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FRANCHISOR'S HIDDEN ASSETS FRANCHISOR'S HIDDEN ASSETS

Although it's not on the franchisor's balance sheet, a franchisee's leased real property can be one of the franchisor's most valuable assets, and a source of liability if not properly handled.

HOW CAN A FRANCHISEE'S LEASE BE AN ASSET TO THE FRANCHISOR?

- Control. The lease should give the franchisor flexibility to take-over and operate the store if needed, or assign or sublet the site to a new franchisee.
- Notice. The lease can give the franchisor timely notice of lease defaults, and limit the franchisor's liability in cases where the franchisor has guaranteed the lease.
- Custom Fit. A properly negotiated lease is tailored to the franchisor's business.

HOW COULD THE FRANCHISEE'S LEASE BE A LIABILITY?

- Lost Profits. Above-market rent hurts the franchisee's bottom-line, and ultimately its long term success.
- Lost Site. A poorly negotiated lease may limit or prohibit the franchisor's ability to takeover and assign the franchisee's lease to a new franchisee.
- Lease Damages. In cases where the franchisor has guaranteed the lease, a poorly negotiated lease could hold the franchisor liable for its lease defaults.

THE LEASE - WHAT TO GET RIGHT. In addition to making sure all business terms are correct, the franchisor may want to review the following issues.

PERMITTED USE. Make sure the permitted use under the lease expressly covers the present scope of franchised operations and any anticipated changes.

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Franchisor's Hidden Assets

TRADE NAME RESTRICTIONS. If tenant must operate under the franchise name, this limits the ability to assign the lease to a third party or change the name of the franchise.

RADIUS RESTRICTIONS. If the lease contains a radius restriction (i.e., no other stores operating under the same trade name within 5 miles), make sure the restriction does not interfere with the franchisor and/or franchisee's plans to operate additional sites near the leased location.

OPERATIONAL REQUIREMENTS. Retail leases typically set standards regarding how the tenant must operate its business (e.g., first class merchandise, trained sales staff, seasonally rotated display windows, etc.). Make sure such requirements do not conflict with the provisions of the franchise agreement or the franchisor's business model (i.e., if the franchise sells discounted merchandise).

SIGNAGE. Make sure the landlord pre-approves all of the logos, trademarks and signage the franchisee needs to use at the premises.

COMPLIANCE WITH LAWS & ADA. If the franchisor knows that its business requires specific alterations for ADA or other legal issues, the franchisor should prepare, in advance, a detailed description of what specific alterations must be performed, who does the work, and who pays for it. This way, the parties can get this issue on the table early in the process.

FRANCHISOR'S TAKEOVER RIGHT. The franchisor should add to the lease a provision allowing the franchisee the right to assign the lease to the franchisor and/or to any approved franchisee, without landlord's consent. Also, any landlord recapture or termination right should not apply to any franchise related transfers. Caution: If the franchisor takes over the site, the franchisor will be liable for all lease obligations from the date of the assignment. This is one of the many reasons why a franchisor should know the material provisions of each of its franchisee's leases.

LEASE DEFAULTS. The franchisor needs to get written notice of every lease default, and the right (but not the obligation) to cure such default on behalf of the franchisee. Ideally, the landlord should agree to use commercially reasonable efforts to mitigate its damages.

LANDLORD REMEDIES. Take special notice of the following 3 remedies and review them with your real estate lawyer:

ACCELERATION OF RENTS – The landlord can collect, in one lump sum, all rent payable under the lease for the rest of the term.

LOCKOUT - The landlord can change the locks or otherwise forcibly repossess the premises. The faster the landlord can take back the premises, the less time the franchisor has to cure the default or negotiate to preserve the site.

CONFESSION OF JUDGMENT - The landlord can go to court and obtain a judgment against the tenant without having a trial where the tenant gets to participate.

DEFAULT UNDER THE FRANCHISE AGREEMENT - Resist agreeing that if the franchisee defaults under its franchise agreement, such a default is deemed to be a lease default as well. Instead, propose operating requirements not tied to the franchise agreement (*e.g.*, operating the store with qualified sales staff, adequately stocked with good merchandise, etc.).

LANDLORD'S LIEN - If the lease gives the landlord a lien on the tenant's personal property, consider whether this may limit financing for the franchise. Most landlords will agree to subordinate their lien in connection with any third-party equipment or inventory lender. Even if the lease is silent about a landlord lien, adding such language gives the tenant additional financing options.

THE LEASE GUARANTY - WHAT TO WATCH OUT FOR.

CAN YOU AVOID IT? As an alternative to guaranteeing the lease, propose a higher security deposit (3 or 4 months of rent) and have it reduced over time if there is no default and the franchisee demonstrates to the landlord that the franchisee is a good tenant.

LIMITING LIABILITY. Try to limit the guaranty, either by (i) having the guaranty run for only a fixed period of time (*e.g.*, 5 years), or (ii) limit the dollar amount (*e.g.*, in no event will the franchisor be obligated to pay more than \$50,000).

NOTICE AND CURE. Guarantees typically permit the landlord to pursue the guarantor for any tenant default without sending any notice to the guarantor (or providing them a cure period). This is another reason why it is very important that the franchisor receives all default notices, and has the right to cure.

A GROWING FRANCHISE – HOW TO SAVE TIME AND MONEY.

To save time and money, and have consistent leases, work with a real estate attorney to develop the following:

- (i) A lease issues checklist covering the major lease issues.
- (ii) Standard lease language governing permitted use, exclusive use, assignment, and default issues and any other franchise specific provisions.
- (iii) A form of limited lease guaranty which could be offered by the franchisor when required, and would always be more favorable to the franchisor than the landlord's standard form.

A PROGRAM FOR THE FRANCHISEE.

As part of its franchise program, the franchisor could negotiate the terms of each franchisee lease using attorneys with retail leasing expertise. This gives the franchisor the best opportunity to limit its liability, and ensure consistency among all of its franchisees' leases. Negotiating costs would be reduced and the franchisor may allocate some (or all) of the cost to the franchisee.

Such a program benefits the franchisee as well. The franchisee gets the benefit of experienced real estate counsel who would ensure that the negotiated lease satisfies the franchise agreement. The franchisee can then focus on running its business, while the franchisor gets the benefit of a lease protecting both the franchisor and the franchisee's business. Consult with your real estate attorney when implementing such a program.

CONCLUSION.

The franchisor has a material interest in the terms of its franchisees' leases. By knowing what to look for and establishing an efficient and cost-effective lease review program, the franchisor can limit its liability and maximize its flexibility.