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**WHEN THE TENANT IS A FRANCHISEE –  
Accommodating the Franchisor's Requirements**

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## **WHEN THE TENANT IS A FRANCHISEE –**

### **Accommodating the Franchisor's Requirements**

#### **I. INTRODUCTION**

This paper will address the added dimension in the relationship between the property owner (“landlord”) and the tenant where the tenant is a franchisee of a franchised business concept. For “brick and mortar” franchised concepts, the franchisor will impose contractual obligations on the franchisee in the franchise agreement regarding the type, size, location, design, construction of leasehold improvements, signage, FF&E, etc. of the premises in which the franchised business will be operate. In addition, many franchisors require that certain provisions in favor of the franchisor be included in the lease and/or in a separate agreement among the franchisor, the franchisee and the landlord be signed as condition to the franchisor’s approval of the lease before the tenant signs the lease. In many cases, the franchisor and franchise sign the franchise agreement before a location for the franchised business is determined.

##### **A. General Description of Franchising as a Method of Distribution**

Franchising is a method of distribution for a company (franchisor) that desires to expand the number of its business outlets using the capital the others (franchisees). The franchise model contemplates that the franchise has developed a proven business system (“system franchise”) or a product (“product franchise”), identified with a trademark or service mark owned or licensed by the franchisor. In a business system format, the franchisor will have developed a system of operating a business under a recognizable name and license the business system and name to the franchisee. The franchisor will also provide to the franchisee certain initial and ongoing services that may include training of the franchisee and its employees, site selection assistance, construction plans and specifications, lease negotiation assistance, marketing and advertising programs, an operating manual, product specifications and sources of supply, accounting systems and other matters relating to the operation of the franchised business.

##### **B. The Economic Impact of Franchised Businesses**

It only takes a stroll in a mall, shopping center or business office, or a drive down the street to see the pervasive impact that franchising has brought to the U.S. economy in the last 50 years. Current economic statistics indicate that:

- There are an estimated 3,000 to 4,000 different franchisors (franchise business companies) operating in the U.S. today.
- There are in excess of 300 different industries and business categories utilizing the franchising business model as a means to distribute goods and services.
- There are an estimated 825,000 franchise businesses in the U.S. providing nearly 18 million jobs and generating over \$2.1 trillion to the economy.

- According to the International Franchise Association (“IFA”), almost 4% of all small businesses in the U.S. are franchises.
- The franchise industry accounts for approximately 50% of all retail sales in the U.S.
- A new franchise business opens every 8 minutes of every business day.
- Approximately one out of every 12 businesses in the U.S. is a franchised business.
- The average initial franchise investment is \$250,000- excluding real estate.
- Most franchisees do not own the real estate comprising the franchised business but lease the franchised business premises primarily from a third party and secondarily from the franchisor through a lease or sublease.
- The average royalty fees paid by franchisees range from 3% to 6% of monthly gross sales
- Most franchise companies have fewer than 100 units.
- The average initial term of a franchise agreement is 10 years plus renewal rights.
- The top franchise industry is the “Fast Food” industry.

## **II. THE ROLE OF A FRANCHISOR IN FRANCHISEE’S BUSINESS PREMISES**

For some franchisors, such as home based businesses and mobile concepts, real estate is not important. Those franchise concepts that rely on visibility and accessibility – such as in food service, retail sales, automotive aftermarket or consumer services - must boast well-defined real estate development programs. The age-old adage "location, location, location" is the basic tenet of any franchise concept that relies on the foot traffic of patrons, whether the franchise concept is a destination attraction or on the convenience of heavily trafficked locations such as major regional malls and transportation centers. For these concepts, real estate has equal importance to well-conceived trademarks and trade dress, well-defined systems and procedures, and highly trained franchisees as a significant component of the success of these franchise concepts.

When real estate is important, franchisors define their real estate needs and develop proper controls and procedures in the franchise agreement and manuals to obtain and maintain real estate, whether the franchisor or a franchisee develops the site. These franchisors have in place an experienced staff of real estate personnel or network of brokers as well as legal counsel to direct the franchisor’s and/or franchisee’s site selection and lease or acquisition negotiations and to oversee the leases in order to track tenant compliance, rent increases and proper exercise of renewal options.

This paper will deal primarily with the franchisor desiring to have certain control of real estate through the leasing of the premises of the franchised businesses (usually by the franchisee from an unrelated third party) rather than through the acquisition and development of land and buildings. A minority of franchisors, such as McDonald's, Burger King and Subway, may own the real estate and lease it to the franchisee or lease the real estate from a third party and sublease the real estate to the franchisee in order to have greater control over the location if the franchisee defaults. Such franchisors must have sufficient capital resources to fund a real estate program. This paper does not focus on this structure but focuses on the practice of the majority of franchisors, particularly start-ups and those franchisors that decide not to be directly involved in the ownership or lease of its franchisees' business premises. However, this does not mean that the franchisor totally abdicates any responsibility toward its franchisees in this regard. When real estate locations are important to the success of the franchise system, the franchisor must be deeply involved in the site selection and development process, not only to assist the franchisees but also to protect the franchisor's interest. Part of the "experience curve" for which a franchisee pays an initial franchise fee, is usually assistance in site selection and development. Certain provisions of the franchise agreement relate to control over real estate such as approval of sites, approval of leases, building design, signage, renovation and upgrading, and relocation. Many franchisors desire to have the right, but not the obligation, to take over the franchised business leased premises, if the franchisee defaults under the franchise agreement. This is the focus of this paper.

#### **A. Typical Franchise Agreement Provisions Regarding the Franchised Business Premises Including Site Selection Assistance and Lease Negotiation**

For franchise concepts where the location of the franchised business is important to the success of the franchised business and the franchisee leases the franchised business premises from an unrelated third party, the franchisor will include in the franchise agreement the parties' respective rights and obligations with respect to finding, leasing, constructing improvements, equipping the premises and opening the franchise business. These provisions assume that the franchisor is selling a new franchise and not an existing Company-Owned Outlet or a turnkey operation (further discussed below).

##### **1. Site Selection Criteria and Approval.**

The franchisor likely has developed site selection criteria for the Franchised Business relating to the type of location, size, estimated base rent and other charges, demographic requirements, traffic counts, zoning and other items. The franchisor must disclose these matters in its Franchise Disclosure Document that are included in the franchise agreement. Usually, the franchisee is responsible for finding a site that satisfies the franchisor's site selection criteria. The franchisor may be actively involved in assisting the franchisee in finding a site, or may refer the franchisee to a local broker to assist the franchisee, or leave the franchisee on his or her own. Once the franchisee has selected a proposed site that he or she believes satisfies the franchisor's criteria and before signing a lease, the franchisee is required to notify the franchisor and send the franchisor certain information regarding the site. This information may include: pictures of the site; population demographics within a 20-mile radius of the site; information regarding traffic counts and patterns; parking spaces; visibility from the roadways; the predominant

character of the neighborhood; competitive businesses within the area; the nature of other businesses in proximity to the site; and the size, appearance and other physical characteristics of the site. The franchisor requires that it approve the site before the franchisee signs the lease to ensure that the site satisfies its site criteria. Typical franchise agreement provisions on these issues are:

**Site Selection Assistance by Franchisor.** We must give you written approval of the proposed site for the Premises for your Franchised Business before you sign a lease or begin any construction. We will supply you our site selection criteria. Within 30 days after signing this Agreement, you must find a site that you believe meets our criteria. You must send to us all material information regarding the proposed site including: pictures of the site; population demographics within a 20-mile radius of the site; information regarding traffic counts and patterns; parking spaces; visibility from the roadways; the predominant character of the neighborhood; competitive businesses within the area; the nature of other businesses in proximity to the site; and the size, appearance and other physical characteristics of the site. We will not unreasonably withhold our approval of any site meeting our standards. We will review site approval submissions on a first-in basis. If we do not approve the site, you have 30 days in which to submit a new site within the Reserved Area for our written approval. If you fail to do so timely, we have the right to terminate this Agreement and retain 50% of the Initial Franchise Fee to cover our costs and expenses for the assistance we have provided to you under this Agreement. **WE DO NOT REPRESENT THAT WE HAVE ANY SPECIAL EXPERTISE IN SELECTING SITES FOR THE OPERATION OF A FRANCHISED BUSINESS. OUR APPROVAL OF A SITE IS NOT A REPRESENTATION OR WARRANTY THAT THE FRANCHISED BUSINESS WILL BE PROFITABLE OR THAT YOUR SALES WILL ATTAIN ANY PREDETERMINED LEVELS. OUR APPROVAL IS ONLY OUR INDICATION THAT THE PROPOSED SITE MEETS OUR MINIMUM CRITERIA FOR IDENTIFYING SITES.**

**Acquisition of the Site by Franchisee.** You are solely responsible for selecting the site for the Franchised Business. If you have not selected a site as of the Agreement Date, you must complete the acquisition or lease arrangements for your Premises within 2 months after the Agreement Date, and obtain our written approval. We may require that you engage a real estate broker of your choosing, or, at our discretion, our approved broker, to advise and assist you in locating, selecting and negotiating the terms of the lease for the site. Any fee charged by our approved broker for this service is your responsibility. If we have not approved a site within 2 months after the Agreement Date, we have the right to terminate this Agreement. Upon termination we will refund to you 50% of the Initial Franchise Fee to you without interest, and we will retain the balance to cover our costs and expenses for the assistance we have provided to you under this Agreement and for our lost opportunities.

## **2. Lease Assistance**

After the franchisee has selected a site for the location of the franchised business that the franchisor approves, franchisors provide varying degrees of assistance to the franchisee in

the negotiation of the terms of the lease. The franchisee should retain its attorney to assist in the negotiation of the lease as there may be concern whether the franchisor's lease negotiation assistance is primarily to ensure the interests of the franchisor are included in the lease and not the interest of the franchisee as a tenant. The franchisor may take an active role in the negotiation, particularly if the franchisee is not experienced or sophisticated, but with the franchisee having final say. In other systems, the franchisor may provide the franchisee with a checklist or guidelines of important issues the franchisee must address with the landlord and included in the lease due to the nature of the Franchised Business and the franchisor's requirements and the franchisee's obligations under the franchise agreement. A copy of a Franchise/Tenant Lease Negotiation Checklist is attached at the end of this paper. In still other systems, the franchisor merely reviews and approves the lease after the franchisee has negotiated it. In these systems, the franchisor may have a separate agreement that amends and/or supersedes inconsistent language in the lease including certain rights given to the franchisor as further discussed below.

The ultimate decision to sign a lease should be the franchisee's decision, as the franchisor will not want impliedly to warrant or guarantee the franchisee's success at the approved site. Typical franchise agreement provisions on this issue are:

**Lease Assistance.** If you intend to lease your Premises from a third party, we will assist you in your lease negotiations including giving you our Franchise/Tenant Lease Negotiation Guidelines. Any lease must provide that the effectiveness of the lease is conditioned upon your obtaining our written approval. The property owner, you and us must sign our form of Agreement with Landlord attached as Exhibit L to the Franchise Disclosure Document. WE DO NOT REPRESENT THAT WE HAVE ANY SPECIAL EXPERTISE IN NEGOTIATING LEASES. YOU AGREE THAT OUR APPROVAL OR DISAPPROVAL OF A PROPOSED LEASE DOES NOT IMPOSE ANY LIABILITY ON US.

**Lease of the Site by Franchisee.** We must approve any lease of the Premises. You must deliver a copy of the proposed lease to us at least 15 days before you sign it. You and the landlord must sign our form of Agreement with Landlord, the form of which is included in Exhibit L to the Franchise Disclosure Document.

### 3. **Plans and Specifications**

Many franchisors have developed a unique look and design ("Trade Dress") of the premises of the franchised business that is protectable under the federal Trademark Act. The franchisee is required to find a site that readily and reasonably accommodates the franchisor's requirements in the form of leasehold improvements, signage, furniture, fixtures, utilities, etc. The franchisor will usually provide the franchisee with its standard set of plans and specifications and/or a recommended floor plan, as well as design specifications for the design, décor, interior layout, fixtures, furnishings, equipment, signs and furnishings based on the design of the prototypical (flagship) operating business. A typical franchise agreement provisions on this issue is:

**Plans and Specifications of Franchisor.** We will loan to you a sample set of certain specifications (which may include sample store layouts and floor plans) for construction of the Premises concerning the design, décor, interior

layout, fixtures, furnishings, equipment, signs and furnishings (collectively, the "Design Specifications"). The Design Specifications may vary in their design and decor by region of the country, at our sole discretion. On or before the Opening Date, you must return these plans and specifications to us.

#### 4. **Construction Requirements**

The franchisor will also require the franchisee's architect and engineer to revise the plans to conform to the site's dimensions and state and local construction requirements. The franchisee must obtain governmental permits to construct the leasehold improvements and will install the required signage, furniture, fixtures, equipment and other items. A typical franchise agreement provision on this issue is as follows:

**Construction Plans and Permits by Franchisee.** For the construction of your Premises, you will do all of the following:

(a) You must employ a qualified licensed architect or engineer with adequate errors and omissions insurance to prepare a site plan and plans and specifications adapted from our standard plans and specifications for your approved location and in compliance with applicable laws including federal and state disabilities laws, lease requirements and restrictions. Any material modification to the standard plans and specifications must be sealed and stamped by the architect or engineer and we must approve the modification. The modified plans and approvals, once approved by us, will not be materially changed or modified without our written approval.

(b) You will employ professional supervision satisfactory to us over the construction of your Premises.

(c) You must obtain all permits and certifications required for the lawful construction and operation of your Franchised Business, together with certifications from all governmental authorities having jurisdiction over your Premises and your Franchised Business. You must provide us with evidence that you have obtained all necessary permits and that you have met all requirements for construction and operation, including zoning, access, sign, fire, health, environmental and safety requirements.

**Construction Requirements.** You will contract with our approved construction vendor, if any, to design, remodel and construct the Premises in accordance with the approved plans and the Design Specifications. You must continuously construct the Premises and complete construction, including all exterior and interior carpentry, electrical, painting and finishing work and installation of the approved fixtures, equipment and signs, no later than 6 months after the date of this Agreement at your expense. You agree that our representatives have the right to inspect the construction at all reasonable times. You agree that time is of the essence in constructing and opening your Franchised Business.



## 5. Opening of the Franchised Business

The franchisor will impose numerous requirements besides the construction of the franchised business in accordance with the franchisor's business model that the franchisee must satisfy before the franchisee opens the franchised business for business. These may include pre-opening training, payment of all initial fees, obtaining the necessary insurance, a certificate of occupancy and authority to do business. A typical franchise agreement provision on this issue is as follows:

**Opening Conditions.** You agree not to open your Franchised Business for business until: (a) all your obligations under this Agreement have been fulfilled; (b) we determine that your Franchised Business has been constructed, furnished, equipped, and decorated in accordance with approved plans and specifications; (c) the training of the Trainees has been completed to our reasonable satisfaction; (d) the Initial Franchise Fee and all amounts due to us and our Affiliates under this Agreement have been paid in full; (e) we have been furnished with certificates of insurance and copies of all insurance policies or all other evidence of insurance coverage as we reasonably request; (f) you have obtained a certificate of occupancy for your Premises; and (g) you have obtained all necessary licenses and permits to operate your Franchised Business. We will give you written final consent to the opening of your Franchised Business. You will comply with these conditions and be prepared to open your Franchised Business for business within 6 months after the Agreement Date. We will give you our written approval to open your Franchise Business. If you fail to open your Franchised Business within 6 months after the Agreement Date, we have the right to terminate this Agreement and retain the Initial Franchise Fee to cover our costs and expenses for the assistance we have provided to you under this Agreement.

## 6. Restriction on the Use of the Premises

The franchised agreement will generally restrict the franchisee from using the Premises solely for the operation of the franchised business in accordance with the terms of the franchised agreement and under the franchisor's trade name. The franchisor will also require that the lease contain a similar restrictions and requirements that are further discussed below.

**Use of the Premises by Franchisee.** You must use your Premises only for the operation of your Franchised Business. You must keep your Franchised Business open for business and in normal operation for the minimum hours and days as we reasonably require in the Operation & Policies Manual or otherwise in writing except as may be limited by local law or the landlord's rules and regulations

### **B. Franchisor's Methods to Impose Certain Contractual Requirements in the Lease Between Landlord and Tenant/Franchisee**

There are several methods employed by franchisors and their counsel to address the franchisor's contractual requirements imposed upon the tenant/franchisee under the franchise agreement relating to the lease between the landlord and the tenant/franchisee.

1. **In Body of Lease.** The franchisor's contractual requirements can be expressly incorporated into the body of the lease with the franchisor given certain third-party beneficiary rights since it is not a signatory.

2. **Addendum to Lease.** The franchisor's contractual requirements can be added as an addendum to the lease including a provision that the terms of the addendum supersede and control over any conflicting terms of the lease with the franchisor given certain third-party beneficiary rights since it is not a signatory.

3. **Collateral Assignment of Lease.** The franchisor may request that the landlord consent to a collateral assignment of franchisee's interest in the lease as tenant by the franchisee to the franchisor effective upon the termination or expiration of the franchise agreement. The collateral assignment of lease may contain more than traditional collateral assignment of lease used in financing transactions, as the franchisor may have included other contractual rights or requirements. A form of Collateral Assignment of Lease is attached at end of this paper.

4. **Agreement with Landlord (Tri-Party Agreement).** The franchisor requires that the tenant/franchisee and the landlord enter into an agreement among the franchisor, landlord and tenant/franchisee that includes the franchisor's contractual requirements including a provision that the terms of the Agreement with Landlord supersede and control over any conflicting term of the lease. A form of Agreement with Landlord is attached at end of this paper.

### **C. Franchisor's Contractual Requirements for the Lease Between Landlord and Tenant/Franchisee**

The franchisor imposes certain requirements on the franchisee in the franchise agreement as to what rights the franchisor requires with respect to the franchisee's lease of the franchised business premises. These contractual requirements vary industry by industry, by the type of franchise concept, the trade dress and by the degree of control that the franchisor desires to exert over the franchised business premises.

#### **1. Franchisor's Signage Requirements**

For many franchisors, the look and design, fixtures furniture, equipment and signage with franchisor's name and logo are an integral part of the franchise system and the objective to develop brand awareness and uniformity of quality, operations and service to its customers/clients. Sometimes these requirements conflict with the look and design, and uniform signage requirements created by the landlord for the mall, shopping center, office, etc. These conflicts will have to be resolved to the reasonable satisfaction of all parties. In other cases, the franchisor's requirements may conflict with the applicable governmental signage requirements or restrictions. The franchisor will also want the right to take down the signs if the franchise agreement is terminated or expires and is not renewed. Typical provisions that the franchisor would want to include on these issues are:

**Signage.** The Landlord agrees to the Franchisor's signage requirements for the Tenant/Franchisee, subject to local signage ordinances and approval by local governmental agencies, if necessary.

**Franchisor's Rights Upon Termination or Expiration of Franchise Agreement.** The Landlord agrees to the Franchisor's rights under the Franchise Agreement, upon reasonable notice to the Landlord, to enter the Premises to take all steps necessary to protect its interest under the Franchise Agreement including the removal of all signs and other Proprietary Marks of the Franchisor (without damage to the Premises).

**2. Franchisor's Restriction on Use of Premises; Exclusive Use; Non-Competition by Landlord in Re-Letting**

The Franchisor will generally require the entire premises be used by the franchisee solely for the operation of the franchised business. There are exceptions such in dual branding. The franchisor will also want to tenant/franchisee obtain exclusive use rights within the mall, shopping center or multi-tenant building so that no competitor can also be a tenant. This requirement may conflict with an exclusive use that the landlord has previously granted to another tenant. The franchisor may also require the landlord to agree that, if the tenant ceases being a franchisee and remains in the premises, and the franchisor does not take over the premises, the tenant cannot operate a competitive business. Typical provisions that the franchisor would want to include on these issue are:

**Use of Premises; Exclusivity.** The Landlord and the Tenant/Franchisee agree that the Tenant/Franchisee may only use the Premises for the operation of the Franchised Business, unless the Franchisor otherwise approves in writing. The Landlord acknowledges that this use does not violate any zoning restrictions, restrictive covenants or existing exclusive uses granted to any other tenant of the Landlord in the building/center or adjacent outparcel owned by the Landlord in which the Premises are located. The Landlord further acknowledges that during the term of the Lease or any extension of the Lease, the Landlord will not lease space within the building/center or outparcel to a business similar to the Franchised Business or permit an existing tenant to offer products that compete with the Franchised Business.

**Non-Competition Covenant of Landlord.** If the Franchisor does not take over the Lease upon the termination or expiration of the Franchise Agreement and the Tenant/Franchisee remains in possession of the Premises, the Landlord and the Tenant/Franchisee agree that, for a period of 2 years after the expiration or termination of the Franchise Agreement, the Premises will not be used for a business in competition with the Franchisor or any of the Franchisor's Franchisees, as well as vested exclusive uses that prohibit or compete with the franchise concept.

**3. Copies of Tenant Information Submitted to Landlord**

While the type and degree of detail of information about the tenant, its use of the premises and its financial information that a tenant must submit to a landlord varies depending on the type of business, whether percentage rent is paid, nature of tenant, etc., the franchisor will want a copies of it to, among other things, make sure that the tenant/franchisee is reporting the same figures to both the landlord and the franchisor. This will also include any other material

communication between the landlord and the franchisee. Both the landlord and the tenant should make a note of this obligation. A typical provision that the franchisor would want to include on this issue is:

**Tenant Information.** The Landlord will send to the Franchisor promptly copies of all sales reports, financial information, correspondence and other communications the Landlord receives from the Tenant/Franchisee.

#### 4. **Notices of Default by Landlord or Tenant**

Most franchisors definitely want to be notified promptly if the landlord sends to the tenant/franchisee or receives from the tenant/franchisee a written notice of default or other legal notice. Under most franchise agreements, a default under the lease also constitutes a default of the franchise agreement. A typical provision that the franchisor would want to include on this issue is:

**Notices of Default.** The Landlord will overnight to the Franchisor at the address listed below by USPS, FedEx or UPS copies of all written notices of default or other notice sent to, or received from, the Tenant/Franchisee.

#### 5. **Franchisor's Right to Cure Tenant/Franchisee's Default and Assume Tenant/Franchisee's Interest in Lease**

Most franchisors want the right, but not the obligation, to cure the tenant/franchisee's default and take over the franchised business including an assumption of the tenant/franchisee's interest under the lease. If franchisor determines that the location is good but the franchisor made a poor franchisee selection or circumstances arose that make the franchisee unable to perform, the franchisor may elect to terminate the franchise agreement (after giving any required notice and the expiration of any applicable cure period), cure the default under the lease and accept an assignment of the lease. If the franchisor determines that the location is poor and is coupled with a poorly performing franchisee, the franchisor may elect to terminate the franchise agreement (after giving any required notice and the expiration of any applicable cure period) but elect not to cure the default under the lease, allowing the franchised business to close. Typical provisions that the franchisor would want to include on these issues are:

**Right to Cure.** If the Tenant/Franchisee defaults under the Lease, the Franchisor may (but is under no obligation to) within 30 days after receipt of written notice from the Landlord, cure the default (or a longer period of time if the default is not capable of being cured within 30 days and the Franchisor is diligently proceeding to cure the default).

**Right to Assign.** The Tenant/Franchisee may assign to the Franchisor his or her interest under the Lease and all rights and obligations under the Lease without the Landlord's consent. The Franchisor may assign the Lease and all rights and obligations under the Lease to another Perfect Franchisee upon the Landlord's written approval of the new tenant/franchisee. The Landlord will not be unreasonably withhold, delay or condition its approval of the new tenant/franchisee.

## 6. **Franchisor's Approval of Material Modification to Lease**

The franchisor will want to have the right to approve any material modification to the lease after it is signed to ensure that a material modification does not adversely affect franchisor's rights or the rights of the tenant/franchisee. A typical provision that the franchisor would want to include on this issue is:

**Modification of Lease.** The Landlord and the Tenant/Franchisee will not make any material modifications to the Lease without the Franchisor's written consent, which consent the Franchisor will not be unreasonably withhold, delay or condition.

## 7. **Landlord's Subordination of Security Interest and/or Landlord's Lien**

Under state law, the landlord may have a statutory lien on the tenant's property located in the leased premises as security for the tenant's obligations under the lease. Some landlords require the tenant to grant it a security interest in the tenant's property located in the leased premises as security for the tenant's obligations under the lease. Some franchisors require the franchisee to grant to the franchisor a first priority security interest in the assets comprising the franchisee's franchised business as security for the franchisee's obligations under the franchise agreement. In this case, the franchisor may request that the landlord subordinate its landlord's lien/security interest to the security interest in favor of the franchisor. If the tenant/franchisee is obtaining financing such as an SBA-guaranteed loan from a bank, the lender will likely require that the landlord and/or franchisor subordinate its landlord's lien/security interest to the security interest in favor of the lender. A typical provision that the franchisor would want to include on this issue is:

**Subordination of Landlord's Statutory Lien.** Upon request of the Franchisor and/or the Tenant's lender, the Landlord will subordinate its statutory lien and security interest in the Tenant's property to the security interest of the Franchisor and or Tenant's lender. The Landlord will further cooperate in signing all required documents to recognize the subordination.

## D. **Turn-Key Franchising; Sale of Company-Owned Outlets**

A hybrid between the franchisor having direct control over real estate and leasing it to the franchisee and the franchisee having direct control over the real estate by owning or leasing it from a third party is the turnkey franchise. A turnkey franchise is the situation when the franchisor owns and develops the outlet and then sells the assets comprising the outlet to the franchisee before it opens as a franchised business including an assignment of the lease. It is similar to an asset sale of an ongoing business with the addition of the ongoing license of the seller's trademark and on-going services and/or controls by the seller/franchisor contained in the franchise agreement, which is signed in addition to the normal purchase and sale documents, conveyance documents and other asset-sale closing documents. A turnkey franchise allows the franchisor to have total decision-making authority and control over site location, lease negotiation, and constructing and equipping the outlet. At the time the outlet is ready to open for business, the franchisor sells it to the franchisee. At the time the franchisor signs the lease with the landlord, the franchisor will want to negotiate the right to sell the assets

and have the buyer assume its interest in the lease and be released from all future obligations under the lease upon the assignment and assumption.

Most franchisors started with the founder owning and operating the first outlet that became the ‘guinea pig’ of developing, testing, refining and proving the franchise concept. Many franchisors continue to develop additional units (Company-Owned Outlets) in addition to selling franchisees (Dual Distribution). At some point, the franchisor may decide to sell a company-owned outlet to a franchisee that will operate the business as a franchise outlet. The sale of a company-owned outlet is usually an asset sale with an assignment to, and assumption of, the lease by the buyer/franchisee and the franchisor released from the tenant’s obligations under the lease upon the assignment and assumption.

### **III. REPRESENTING THE TENANT/FRANCHISEE**

If you are retained by the client at an early stage of his or her interest in purchasing a franchise, usually after the client has done due diligence and has targeted a particular franchise. In this instance, you and your client need to review the franchisor’s Franchise Disclosure Document, Franchise Agreement and other agreements that the franchisee will sign at the same time. A franchisor is required under the FTC Franchise Rule to give its current Franchise Disclosure Document to a prospective franchisee at least 14 days before the prospect signs any agreement with the franchisor or gives the franchisor any money. It is beyond the scope of this paper to discuss all the issues that you should raise with respect to the franchise agreement. If you limit your practice to real estate, you should consider referring the franchise review and negotiation process to an experienced franchise attorney. Oftentimes the franchisee signs the franchise agreement and then the site selection and lease negotiation process begins as part of the development of a new franchised business.

The client may have come to you after the franchisee signs the franchise agreement. They probably did not have an attorney represent them in connection with the purchase of the franchise. They come to you because of your expertise in lease negotiation. You should likewise ask the client to supply you with a copy of the signed franchise agreement and related agreements as well as the Franchise Disclosure Document. This will help you understand the nature of the franchised business and your client’s contractual obligations relating to the lease and the franchisor’s contractual requirements to be agreed to by the landlord and tenant/franchisee. You will want to coordinate with the franchisor’s representative or its counsel with respect to the lease negotiation as the franchisor’s approval will likely be required.

Here are some of the issues you may want to raise with your client with respect to the lease of the franchised business premises. If the franchise agreement has been signed, you may be hamstrung on some of these issues.

- Is the type of franchised business lawful in the jurisdiction where it will be located and operated?
- Does the franchised business or business owner need a special permit or license?
- Is the property zoned for the franchisee’s intended use?

- What will the franchisee's exclusive or protected territory based on the location of the leased premises? Is it sufficient?
- Do the lease costs fall within the range disclosed in ITEM 7 of the Franchise Disclosure Document?
- Try to limit the franchisor's right to take over your lease to where the franchisee's defaults and not where the franchise agreement expires and is not renewed or the franchise agreement is terminated by the franchisee due to the franchisor's default.
- Try to negotiate the right to continue in the space under a different name if the franchise agreement expires or the franchisee's terminates the franchise agreement due to franchisor's default.
- Upon an assignment to the franchisor or its designee due to the franchisee's default, the franchisee and any guarantors are released from its obligations under the lease and any guaranty.

#### **IV. REPRESENTING THE LANDLORD**

Merely because a franchisee agrees as part of the purchase of a franchise to obtain from the landlord certain contractual provisions in favor of the franchisor, the landlord is under no legal obligation to agree to them. However, for a good tenant, the landlord may desire to accommodate the franchisor as reasonably possible. Having another person (the franchisor) worrying whether the tenant pays your landlord client is not a bad thing. However, some franchisors overreach in their demands, wanting the cake and eating it too, such as:

- The franchisor assuming the lease without having to cure the franchisee's prior monetary and non-monetary defaults.
- Agreeing not to re-let the premises to a competitive business after the franchisee vacates and the franchisor does not take over the lease.

#### **V. CONCLUSION**

Many of these types of transactions occur every business day. It is helpful to know all the players and their competing business interests to come to an understanding that balances the parties' rights and obligations and, hopefully, have a business arrangement that works for everyone including the consumer.

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