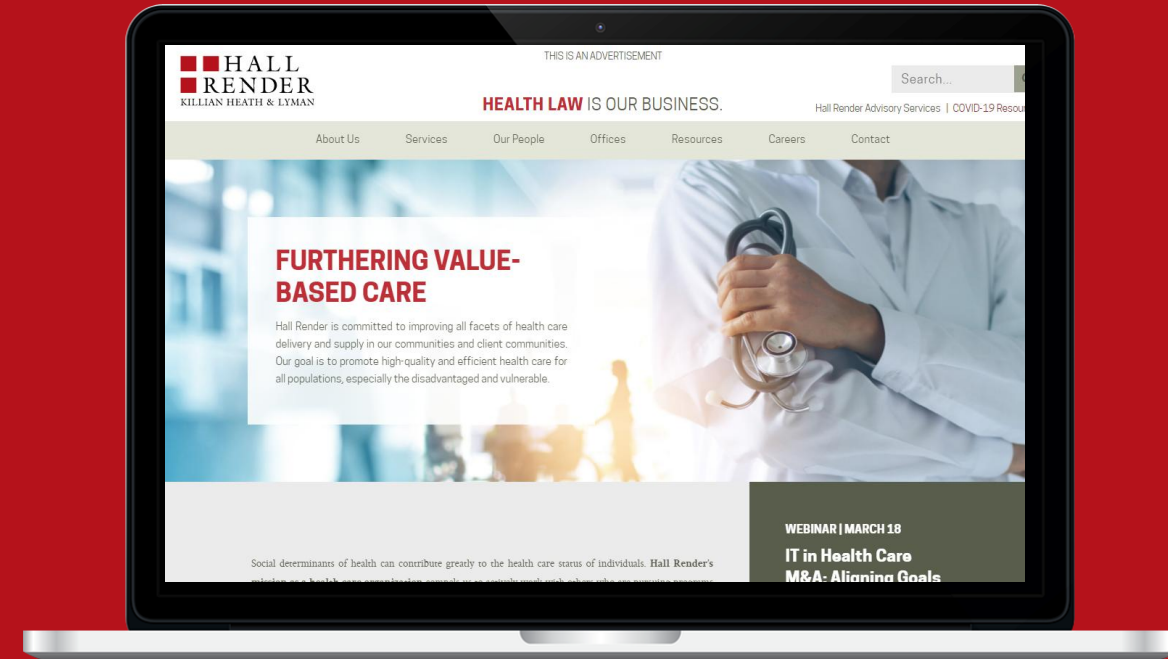
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