
Franchisor Lease Addenda: Just the Three of Us

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Lease negotiations are traditionally a two-party activity; you have the landlord and the tenant going head-to-head to work out the best deal. When dealing with a franchisee as a tenant, however, there is a third party lurking in the background: the franchisor.

Many franchisors have a standard addendum they require franchisees to add to their leases. The addendum is designed to protect the franchisor's interests in the transaction. Contrary to first impressions, landlord interests do not necessarily run contrary to a franchisor's. The parties can reach a mutually beneficial arrangement – one which will offer the landlord greater long-term security *and* protect the interests of the franchisor.

Assignment Provision – Landlord Takes Over

The key element to these franchisor addenda is a clause allowing the franchisor to take an assignment of the lease. Assignment provisions take different forms, but the common theme is that the franchisor is given the right to take an assignment of the lease in the event of a franchisee default – either under the lease or under the franchise agreement. From a landlord's perspective, this provision can be a great advantage as it provides additional security. It affords the landlord another ready and available party to take over the lease if the original franchisee-tenant has defaulted. More importantly, the franchisor will likely have deeper pockets than its franchisee, allowing the landlord to have greater security. Landlord's counsel should make sure that the assignment provision contains adequate notice requirements so that the landlord will know which entity is responsible under the lease.

The key to making this provision work for all parties is knowing who is responsible for the liabilities of the defaulting franchisee and clearly identifying those responsibilities in the addendum. Generally, the franchisor will take the position that the liabilities of the franchisee stay with the franchisee and the franchisor will not have to assume its existing debts. This approach would result in the landlord

having to pursue the franchisee for outstanding debts. Landlords, of course, will take the position that the franchisee was chosen by the franchisor, and the franchisor should share in the burden of the franchisee's failure to meet its obligations. The outcome of this provision will often be determined by the relative leverage of the parties.

Second Assignment Provision – Assign to New Franchisee

Closely connected with the above provision is a second assignment clause allowing the franchisor to assign the lease to a new franchisee. As with the assignment to franchisor provision, landlords can benefit from this provision. A new tenant is put into the space and the landlord has no build-out costs and no commission payments. Franchisors desire this provision because many franchisors either: (a) do not have a business plan that includes company owned stores; or (b) may not have the administrative capacity to manage a company store in a location far from corporate headquarters. Allowing a franchisor to assign the lease to a new franchisee also gives the franchisor the ability to continue business in a desirable location or target market.

Notice Provision and Right to Cure

Most franchisor lease addenda also contain a requirement that the landlord give the franchisor notice of defaults that occur under the terms of the lease. Notice of a default from the landlord affords a franchisor the ability to address a breach in the lease before there are no options left. The landlord also benefits from this requirement by having a second party ready to cure a breach of the lease. If the landlord agrees to provide notice, and the provision is left in the addendum, rather than moved to the lease, landlord's counsel must consider another critical issue. There should be consistency between the lease and the addendum language with regards to notice. In many landlord form leases, a landlord does not have to provide notice in the event of a failure to pay rent.

Along with notice, franchisors frequently request: (a) the right to cure the franchisee's defaults; and (b) an additional time period to cure such defaults. As noted previously, granting franchisor the right to cure a franchisee's breach benefits both parties. The additional time period to cure, however, can be more problematic.

Proceed with Caution

Some franchisor remedies may be more contentious. One such remedy would allow the franchisor to “take over” the lease for a set time period, for example six months, but not have any liability under the lease (*i.e.*, the franchisee is still the responsible party). This provision places a landlord in an impossible position: The landlord can neither evict the franchisee nor make any long-range plans without knowing whether the franchisor will ultimately take over the location. The limitation of liability provision in the franchisor’s “take over” remedy is often a source of dispute. This type of provision states that the franchisor is only responsible for paying rent and day-to-day operations during the applicable take over time period, and that the franchisor has no ongoing liabilities under the lease. If the existing franchisee is already in default, presumably for failure to pay rent, the landlord should be wary of allowing the franchisor to continue operating the business. In such a situation, the landlord is left with no one, other than a defunct franchisee, to take responsibility for the liabilities that exist before the franchisor took over the lease, or for subsequent liabilities beyond the mere obligation to pay rent.

The Dreaded Default Clause

One common clause in franchisor lease addenda does place landlords squarely in between the franchisor and franchisee. This provision states that a franchisor may request that any default under the franchise agreement triggers a default under the lease. While the franchisor has an interest in limiting its liabilities and terminating obligations if a franchise relationship does not work according to plan, a landlord should not have to grant a third party the ability to terminate the lease. Landlords will not want to be in the position of having to terminate a lease because of a technical default under the franchise agreement. A landlord may propose that, if the franchisor does not approve of the operations of its franchisee, the franchisor can terminate its agreement, remove branding and equipment and employ whatever other remedies it has under its franchise agreement. However, the franchisee’s lease agreement with landlord would remain in place, and landlord and franchisee will have to determine separately how or whether that contractual relationship will continue.

Right to Inspect

In addition to notice from landlords, franchisor addenda often include the right of franchisor to inspect and repair or modify the premises. Allowing the franchisor onto the property will presumably permit the franchisor to spot problems and assist the franchisee before a crisis occurs. Nevertheless, there are certain

protections and restrictions that the landlord may consider before providing a franchisor unlimited access to the premises, and the unlimited right to make repairs on the franchisee's behalf.

First, the landlord could require that the franchisor indemnify the landlord in case the franchisor causes damage on the property. Second, the landlord may require that the franchisor provide additional insurance – particularly if the franchisor is making improvements on the property – with the landlord being listed as an additional insured. Landlords should also consider limitations on what type of repairs the franchisor is allowed to perform.

The Landlord's Security

The final addendum item to address is a landlord security instrument that often directly conflicts with the standard security interests of franchisors. Quite frequently, landlords will want to take a security interest in the equipment and inventory of a franchisee. A few states currently afford landlords a statutory lien right over tenant's equipment and inventory. Where the statutory framework is missing, landlord's counsel may seek to provide for a landlord's lien in the lease.

In those leases involving a franchisee, the franchisor will, in many instances, be the party that provides the equipment and inventory for the franchisee's operations either on a rental or financed basis.

As with many lease negotiations, the outcome of these various issues will depend on which party has the greatest amount of leverage. Nevertheless, there is often enough middle ground to arrive at a compromise that benefits all parties. By spotting the issues that may arise in franchisor addenda, and bringing potential solutions to the negotiation table, the landlord and the franchisor each may realize greater protection than if they were operating without a franchisor addendum.

