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Leasing to Franchisees (and Franchisors): Important Distinctions for the Landlord and Tenant

I. Introduction

This presentation addresses the myriad of issues and concerns that a franchisee tenant, prospective landlord and franchisor consider and resolve as the parties negotiate and finalize a retail lease. All of the parties have the mutual goal of ensuring the lease arrangement is successful for the franchisee tenant since its success at the premises benefits all parties: the franchisor brand is strengthened by a new successful location and the resulting royalties; the franchisee enjoys success, which may allow it to expand; the landlord receives the benefit of a successful tenant which will likely attract additional tenants and positively impact the property. However, each party has distinct interests which need to be reconciled in order to protect each party and their respective additional third parties, such as lenders or financing partners. We will discuss each of the parties' most crucial concerns and propose mutual approaches to finalize the relevant lease arrangement in the best interest of all parties.

II. The Franchisee's Perspective

In general, a franchisee desires a quick and efficient lease negotiation, without becoming stuck between conflicting requirements of its landlord and its franchisor.

A. Timing Issues

A franchisee must balance the timing issues involved in negotiating a lease and obtaining approval from the franchisor. A franchisee does not want to spend money in negotiations and preliminary due diligence not knowing if the deal will be approved. On the other hand, the franchisee would not want to spend significant time and money on franchisor approval without a fairly firm deal on a lease.

B. Value of the Brand

Landlords understand the drawing power and overall value of retailers with strong name brands. Franchisees recognize that representing a strong brand often can allow them to secure more desirable locations than independent retailers.

C. Common Interests with the Franchisor

In most respects, the interests of the franchisee and the franchisor are well aligned, and the requirements are in the best interests of both entities. Certain requirements often bring a visceral, negative reaction from a landlord's attorney. Examples are transfers without consent, alterations to the premises, and removal of proprietary property.

A franchisor has a strong interest in maintaining brand image, and typically hates to see a franchise store go under. It often makes sense to step into the lease, or arrange for a transfer to a healthy franchisee. At first blush, many landlords' attorneys are not open to allowing transfers to a franchisor entity or another authorized franchisee without consent. A forward thinking franchisee also should negotiate for similar transfer rights in situations where there is no default, such as in a sale of the business. The connection to the large brand should make this positive exit strategy much easier to obtain.

The ability to remodel and even temporarily close a location without landlord consent is another example. Having the connection with the brand and franchisor should help the franchisee obtain this desired flexibility.

The franchisee is under an obligation to the franchisor to return proprietary property. If the franchisor has the ability to recover these items after the franchisee no longer has rights in the property, it helps the franchisee satisfy this obligation. Landlords cannot use this property anyway, so allowing the franchisor such rights (with some reasonable conditions) benefits them as well.

III. <u>The Franchisor's Perspective</u>

A. Franchisor Approvals

The most typical situation is where the franchisee is the tenant and the franchisor is a third-party beneficiary, rather than a party to the lease. In this case, the franchisor typically approves the site, the economic terms and the form of the lease. A franchisor will have established requirements for the leases of its franchisees, and most often there is a lease rider or addendum containing the required provisions. Some franchisors take the position that the rider must be incorporated verbatim. Others allow some minimal modifications. The best practice for all parties is for the franchisee to present the rider to the landlord very early in the lease negotiations.

It works best if the franchisor's approval is handled prior to lease execution.

B. Brand Protection

1. During the Lease Term

Franchised operations have standardized looks and operations, which are critical from a branding perspective. Landlords usually recognize the benefits of having national brands, particularly large ones, as tenants. From time to time, franchised concepts must be updated, and the lease needs to allow the franchisee to adapt to changes required or recommended by the franchisor. The franchisor will attempt to eliminate landlord consent for changes required or authorized by the franchise agreement. A reasonable compromise would be not to require landlord's consent, if the changes in the facility and signage are part of a regional or national upgrade.

Use clauses, trade name provisions and other restrictive language come into play as well. Retailers are stretching their product offerings and menus in order to capture larger retail audiences. Concepts continue evolving, and sometimes this brings about name changes, like those of IHOP and KFC. As a result, franchisors now are looking for more flexibility. This flexibility, of course, must be subject to exclusive rights granted to others by the landlord.

2. End of the Lease Term

The franchisor needs to protect its proprietary marks, which the franchisee is allowed to use during the term of the franchise agreement. At the end of the term of the lease or the franchise agreement, the franchisor insists on the ability to remove its protected marks from the premises, if they are not removed by the franchisee. This makes sense for all parties, as the landlord would not have permission to use the marks and could face liability if they were used without proper authority. For these rights, the franchisor should be willing to provide adequate insurance coverage, repair any damage caused by the removal and possibly pay rent for the time franchisor is on the premises.

3. Franchisee Default Issues

In order to maintain the strength of the particular brand, a strong franchisor insists on the ability to continue operations at the leased premises. A franchisor will require that the franchisor, its affiliates, or another franchisee be allowed to step into the failing franchisee's position. Understandably, landlords are sensitive about choosing their tenants, and often resist allowing these rights. Certain practical factors should affect the landlord's willingness to agree to grant these rights to the franchisor. These include the maturity of the brand, the strength of the franchisor, whether the franchisor operates company stores, the size and strength of the franchisees in the system, and the importance of markets vs. individual stores to the franchisor. If a franchise operation is comprised of small franchisees with one or very few stores, the franchisor may be more likely to allow one to fail. If, however, the franchisees are large and hold development rights to entire markets, the franchisor would be inclined to go much farther to preserve its brand image in a significant market.

The franchisor typically requires notice of default and a right to cure, sometimes with a longer period of time than the franchisee. The franchisor will insist on being able to step in and operate a company store, or to substitute another healthier franchisee without landlord's consent, without significant costs, and without overly restrictive tests. Franchisors believe that the determination of who is a qualified franchisee should be the franchisor's alone. It certainly is not in the franchisor's interest to substitute a weak franchisee for a troubled franchisee. Nonetheless, it is common for landlords to balk at allowing such substitutions without their consent. The size, history and reputation of the franchisor usually have a significant bearing on how this discussion plays out.

C. Quality Control From a Real Estate Perspective

Being a great operator does not necessarily mean being a great real estate developer, even for large franchisees. Franchisors sometimes feel the need to protect some franchisees from themselves, as well as protecting the franchisor or another franchisee who later may take over a lease. For this reason, franchisors often require that certain basic tenant protections exist in the lease. These include protection of access, parking and visibility, a fair allocation of risks, non-disturbance from current and future mortgagees, and other typical tenant provisions.

IV. The Landlord's Perspective

A. Analysis of Franchisee

Each franchisee, no matter how large or how successful, will likely be vetted by the landlord in some capacity

It is important that a franchisee be prepared to provide financials to the landlord early on in the lease process as it can impact negotiations regarding security deposits, personal guaranties and even rental payments.

In addition to the financial state of the franchisee, a landlord may be interested in the operational status of the tenant entity and may request background information and include certain representations from the franchisee in the lease agreement.

B. Review of Franchise Agreement

Because the landlord is interested in ensuring that the operating tenant remains a reputable "franchised" company, the landlord representative (especially for more sophisticated centers and landlords) will often request to review a copy of the franchise agreement to review the term and ability of the franchisor to terminate the agreement and affect operations at the leased premises Alternatively, the landlord may require a warranty from the franchisee that the term of the franchise agreement is co-terminous or extends past the lease term.

C. Negotiations with Franchisor

As previously noted, a franchisor will very often request/require that a landlord agree to a franchisor rider or addendum which helps to decipher and establish the rights and obligations of the parties. The addendum, after all, serves to protect the interests of the landlord because, in addition to an inducement to execute the lease, it can contain a cure right for the franchisor which will allow the landlord to feel some level of security that in the event of a default by the franchisee tenant, another (and deeper) pocket may step in to keep the premises operating. However, there are a few common provisions in an addendum that are negotiated by the landlord. First, the landlord may request that its lien rights be preserved (even if subordinate to those of the franchisor or a tenant's lender). Secondly, the landlord often understands the franchisor's desire to protect its trademark and trade dress or the right to require specific signage or build-out (e.g. the famous McDonald's arches); however, the landlord will want to make sure that the tenant follows all applicable governing regulations for such items and will include such a provision in any addendum or build-out exhibit.

V. <u>Imperative Lease Clauses to Consider</u>

A. Exclusive Use

An example of a generally acceptable Exclusive Use clause is:

"Landlord agrees that during the entire Term of this Lease, including any renewal terms, Landlord shall not rent any other space in the Shopping Center [development, property, etc.] to another person or entity whose primary business activity within the space leased is or would be [the sale of a certain type of food or menu item (i.e. Mexican food or chicken wings)]. Landlord agrees that it will include a provision in future leases prohibiting the uses described in this section in the Shopping Center, [development, property, etc.] This exclusivity provision shall not be applicable to the extent that any of the above prohibited uses are currently permitted under an existing lease for another tenant in the Shopping Center [development, property, etc.]."

It is important to receive a commitment from the landlord that it provides notice of the Exclusive Use to future tenant and a provision that if the landlord violates the Exclusive Use provision, then the tenant has the right to stop payment of base rent until the impeding use is stopped and/or gives the tenant the unilateral right to terminate the lease.

As consideration for granting an Exclusive Use to a tenant, a landlord may want to limit the franchisee's ability to open another location within a certain number of miles of the property.

B. Right to Terminate

If possible, the franchisee should negotiate a right to terminate the lease under certain conditions. This will require the franchisee agreeing to pay some sort of early termination amount, but the franchisee's exposure will likely be much less than being held to the ongoing contractual obligations of the lease in the event of a default if the location fails to thrive.

	Examples of situations in which the franchisee may want to have a right to terminate include: **1. Level of Occupancy** If a newly built retail development has not achieved a certain percentage of occupancy by a certain date following the commencement date of franchisee's lease, franchisee may want a right to stop paying base rent or to agree to pay a reduced base rent until the requested percentage of occupancy has been reached; or, alternatively, if it is not reached within a certain time period request the right to terminate the lease and receive some sort of relief on any payments of unamortized tenant improvements or other costs that franchisee has expended. Alternatively, if the occupancy rate within the development drops below a certain percentage for a certain duration of time (6 months for example), franchisee may want to request a reduction in base rent with a right to terminate if the occupancy level does not return to the requisite level within a certain period of time. **2. Anchor Tenant (Co-tenancy clauses)** It will often be important to the success of franchisee's business that a major anchor tenant is open for business at the retail development. The franchisee may want to negotiate to pay no (or reduced) base rent until such date as the anchor tenant or tenants (be sure to specifically name such tenants) opens for business or there is a "grand opening" of the development. Alternatively, if an anchor tenant leaves the retail development and is not sufficiently replaced within a specific time period, franchisee also may want to request the right to terminate the lease and receive some sort of relief on any payments of unamortized tenant improvements or other costs that franchisee has expended. **3. Minimum Gross Sales** If the restaurant has not achieved a certain level of sales by the end of a defined time period (often 2 years), franchisee may want to request a right to terminate the lease. Since the sales are deemed to be more in franchisee's control, than that of the landlord's, as is more the case with the occupancy or tenant mix at the development, a termination under these circumstances will often result in a higher termination penalty. A typical

penalty that a tenant should expect to pay for receipt of this unilateral right would be 15- 25% of the remaining base rent of the term and the unamortized portion of the tenant improvements.

C. Landlord Lien/FF&E

For financing and other reasons, it is crucial that a franchisee does not agree to allow a landlord to place a priority lien, upon furniture, fixtures or equipment (FF&E) within the premises. As previously noted, it is also important to include a provision which allows the franchisee to remove the FF&E upon expiration or termination of the lease, even upon an event of default, and to de-identify the restaurant in accordance with any applicable terms of the franchise agreement.

D. Substitute Premises

A landlord will often request a provision that allows it to move a tenant within the retail development at its discretion and pay for limited relocation costs. Usually the chosen location for the franchisee tenant was and remains crucial for its success due to access, visibility, etc. and so the franchisee should avoid agreeing to any relocation provision. If a substitution is required, a list of mutually agreed upon substitute premises should be identified in the lease so that the relocation is limited to one particular site or the relocation can only be triggered upon a larger scale event, such as a condemnation or the addition of buildings to the development.