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Real estate issues for franchises - by Eric Sigman

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The key to success of many franchise systems lies in establishing and maintaining great locations. In addition to the franchise agreement, the commercial lease is a fundamental document in any brick and mortar franchise. Given the competing interests of franchisees, franchisors, landlords, and lenders, legal issues abound at the intersection of real estate and franchise law. The three primary issues that these parties face when entering into a lease have to do with the use of the property, the assignability of the lease, and what happens if the tenant/franchisee defaults. Most franchisors will require that the franchisee and the landlord execute and deliver an addendum to the lease that, among other things, clearly defines the use and supersedes the assignment provisions in the lease and allows the franchisor to take over the location in the event of a default or in the event that the franchisee fails to renew its franchise agreement without having to obtain the landlord's consent.

Use – Defining the use of the property in a commercial lease is an important and often overlooked provision of a lease especially when it comes to franchises. A landlord will want to ensure that the use is very narrowly defined so as to more easily grant and monitor exclusive use rights in a shopping center. The franchisee and franchisor will favor a more broadly defined use clause which will afford the franchisee with more flexibility if the franchisor were to begin offering additional products or services. The use clause is typically coupled with language granting the franchisee with the exclusive right to a particular use in the shopping center. Take a pizza restaurant for example. A franchisee would prefer the use defined as “restaurant” so as to potentially preclude other food service concept from entering the shopping center whereas a landlord may prefer that the use is defined as “a carry out restaurant serving pizza and salads”.

Assignment –The franchise model introduces several complicated twists into one of the most heavily negotiated provisions of a commercial lease. Landlords seek to ensure that they have complete control over the assignment process. Losing a profitable or conspicuous location may be damaging to the brand and the system. The franchisor addendum also often permits a transfer of the lease to another franchisee without the landlord's consent which facilitates an exit of the franchisee. This runs counter to the landlord's interests when it comes to an assignment. One way to address this issue for the landlord would be to include criteria that a potential assignee would have to meet in

order to avoid getting the landlord's consent.

Some franchisors will take this a step further and directly lease a location from the landlord and sublease the space to a franchisee (if allowed under the lease). This allows the franchisor to maintain control of the location notwithstanding a default by the franchisee on either the lease or the franchise agreement. The franchisor can simply terminate the sublease, step in, continue to operate the location or replace the defaulting franchisee with another franchisee.

Default – The franchisor addendum also typically requires the landlord to give the franchisor notice (given simultaneously with the notice to the tenant) and the option to cure a default under a lease. This allows the franchisor to prevent the landlord from terminating the lease upon a tenant default thereby preserving the brand's right to the location. A franchisor's act of curing a default does not mean that the franchisee/tenant is off the hook - many franchise agreements contain cross default provisions that trigger a default in the franchise agreement upon a default in the lease.

A default usually raises issues from another interested party – the franchisee's lender. Some commercial leases will grant the landlord a security interest in the furniture, fixtures, and equipment of the franchisee. Most lenders will collateralize the furniture fixtures and equipment of the franchisee as security when granting a loan to the franchisee. Most franchise agreements contain provisions which give the franchisor a security interest in the furniture fixtures and equipment of the franchisee. There is an inherent conflict amongst these three parties for priority which is typically solved by multi-party agreements. These agreements kick in when the franchisee/tenant defaults and allow the franchisor to maintain its right to and trade dress, the lender securing its rights in the remaining assets and the landlord getting whatever is left over (if anything).

There are many complex issues and relationships arising out of the franchise model. For a more complete understanding, we recommend contacting experienced counsel of your choosing.

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