

## Leasing to Franchise Tenants — A Guide for Landlords

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Franchised companies continue to be one of the largest growing sectors in retail. This is due in part to the many benefits for small business owners to utilize a larger company's proven business model. This higher chance of success makes franchising attractive to both established and new entrepreneurs alike. With so many executives and mid-level managers facing job changes in the past few years of the economic downturn, the influx of new business people into the franchise world continues to grow. A growing supply of new franchisees has led franchisors to consider expansion into new markets and territories. Even as the majority of the retail sector remains generally depressed, the expansion of franchised brands seems to be the one source of good news and hope for retail centers across the country looking to fill vacancies and generate positive energy and public relations.

### **The Benefits of Franchise Tenants**

There are many benefits to securing a franchise tenant at a retail site. One of the most immediate benefits is the value of a regionally or nationally established trade name and brand that can draw in both loyal and new customers to a retail development or center. Other tenants are more inclined to

desire long-term, established businesses as their neighbors, and having a franchise tenant can certainly lend credibility to a new or struggling development. Additionally, most franchisors require that franchisees possess a high net worth and personally invest large sums into their business operations and build-outs. This may lower the risk a landlord faces when evaluating a new tenant.

Also, a landlord's financing partners are often more inclined to invest in leasehold improvements or incentive packages when the concept is proven and the tenant has a substantial equity investment in the operation. The very fact that the principals of the tenant passed the vetting process of a franchisor may give the landlord additional comfort regarding the tenant's chance of success. Finally, since franchisors often require that their operators commit to the enterprise over the long term, a landlord may benefit from longer lease-term and renewal periods than what is currently considered as "market." Having a property under a long-term contract is always advantageous to a landlord for both the rental stream it will generate and the marketability it can lend to the development.

## **Franchise Tenants vs. Other Retail Tenants**

In most respects, the lease negotiation process involving a franchise tenant should include a due diligence review similar to that found in any lease situation. The landlord should familiarize itself with the prospective tenant's business plan, operations, financial strength and reputation in the marketplace. In addition, the landlord should request information on the franchisee itself, and understand the quality of the franchise system. Requesting the financials of a prospective tenant is pivotal in determining what rental rates and tenant improvement allowance the landlord should offer. Understanding the financial strength of the tenant also affects the amount of security deposit and the terms of any personal or company guaranties requested by the landlord for the monetary obligations under the lease.

Many landlords are curious about any differences between leasing to a franchise tenant as opposed to leasing to a regular corporate tenant. One common misperception is that a franchisee tenant is somehow related to the actual franchise company, which is generally much larger, more established and has stronger financials than, say, the franchisee tenant. However, a franchisee business is its own stand-alone operation that simply has licensing rights to the franchisor's branding, systems and products; the franchisee business is not otherwise affiliated with the franchisor company. Consequently, the landlord should not expect to receive any corporate guaranty for the lease obligations from the franchisor, nor should the landlord believe that it has any privity of contract with the franchisor.

When negotiating a lease with a fran-

chisee tenant, the landlord should also consider what kind of atypical resources are required for the planned franchise operations—for example, placement of satellite dishes at the building for a sports bar concept, required outdoor patio space, or any unusual design elements or signage requirements. Prior to commencement of the lease, it is crucial that the costs of both the original construction of these items and the associated ongoing maintenance, repair and/or replacement be considered in the lease agreement provisions, and that all obligations relating thereto are fully understood by all the parties.

Finalizing the initial lease discussions with a letter of intent is wise in any lease situation. A letter of intent can be especially useful when dealing with a franchise tenant, since the third-party franchisor requirements for build-out design, signage and related matters can be disclosed, discussed and agreed upon by the parties early in the lease negotiation process. Attaching any written requirements, such as exhibits, to the letter of intent and the final lease agreement is useful in minimizing the chances of the parties' misunderstanding their expectations and obligations with regard to these matters.

## **Review of the Franchise Agreement**

While landlords may appreciate and understand the benefits of a franchise tenant, they also wonder what risks to consider and investigate as part of their due diligence process. A landlord should ask to review pertinent portions of the tenant's franchise agreement with the franchisor. The agreement is the cornerstone document between the franchisor and franchisee, and sets out the obligations and rights of each party. A

landlord should understand what constitutes events of default under the franchise agreement, to determine if there is a high probability the franchisee may lose its rights to the franchise. This, of course, would negatively affect its business operations and viability as a tenant. A landlord should ensure that the term of the franchise agreement is coterminus or for a longer duration than the proposed lease term (inclusive of option/renewal periods). Finally, it is wise for the landlord to inquire if there are any termination rights (for either party) under the franchise agreement. This information will help the landlord understand the impact of the exercise of such rights on the business operations and tenancy.

### **The Franchisor Addendum**

One challenge that a landlord may face when leasing to a franchise tenant is that the lease negotiation process may have to include both the franchisor and its counsel. Most franchisors also require that a franchisor consent or addendum be incorporated into a lease agreement. The provisions included in such an addendum are similar to those found in a lender-requested addendum or consent agreement:

- Rights to notice of a default under the lease;
- Additional cure rights or time periods upon an event of default under the lease, and
- Consent rights to any amendments or modifications of the lease agreement.

There is relatively little flexibility in negotiating these provisions with the franchisor; however, a landlord should rightfully

request reasonable time periods for providing notice and any extension of cure rights.

### **Protecting the Franchisor and the Franchise Brand**

The franchisor seeks to protect its collateral rights—as does a lender—by taking precautions both to ensure that the lease location is a success and to protect its brand in the process. Some common provisions within an addendum include the franchisor-approved “use” provision to be included in the lease. The use provision often is incorporated into an “exclusivity” provision, which helps to guarantee primary market share of customers for the particular franchise operations. Also, some franchisors may request certain restrictions on adjoining uses within the retail development or center. The landlord should carefully review these provisions to eliminate any conflicts with existing or planned uses at the retail site.

In addition, the landlord should consider whether the franchisor’s requests are reasonable and whether they hinder the potential or marketability of the remainder of the retail development. The franchisor will also request the right to enter the premises (following the expiration or termination of the lease) to de-identify the premises of any “branded,” franchisor-owned marks, designs or logos. Landlords should be aware that de-identifying the premises can extend not only to removing signs or items bearing logos, but may also include altering the design and colors of the interior and exterior of the building to a state that is materially different from the authorized franchise building design and paint scheme/palate. Landlord concerns can be minimized if this provision includes a requirement that the de-

identification be done within a reasonable time period following the expiration of the lease (30 days is standard), that it be completed at the franchisor's sole expense and that the franchisor agrees to repair all damage done to the premises from such activities. A wise landlord would ask for an indemnification from the franchisor for all costs and potential damages relating to the de-identification process.

### **Landlord Concerns**

Franchisors often request other provisions that a landlord should carefully consider when presented in a franchisor addendum or in negotiations involving the actual lease. One such provision is the right of the franchisee to assign its interest in the lease to the franchisor or to another "authorized" franchisee of the particular franchise system. As with any assignment provision, the landlord should include provisions allowing the landlord to review the particulars of the assignee as a new tenant. The landlord will want to analyze the same factors that were considered when it chose to enter into a lease with the original tenant, including: financial net worth, reputation in the marketplace and strength of business operations. A franchisor needs to be reasonable in its request to require a landlord to accept an assignee tenant, and a landlord should request that the tenant be given adequate notice and review time periods, as well as unabridged consent rights to any assignment of the lease.

Often a franchisor will require rights to "take over" the franchise operations following an event of default under the franchise agreement. This is beneficial to the landlord, as it will result in the store's continuous operation and payment of rent; and the

landlord will receive the added benefit of a stronger, more reliable tenant. However, if the location is so valuable that the franchisor has assumed the lease obligations, the landlord may have enough leverage to require a corporate guaranty for the remaining lease term, which is always advantageous. Finally, it is important that the landlord require that the franchisor (or any assignee) enter into an assumption-and-assignment agreement as to the lease so that there is no ambiguity regarding the contractual rights of the parties following an assignment of the original lease.

A franchise addendum will often include a provision that the landlord is not allowed to place any liens or maintain any security interest either in the personal property that is trademarked or to the property of the franchisor. This is a reasonable request of the franchisor and, practically speaking, a landlord would be unable to use or sell any of the trademarked items without violating the rights afforded the owner of such items under federal law. As such, a landlord should not expend much effort in negotiating this provision. However, generally, the lease provides for a landlord lien on personal property located at the premises. In the event of default under the lease, the landlord should include a carve-out for these trademarked or franchisor-owned items, rather than strike the provision altogether. Instead, the landlord should include lien rights as to any other personal property owned by the tenant (that is not trademarked)—for example, general equipment located on the premises—as this may be helpful to offset losses that the landlord may experience in the event of a lease default.

### **Ensuring a Successful Relationship With a Franchise Tenant**

As illustrated, there are myriad issues and concerns that a franchise tenant, prospective landlord and franchisor should consider during the negotiation of a retail lease agreement. While each party has distinct interests in the outcome of the lease arrangement, it is crucial for each of those parties to remember that they all share a mutual goal that will benefit all parties: to create and maintain a relationship that reconciles the various interests and is helpful to promote the success of the franchisee and the store.

The franchisor benefits from a successful retail location in that the reputation of its brand in that region will grow stronger; will result in higher revenues and, therefore, royalty payments to the franchisor; and will have additional expansion opportunities for the brand. A franchisee that is experiencing

success will not only receive higher revenue and profits for its business, but such success may also lead to business growth and expansion rights with the franchisor. Concurrently, a successful store results in a steady rental stream at the property for the landlord and the benefits of a thriving and active development, which can only serve to attract additional customers and tenants.

### **Conclusion**

The negotiation of a lease for a franchise tenant includes unique challenges. However, if the parties, and their representatives and counsel, employ practical thinking and focus on their mutually beneficial goal, the lease can and will be resolved without unnecessary conflict, and the relationship between the parties will begin positively. This is a win-win situation for all involved.

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