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LEASE ISSUES PECULIAR TO FRANCHISE SYSTEMS

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Lease Issues Peculiar to Franchise Systems

I. Introduction¹

The key ingredients in almost every successful franchise system are brand recognition, consistency and continuous operations. These attributes create valuable goodwill for the company's trade name, and in turn make it easier to sell franchises. The starting point for achieving that success is finding, securing and retaining great retail sites. The site could be operated as a restaurant (such as a McDonald's® restaurant), a store (such as a Wild Bird® Center), a hotel (such as a Cambria Suites® hotel), an office (such as a We The People® document preparation service) or another type of operation (such as a The Little Gym® gymnasium). As the old adage goes, the three principles of real estate success are "location, location, location."

Because site selection and continuous operations are so valued by successful franchisors, they expend considerable resources protecting their valuable properties. For both franchisor and franchisee, the leased premises must meet the franchisor's established criteria for a successful franchised business. In addition, it is important that the lease contain certain provisions to protect the parties' respective positions. This paper discusses those criteria and those lease provisions that are unique to a franchise system, from the franchisor's, franchisee's and landlord's points of view. We will also discuss the pros and cons of placing such provisions in the franchisee's lease with the landlord versus the franchisor entering into a lease agreement with the landlord and subletting the premises to the franchisee.

II. Considerations Specific to Leases of Premises for Franchised Businesses

A. The Franchisor's Interests

The franchisor is interested in seeing its franchisees prosper. However, it also has an interest in retaining control of valued real estate upon the expiration or termination of a franchise agreement. Assuming that the franchised business was doing well or could be turned around with a different operator, the franchisor would want to continue the operations of the franchised business at the premises, either directly or indirectly through another franchisee. Moreover, it needs to ensure that the franchisee or a third party does not operate a similar concept bearing a different name, thereby capitalizing on the franchisor's locational goodwill.² Although a restrictive covenant might serve to prevent that occurrence with respect to the franchisee, it would not serve that purpose with a third party or under circumstances in which post-termination restrictive covenants are unenforceable, such as in California.

In addition to retaining control of the real estate, the franchisor wants the terms of the lease to be favorable to the franchisee so that the franchisee's operation of the franchised business has the best chance to be successful and, in the event that the franchisor or another of

¹ The authors acknowledge the assistance of Dean Waldt, a partner with Ballard Spahr Andrews & Ingersoll, LLP, with the bankruptcy issues discussed.

² The Court in *Snelling and Snelling, Inc. v. Martin*, [1997-1998 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 11,384 (N.D. Cal. Jan. 28, 1998), in enforcing a lease assignment clause, well describes the franchisor's interest in the locational goodwill. It stated: "The lease assignment provision in this case is apparently intended to allow Snelling to retain clients who are familiar with the precise location of the business; if defendants remain in the premises and Snelling is forced to operate elsewhere, it loses the intangible benefit of that location."

its franchisees assumes the lease upon the expiration or termination of the franchise agreement, that operator's business will have those same favorable terms.

In most franchise systems, the franchisee will directly contract with an unrelated landlord for space. In those cases, the preferred method of the franchisor imposing indirect control over the premises is inserting certain provisions into the lease between landlord and franchisee, together with a collateral assignment of lease between franchisor and franchisee, which is agreed to by the landlord in a writing. Typically, the method for inserting the mandated lease provisions is a rider to the lease (herein, the "Lease Rider"). The Lease Rider will expressly designate the franchisor as an intended third-party beneficiary. Set forth below are the specific interests franchisors seek to protect through a Lease Rider.

1. Maintaining Uniformity in the Franchise System

a) Use of marks

The franchisor needs to ensure that the lease permits the franchisee to (i) use the franchisor's trademarks in signage and otherwise in connection with the leased premises and (ii) build-out the leased premises in a manner consistent with the functional needs of the franchised business and the franchisor's mandated trade dress. To satisfy these requirements, the franchisee should submit to the landlord, in advance of lease execution, a design plan for the leased premises, including the trademarks and the signage features. In turn, the landlord should provide its express written approval to use the trademarks, desired signage, functional build-out and trade dress. The franchisor should require the franchisee to submit to it a copy of the landlord's consent to the design. Some landlords (such as Desert Ridge Marketplace, immediately south of the JW Marriott Desert Ridge Resort & Spa), desire a uniform appearance or theme and, therefore, require that each retailer's signage be designed by the landlord's architect; modifications to the franchisor's trademark may be required. Further, the parties should confirm that applicable zoning actually permits the franchisor's signs and trademarks to be displayed.³ See Appendix 1 for sample provisions to consider for insertion into the Lease Rider.

b) Operation of the premises

The use clause of the lease should expressly permit the franchisee to operate the franchised business (including the sale of the full range of product and service offerings) at the leased premises. The lease should also expressly permit the franchisee to remodel the leased premises and change the signage as the franchise system's format and trademarks evolve over time. Most retail leases will call for the landlord's consent for alterations over a base threshold dollar amount. Landlords justifiably want to review and approve work which impacts their property, especially the structure. However, franchisors need to know that the re-imaging

³ Municipalities have caused franchise systems to alter marks in signage. In *Payless Shoesource, Inc. v. Town of Penfield*, 934 F. Supp. 540 (W.D.N.Y. 1946), the court enforced a municipal sign ordinance that required all signs to be one color. Payless' federally registered mark contained both yellow and orange. The Payless court naively reasoned that the town was simply imposing a uniform sign ordinance and that the sign and trademark were two difference concepts. In contrast, the court in *Blockbuster Video, Inc. v. City of Tempe*, 141 F.3d 295 (9th Cir. 1998), found the Lanham Act prohibited the municipality from requiring the mark owner to alter its registered service marks, but that the municipality could preclude display of the marks. For an excellent discussion of the conflict between sign ordinances and Section 1121(b) of the Lanham Act, see *Roberta Rosenthal Kwall, Regulating Trademarks or Exterior Signs: Should Local Law Trump the Lanham Act and the Constitution?*, 71 S.CAL. L. REV. 1105 (Sept. 1998).

programs may be completed. Accordingly, franchisors like to see a carve-out from the landlord approval requirement for system-wide mandated remodel projects.

If the landlord previously granted anchor tenants (or other tenants with significant leverage) exclusivity clauses, the landlord arguably cannot grant the franchisee the right to engage in a prohibited business or sell a prohibited product or service. If that is the case, the franchisee may need to obtain waivers or consents from such tenants to permit the proposed use. Compromises often include *de minimus* exceptions, such as: "tenant agrees not to display for sale more than 10 linear feet of a particular product or products."

At the same time, the franchisor needs to limit the franchised unit's operations to those contemplated by the franchise agreement. The franchise agreement will virtually always prohibit the franchisee from operating as anything other than a system unit. The lease's use clause will further protect the franchisor by causing the landlord to monitor the tenant's use of the premises. In addition, and more importantly, upon a tenant's/franchisee's bankruptcy, the use clause would limit the assignment of the lease to the franchisor or an approved franchisee because that could be the only party permitted to operate under the lease's use clause.

2. Preserving Control Over the Lease Premises

a) Lease assignment

In addition to requiring the lease to contain certain other control provisions, franchisors often require the Lease Rider to contain a collateral assignment or the signing of a separate collateral assignment agreement. In a collateral assignment, the franchisee presently assigns to the franchisor the franchisee's rights under the lease, but the exercise of the assignment rights is contingent upon a condition subsequent, typically, the franchisee's default under the lease or the franchise agreement *and* the franchisor has the right to elect whether or not to exercise those rights. If the franchisor exercises its rights, it usually must cure the franchisee's defaults under the lease and otherwise assume the franchisee's obligations under the lease. Depending upon the parties' respective leverage at the time that the franchisor is considering whether to exercise its rights to take over the lease, the franchisor may be able to negotiate a reduced cure amount with the landlord. The collateral assignment should also clearly state that the franchisor's cure of the franchisee's defaults under the lease will not excuse the franchisee from liability for the amount expended by the franchisor to do so. A careful franchisor will seek to preserve recovery rights against the franchisee/tenant for these payments. The collateral assignment must be consented to by the landlord at the time the lease is signed (not at the time that the franchisor desires to exercise its rights); otherwise, the landlord may not be obligated to recognize the franchisor's rights to the premises under the lease and the landlord may try to extract more favorable terms from the franchisor upon the tenant's/franchisee's default.

Optimally, the collateral assignment would allow the franchisor (or its designee) to take over the franchisee's position under the lease, without having to satisfy (or having its designee satisfy) any additional requirements. The landlord, in contrast, desires to ensure that the party occupying the premises has the ability to make the required payments and successfully operate the franchised business. Therefore, landlord should retain the right to approve or disapprove the party taking over the franchisee's position under the lease. Whether the landlord's consent to the franchisor (or its designee) taking over the franchisee's rights is required will depend upon the respective leverage of the parties. As a compromise, the parties may agree that the landlord's consent will not be required if the franchisor or the other franchisee meets certain agreed-upon financial and operational criteria.

The franchisor should seek to minimize its exposure under the lease if it assumes the franchisee's position under the lease. First, it may seek to do so under the circumstances in which it operates the franchised business at the leased premises only on a temporary basis, as necessary until another approved operator assumes the franchisee's position. Second, it may seek to do so under the circumstances in which it operates the franchised business at the leased premises, but subsequently decides to cease operating and close operations. Depending upon the respective leverage of the franchisor and the landlord, the landlord may agree that the franchisor will not be liable beyond the date of the assignment of the lease to the successor franchisee or may agree to limit the franchisor's exposure to a stated dollar amount or a number of months of rent. By way of example, a franchisor with leverage may be able to negotiate that the cure amount will be limited to the 30-day period prior to landlord's default notice and forward. This way the landlord is motivated to send default notices promptly (and to the franchisor too, an additional step landlords often dislike to take), which keep the franchisor apprised of the franchisee's financial condition.

Some franchisors will request the right to exercise renewal or extension options that the franchisee/tenant fails to exercise. This is another way of protecting locational goodwill. If granted, the franchisor, following notice of the failure to exercise, would have the right to assume the lease for the option period, and upon satisfaction of the franchisee's lease obligations, the franchisee would be released.

b) Amendments to the lease only with the franchisor's consent

The franchisor needs to know that the lease cannot be amended (in any respect, in any material respect or, at a minimum, in any respect that may adversely affect franchisor's rights) without the franchisor's consent. Further, the tenant/franchisee should not be allowed to renew the lease or extend the term without the franchisor's consent. Being able to do so could defeat the purposes in the Lease Rider and the franchisor would not even know that the protections have been eliminated. For many franchisors it is important that the term of the lease match the term of the Franchise Agreement to ensure that the franchisee (1) has a physical location from which to operate during the franchise agreement term and (2) does not retain the premises (and with it the attendant goodwill) without operating under the franchise system (*i.e.*, not in competition with the franchised business).

The franchisor wants to restrict the franchisee's ability to assign its rights under the lease (specifically, to an existing competitor, to one who will operate the premises as a competitor and, generally, to any person), without the franchisor's consent. For similar reasons, subleasing without the franchisor's consent should be prohibited.

Although a landlord may impose a radius restriction (*i.e.*, a covenant that the tenant will not operate a similar business within a certain mile radius of the leased premises, designed to focus the tenant on succeeding at the landlord's center) on the tenant/franchisee with respect to other operations of the franchised business, the franchisor needs to ensure that those restrictions do not extend to the franchisor (by virtue of being a party to a Lease Rider or by exercising its rights to assume the lease) and prohibit the franchisor from operating, or licensing others to operate, the franchised business (or any other business) in proximity to the leased premises.

Finally, the franchisor should require that the landlord provide the franchisor with a copy of any notice of default at the same time that such notice is given to the franchisee, as well as the opportunity (but not the obligation) to cure the default (optimally with an additional period to

cure, beyond the tenant's cure period). The lease should provide that a default under the lease will be a default under the franchise agreement. In the event that the franchisor does not use a cross-default provision, simply adding the loss of the right to occupy the underlying premises as a ground for termination of the franchise agreement should suffice.

3. **Bolstering Its Enforcement Rights under the Franchise Agreement**

a) **Right to receive reports**

The franchisor should have the right to obtain the franchisee's revenue or sales information submitted to the landlord (e.g., in connection with a percentage rent arrangement) for the purpose of verifying the franchisee's reporting information and royalty and other payments to the franchisor. Placing this requirement in the lease, in addition to the franchise agreement, permits the franchisor to receive the reports directly from the landlord, instead of simply relying upon the franchisee to furnish them.

b) **Inspection rights**

The franchisor should have unrestricted access to the leased premises, without liability for trespass, to ascertain compliance with the franchise agreement and the lease. Especially important is the franchisor's ability to cause a de-identification of the premises, including the right to remove signage and fixtures. At the end of the franchise agreement's term, whether due to expiration or termination, the franchisor must be able to enforce the franchise agreement's post-termination obligations.

c) **Enforcing the Lease Rider**

Once the effort is made to create a Lease Rider, the franchisor needs to know its intent will be enforced in its favor. A clause should be included in the Lease Rider explicitly stating that the Lease Rider supersedes and controls over any conflicting or inconsistent provision of the lease. Additionally, the franchisor must be able to show standing to enforce its rights. Franchisors create standing by being either (1) a party to and executing the Lease Rider or (2) designated an intended third party beneficiary, with the right to enforce the lease and/or Lease Rider in its own name. To further support the third party beneficiary designation, a franchisor will also often enter into a separate collateral lease assignment agreement with the franchisee/tenant. The collateral assignment would then be consented to, in writing, by the landlord. Again, if the franchisor is not a party to the Lease Rider, it must state that the franchisor is an intended third-party beneficiary, with the right to enforce its terms. A franchisor who does not sign the Lease Rider as a party may be trying to limit its exposure for potential liability under the lease.

After the franchisor exercises its right to take over the leased premises, the tenant may argue that it is relieved from obligations to the landlord. To prevent such a position from being successful, a provision may be added to the Lease Rider stating that the tenant shall remain liable to the franchisor for reimbursement for all amounts paid by franchisor to landlord to cure the tenant's defaults.

Courts will generally enforce lease assignment provisions in favor of franchisors, especially where the franchisor's enforcement rights are acknowledged by the landlord. The

leading case on enforcing lease assignment provisions is *Snelling & Snelling v. Martin*.⁴ The *Martin* court upheld a franchise agreement provision that required the franchisee to assign its lease to the franchisor upon termination of the franchise agreement. The court recognized the importance of protecting the franchisor's "locational goodwill" and granted preliminary relief. The court stated, "the lease assignment provision in this case is apparently intended to allow Snelling to retain clients who are familiar with the precise location of the business; if defendants remain in the premises and Snelling is forced to operate elsewhere, it loses the intangible benefit of that location. The *Martin* court also directed the defendants to cooperate as necessary for Snelling to obtain the telephone numbers associated with the franchised business. Lease assignment provisions are particularly useful to franchisors in California, where covenants not to compete are unenforceable. Without the lease assignment provision, breakaway franchisees would have greater success in blocking a franchisor from protecting its interest in the more attractive franchise locations.

Other courts have also enforced lease assignment provisions. In *Dunkin' Donuts, Inc. v. Dowco*,⁵ the court determined that a lease option agreement between a franchisee and its landlord, which prohibited the landlord from leasing the location to a competitor and granted the franchisor the right to assume the lease, was enforceable. The court ordered specific performance in spite of the fact that it was a unilateral option contract not signed by the franchisor.⁶ Similarly, in *Dunkin' Donuts of America v. Middletown Donut Corp.*,⁷ the New Jersey Supreme Court affirmed the enforcement of a lease assignment provision and compelled a terminated franchisee to turn over the leased premises to the franchisor. In contrast, the court in *Trient Partners I, Ltd. v. Blockbuster Entertainment Corporation*⁸ permitted a franchisee to freely sell its leases, together with its video store assets, to a third party upon the expiration of the franchise agreement, despite the fact that certain of the leases provided the franchisor the right to assume the leases upon default. The court first noted that the franchisor's right to assume would only be triggered upon a default by Trient, not upon the expiration of the franchise agreement. The court, applying Texas law, found real estate to be "unique." Even if the agreement gave Blockbuster the right to assume the leases in the absence of a default by Trient, Blockbuster would not have equitable title because there was no privity of contract between Blockbuster and Trient's landlord.⁹ This case underscores the practical advice that if the franchisor is not a party to the lease, the franchise agreement must provide that the lease identify the franchisor as a third party beneficiary under the lease, with the right to enforce its rights to assume the lease. This strategy will create privity between the landlord and the franchisor and clearly allow the franchisor to enforce the lease terms against the landlord in the future.

In *Cottman Transmission Systems, Inc. v. Hocap Corp.*,¹⁰ the franchisor sought to enforce the collateral assignment provision in its Lease Rider against the landlord. After the franchisee defaulted, the landlord did not provide franchisor the mandated 20-day written notice before the landlord repossessed the leased premises. The appellate court overruled the trial court's finding that the franchisor had no standing to enforce the Lease Rider. The landlord

⁴ *Snelling*, [1997-1998 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 11,384.

⁵ *Dunkin' Donuts, Inc. v. Dowco*, No. CIV. 5:98-CV-166, 1998 WL 160823 (N.D.N.Y. Mar. 31, 1998).

⁶ It helped Dunkin's case that the franchisee and the landlord were related parties.

⁷ *Dunkin' Donuts of Am. v. Middletown Donut Corp.*, 495 A.2d 66 (N.J. 1985).

⁸ *Trient Partners I, Ltd. v. Blockbuster Entm't Corp.*, 959 F.Supp. 748 (S.D.Tex.1996).

⁹ *Id.* at 753. The Court stated that "Blockbuster is not bound by Trient's leases, as probably would be required for it to bind Trient's landlords." The language, which is dicta in the case, appears to undermine the validity of third party beneficiary clauses.

¹⁰ *Cottman Transmission Sys., Inc. v. Hocap Corp.*, 803 A.2d 402 (Conn. App. 2002).

argued that the assignment was conditional and that the franchisor had not perfected its rights under the assignment. The appellate court agreed with the franchisor's position that it had the 20-day period within which to exercise its option to make the conditional assignment effective. When the landlord repossessed the leased premises and altered the space in a manner making it unfit for the operation of a transmission repair center, the landlord had committed an anticipatory breach of the contract.

The importance of having a landlord acknowledge and consent to the collateral assignment is highlighted by *Danbury Mall Associates Ltd. Partnership v. Mazel Enterprises, LLC*¹¹. Mazel was a franchisee of Candy Express Franchising, Inc. The franchisee opened a store in a mall in September 2001 and abandoned the space in November 2002. The franchisor guaranteed the lease on a one-year rolling basis. Following the abandonment by the franchisee, the franchisor tried to take over the space by virtue of a collateral assignment executed by the franchisee. However, the franchisor offered no evidence that the landlord had consented or acquiesced to the assignment. Despite the franchisor's willingness to cure and continue operations, the landlord rejected the assignment. Had the landlord consented to or acquiesced to the collateral assignment, the franchisor would likely have been able to enforce it.

B. The Franchisee's Interests

1. Quick Execution of Acceptable Form

The franchisee's goal is to expeditiously find a suitable location and execute a lease in a form acceptable to the franchisor, in a manner as to meet the franchise agreement time deadlines for signing a lease and opening the franchised business. Therefore, one of the basics for a franchisee in lease negotiations is to expressly make the lease contingent on the franchisor's approval of the form and substance. With the right to terminate, the franchisee will have an easier time insisting on the terms required in the franchisor's Lease Rider. Once the lease is ready for franchisor-reviewed approval, the franchisee hopes for a franchisor that appreciates the time pressures of lease negotiations and will produce a fast turnaround time.

2. Franchisor-Related Benefits

The franchisor's reputation, success and contacts may assist the franchisee in locating, and gaining access to, a prime location, one it might otherwise not have had the opportunity to lease. In addition, although franchisors typically will not guarantee a franchisee's obligations under its lease, a franchisor that is willing to do so can assist its franchisees in gaining access to locations that the franchisee's credit alone may not provide. Furthermore, with the franchisor standing behind its franchisee's obligations, the franchisee will increase its leverage in negotiating the lease terms. The landlord should be impressed that the franchisor is betting on the success of the franchisee and the site by putting its own assets at risk. (See also Section D below entitled "Lease by the Franchisor from the Landlord and Sublease to the Franchisee.")

3. Financing the Franchised Unit

a) Collateral

¹¹ *Danbury Mall Assocs. Ltd. P'ship v. Mazel Enters., LLC*, No. CV030347873S, 2004 Conn. Super. LEXIS 1919 (2004).

To complicate matters, franchisees often obtain loans. The franchisee's lender needs to be satisfied that it has underwritten an acceptable loan. The lender may seek an assignment of the lease (a leasehold mortgage interest) in addition to a pledge of the franchise agreement. This presents an obvious and direct conflict with the franchisor's objective of being able to retain the locational goodwill (and to specifically approve any successor franchisee). The franchisee becomes caught in the middle of this tug-of-war. Most often, the franchisor will win, and a leasehold mortgage will not be permitted, as it would interfere with the franchisor's rights under the collateral assignment. The lender will often settle by accepting a security interest in the franchisee's furniture, fixtures and equipment. To obtain a priority lien on these items, a landlord may have to waive its statutory lien on these assets. In many states, a landlord is entitled to a statutory lien on tenant's personal property to the extent of unpaid rent.¹² To satisfy its lender, the franchisee will need the lease to provide that the landlord waives, or at least subordinates, its landlord lien to the lender.

b) Estoppel Certificates

When a lender finances a franchised unit, it will want to know the status of the lease from time to time. An estoppel certificate, a written statement from the landlord, will confirm certain information about the status of the lease. The purpose is for the lender to rely on the information in assessing its position and to estop the landlord from later arguing facts to the contrary of the certificate. Accordingly, the franchisee, who receives or intends to receive, financing should include an obligation on the part of the landlord to supply an estoppel certificate upon request. A franchisee lender seeks some of the same protection a franchisor desires in the Lease Rider. In the absence of a franchisor seeking control of the site upon a default or termination (under either the lease or the franchise agreement), the lender's form of estoppel may include some of the following:

- The lease term, including commencement and expiration dates and renewal option, and the amount of rent and security deposits.
- The date through which rent has been paid.
- A statement that the lease is in full force and effect and that there are no existing defaults under the lease.
- Landlord consents to lender's security interest in the lease.
- No lease amendment without lender's consent.
- Lender has no obligations under the lease, unless and until it has exercised its right to foreclose on its security interest.
- Landlord agrees to provide notice to lender at the same time it sends notices to the franchisee.
- If lender becomes the tenant, it may elect not to operate or may alter the use of the premises.¹³ A form of landlord estoppel is attached as Appendix 2.

¹² See, e.g., Ariz. Rev. Stat. Ann. § 33-362; 68 Pa. Stat. Ann. §321; N.J. Stat. Ann. § 2A:42-1.

¹³ This is another reason why the franchisor wants the lease to have a narrow use provision, which may not be altered without franchisor's consent.

4. Exclusivity Rights

Some franchisees will be able to negotiate an exclusivity clause: a landlord's covenant to refrain from leasing to a competitor. Exclusivity clauses are generally enforceable if reasonable in territory, time and person.¹⁴ Exclusivity clause generally appear in two categories: (1) an exclusive right to conduct a specified business, which is not literally directed against specific products, and (2) an exclusive right to sell specified products.¹⁵ A right to conduct the only pizza shop in the shopping center may permit other food tenants to sell products also sold in the pizza shop, whereas, the exclusive right to sell pizza and pizza-related products would be a true exclusive. Since franchisees are subject to a franchise agreement - which will typically provide that the franchisor has the right to modify the products and services being offered by the franchisee - it may want a limited exclusive. That is an exclusivity clause where the landlord covenants not to lease to a tenant having the same principal business. But if the core items being offered by the franchisee will not change, a true exclusive would be more appropriate. The lease would list the restricted items and other tenants would not be permitted to offer them for sale. An aggressive franchisee may propose that it receive an exclusive right to sell the "items then being sold by the franchise system." The problem with evolving or expanding use provisions is that they limit the landlord's future leasing possibilities and increase the possibility of a future violation. Accordingly, landlords are generally more willing to limit any restrictions to the primary items being offered as of the date of the lease. Where the landlord is flexible and permits a future expanded exclusive, expect the landlord to insist on advance notice of the new items and no exclusivity rights for items already covered in another tenant's exclusivity clause.

5. Control Following Termination

The franchisee should seek to eliminate continuing liability under the lease if the franchise agreement expires or is terminated, if the franchised business is transferred or if the franchisor takes possession of the leased premises pursuant to the collateral assignment. Although this would be doubtful from a contractual point of view, it is likely from a practical point of view if the franchisor operates the franchised business in succession to the franchisee or if the franchised business is transferred to a strong franchisee.

If, however, after the franchise agreement expires or is terminated the premises will not continue to be operated as a franchised business and the franchisee has continuing liability under the lease, the franchise needs to have the latitude to assign or sublease it to whomever may be interested in taking over the leased premises (without limitations on the nature of the business that may be conducted).

C. Landlord's Interests

1. Quality Tenants and Good Mix

¹⁴ *Walgreen Co. v. Sara Creek Prop. Co.*, 775-F. Supp. 1192 (E.D. Wis. 1991).
¹⁵ M. FRIEDMAN, FRIEDMAN ON LEASES § 28:7 at 36 (5th ed. PLI 2007).

The landlord needs to have quality brand name tenants with an appropriate mix of types across the shopping center. It wants continuity, despite franchisor-franchisee tensions, for optimal sales/rent levels; to retain and attract other tenants; and to maintain a valuable relationship and thus leverage with its lender. Therefore, it may be attracted to a member of a franchise system as a tenant and be amenable to making concessions that benefit the franchisor.

2. Certainty of Payments

The landlord needs to have certainty of rent and common area maintenance (CAM) payments. It needs to know that it will have sufficient cash flow to meet its debt and other monetary obligations and, hopefully, realize a return on its investment. It needs continuous operation, which benefits the other tenants and the public at-large. Therefore, it may be willing to agree to certain provisions that facilitate the franchisor (or a subsequent franchisee) succeeding to the franchisee's interest upon the expiration or termination of the franchise. Those provisions, however, would optimally provide the landlord with assurances regarding the successor operator's ability to make the required payments and successfully operate the franchised business. Before a landlord should permit the franchisor to step into its tenant's shoes and operate the store itself or re-franchise it, there should be an appropriate level of security. For example, in order for the franchisor to take an assignment of the Lease, it must cure all outstanding defaults, without exception or limitation, and it must remain liable for the remainder of the term regardless of future assignments. Any franchisee/assignee must meet financial capability standards and the franchisor may not assign the lease to a shell affiliate. In contrast, franchisors seek to limit the cure amounts to 30 days (or an amount tied to default notices delivered to franchisor) and seek a full release upon assignment to a new operator.

3. Consistent Look and Operations

The landlord often wants its shopping center to have a uniform appearance or theme and, therefore, may require that each retailer's signage be consistent with that appearance or theme. In those instances, the landlord will involve their architect in creating or approving the tenant's façade.

Further, certain landlords expect that the businesses operated at their development will have consistent hours of operation. Therefore, exceptions to the franchisor's "standard" hours of operation may be necessary.

4. Protection of Premises

In response to a franchisor's need to enter the leased premises, without liability, to "protect the system" (for example, to remove signage bearing its trademarks and/or obtain possession of its operating manual), the landlord should require a high threshold for such action. There should be evidence of a material default, which has not been remedied after notice and an opportunity cure. Further, if the franchisor does enter the leased premises for the purpose of protecting the system, it should first provide evidence of insurance to the landlord and agree to indemnify the landlord for any costs or losses incurred by landlord resulting from such entry.

5. Right to Approve Future Operators

The flip side of the franchisor's desire to be able to assign the lease to itself or a subsequent franchisee is the landlord's desire to control who its tenant will be. Landlords with leverage will require the franchisor to remain liable for the franchisee's/tenant's obligations in the event of an assignment to a successor franchisee and will perform due diligence with respect to such franchisee, the same way it would a new prospective tenant. If the new operator lacks sufficient financial resources and operational experience, the landlord will want the right to reject the assignment request. In any event, the right to assign to either the franchisor or the next franchisee should be subject to the landlord's consent, in its sole judgment.

6. Non-Competition in Close Proximity

The landlord wants to prevent tenants from operating competing units within a particular radius of the premises that may draw sales (and, therefore, rents payable to the landlord) away from the premises. Although franchisees may not be concerned about these radius-restriction provisions, most franchisors would not be amenable to agreeing to this provision. Franchisors, especially those who do not grant territorial protection, want to retain the right to exploit their brand as deemed necessary, without restriction from a landlord. In fact, diligent franchisors will request in the Lease Rider that the landlord waive the radius restriction applicable to the franchisor upon assignment of the Lease to the franchisor.

7. No (or Narrow) Exclusive Rights

For administrative reasons and to maintain maximum future leasing flexibility, landlords try to avoid exclusivity provisions. If necessary to lease-up the center, the landlord will limit exclusive rights to a steady, express list of protected items not to be sold by other tenants. It will strongly resist a broad evolving concept such as "all items then being sold by the majority of franchisees operating under the ABC Franchise System." Such a clause would be impractical to enforce. Other existing tenants would not have a clear understanding of the restriction, and the landlord would be severely challenged in its ability to lease to new tenants.

8. No Additional Notice to Parties

Landlords often resist the administrative burden of sending copies of tenant notices to the franchisor and the franchisee's lender or partners. It seeks simplicity, as the person who is sending out the notice may not have, or may not review, the various ancillary documents (*e.g.*, collateral assignment of lease) that require additional notice to parties.

D. Lease by the Franchisor from the Landlord and Sublease to the Franchisee

To bolster the franchisor's control of the premises, including the ability to remove an uncooperative terminated franchisee from the premises on an expeditious basis, a franchisor may elect to lease (or have a dedicated affiliated company lease) the premises from the landlord, and then sublease the premises to a franchisee. The franchisor may choose this mechanism, regardless of whether it or the franchisee selected the site.

The franchisee needs to be able to continue operating the franchised business in the event of the franchisor's bankruptcy. If the franchisor is the lessee of the premises and subleases the premises to the franchisee, the franchisee may be able to retain possession under two separate theories. First, if the franchisor elects to reject the master lease, depending on state law, the rejection may not be treated as a termination and the franchisee/tenant may

have an independent right under state law to continue to occupy the property. Second, the Bankruptcy Code¹⁶ permits a lessee to remain in possession of the leased premises for the balance of the term if the debtor landlord rejects the lease.¹⁷ The balance of the term includes any renewal or option periods.¹⁸ Therefore, the franchisee will not be deprived of its lease rights for the term for which it bargained. The franchisee/tenant may offset the rent reserved under the lease against damages caused by the rejection, but does not have any affirmative rights against the bankruptcy estate for any damages after the rejection that result from the rejection.

1. Advantages

An established franchisor will typically have access to more attractive spaces within shopping centers, will be presented with more deals, and will be able to negotiate more favorable lease terms than a single-unit operator. System franchisees benefit from the financial strength of the franchisor, its operational history and the landlord's knowledge that the franchisor believes so strongly in its system that it is willing to assume lease liabilities. The franchisee may wind up with a better site than it could have obtained on its own, with better economic and legal terms. The franchisor also benefits in a number of ways. As sublandlord, it is better able to monitor the financial health of its franchisee.¹⁹ Instead of relying on an independent landlord for information on late or non-payments, the franchisor learns directly of any problems. Warning signs of distress will be received sooner. Further, a franchisor, as sublandlord, will be able to take possession of the unit following default under the lease or franchise agreement by eviction, if necessary.

In a franchisee's bankruptcy filing, the franchisor will have more control in the process. It has the option of extending the assumption/rejection period for the lease, or not. It need not be dependent upon the landlord's willingness to honor the Lease Rider. Finally, instead of hoping for a cooperative landlord to work with the franchisee in structuring a payment plan over time, the franchisor, as sublandlord, has the option of helping the financially troubled franchisee with financial assistance.

2. Disadvantages

Real estate leases are expensive. When computing base rent, additional rent and security deposits for many sites, the cumulative costs can be very high. Capital is often tight and may be one of the reasons the franchisor chose franchising as a method of distribution in the first place. It may not have the resources to enter into leases itself. Entering into leases creates contingent liabilities, which negatively impact the franchisor's financial statements.

The franchisor who subleases is assuming a greater risk of liability in connection with a franchisee's operation of the franchised business due to (1) an arguably greater degree of control over the franchised business' operations and, thus, vicarious liability claims for the franchisee's liabilities, (2) non-payment of rent or other monetary obligations, and (3) statutory

¹⁶ 11 U.S.C. § 101 et seq. (2004)

¹⁷ 11 U.S.C. § 365(h)(1)(A) (2004).

¹⁸ A tenant electing to remain in the premises is not required to remain throughout all possible renewal periods or to exercise all of its renewal options at the time the tenant elects to remain in possession. *In re Flagstaff Realty Assocs.*, 60 F.3d 1031 (3d Cir. 1995).

¹⁹ This is especially so where there is a reporting requirement under a percentage rent arrangement. The franchisor can compare the gross sales reports delivered under percentage rent reporting to the gross sales reports under royalty reporting.

liabilities associated with being a landlord/tenant of real property (for example, liabilities under the Comprehensive Environmental Response, Compensation and Liability Act, state environmental statutes, and the Americans with Disabilities Act).

These risks can be reduced by having a dedicated affiliated leasing company execute the lease instead of the franchisor acting as sublandlord. However, (1) certain of the benefits of the franchisor signing the lease (such as greater financial capability and greater leverage) would not be available and (2) it is important that the franchisor not misrepresent the actual party on the lease.²⁰

3. Master Lease Provisions

Although not always the case, under most circumstances the franchisor would negotiate the terms of the master lease and, due to its greater experience and possibly leverage, it could extract better lease terms (such as a dollar or percentage cap on CAM, a cap on annual CAM increases, a narrower definition of expenses included in CAM and an exclusivity clause) than a franchisee could. (Of course, it could utilize that experience and leverage even if the franchisee were signing the lease.)

Depending upon the franchisor's leverage, the master lease may include the right for the franchisor to sublease the premises to either a specified franchisee, a franchisee who meets certain criteria or any franchisee selected by the franchisor.

The franchisor desires to minimize its exposure under the master lease once it has subleased the premises to the franchisee. Depending upon the respective leverage of the franchisor and the landlord, the landlord may agree that the franchisor's liability under the lease will be either subordinate to the franchisee's and its principals' obligations to the landlord and/or limited to a stated dollar amount or a number of months of rent.

The franchisor may have a "chicken and egg" problem with respect to the master lease and the franchise agreement. The franchisor may want to tie up a valuable site for the operation of the franchised business although it has not yet located a franchisee interested in operating the franchised business at that site. Therefore, it may execute the master lease and seek to sublease it to a franchisee after it has located that franchisee.

4. Sublease Provisions

A lease can be transferred by the lessee in one of two ways: by assignment or sublease. The formal distinction between an assignment and a sublease is based on the difference in what each transfers.²¹ An assignment is a transfer by a tenant of its entire interest in the lease, whereas a sublease is a transfer of something less than the tenant's full interest.²²

When a lease is transferred by assignment, the assignee steps into the lessee's shoes and acquires all the lessee's rights in the

²⁰ See *OTR Assocs. v. IBC Servs., Inc.*, 801 A.2d 407 (N.J. Super. Ct. App. Div. 2002) where the New Jersey Appellate Division found that it was appropriate to pierce Blimpie International's leasing subsidiary's corporate veil to hold the parent company liable for rent because the true identity of the tenant was not made clear to the landlord. The tenant was actually a leasing shell entity. The court determined that the landlord was misled to believe that the tenant was the Blimpie franchisor.

²¹ Milton R. Friedman & Patrick A. Randolph, Jr., *Friedman on Leases*, § 7:4.1, at 7-83 (5th ed. 2006).

²² *Id.*

lease. Privity of estate ends between the lessor and lessee and is created between the lessor and the assignee. The assignee therefore becomes bound by the covenants running with the land. *Privity of contract between the lessor and lessee, however, does not end by the mere assignment of the lease and the lessee is therefore still bound by the lease provisions.* On the other hand, when a lease is transferred by sublease, a new lessor-lessee relationship is created between the original lessee and the sublessee. *The original lessee retains both privity of estate and privity of contract with the original lessor and no legal relationship is created between the lessor and the sublessee.*²³

Typically, but not always, the franchisor will sublet the leased premises, as opposed to assigning the lease to the franchisee. Assignment will divest the franchisor of privity and therefore direct control of the leased space. On the other hand, an assignment and release will relieve the franchisor of continuing liabilities. The sublease will be subject and subordinate to the master lease and the franchisee will agree to comply with the terms and conditions of the master lease. In addition, there will be a broad indemnity of the sublessor by the franchisee. Delivery of the subleased premises from the franchisor to the franchisee will be without warranty and in "as is" condition to franchisee. The sublease will terminate upon the expiration or termination of the master lease. The sublease also gives the franchisor another chance at disclaiming its involvement in the site selection process (e.g., "sublessee has selected the site and requested that the franchisor/sublessor enter into a lease with prime landlord") to further shield itself from bad site selection claims. The franchise-specific provisions are (1) a narrow use clause so that the only permitted use is operation of the franchised business; (2) no right to further assign or sublet without the franchisor's consent; (3) no alterations or renovations without the franchisor's consent; (4) the franchisor's right to gain access freely; and (5) a negative representation on the suitability of the site for the sublessee's business.

The franchisor may pass on the security deposit, rent and CAM charges as they exist under the master lease or may increase them in an attempt to cover administrative costs in entering into and maintaining the master lease.

The franchisor may require that rent and CAM charges be paid to either the franchisor (which will pass them on to the landlord) or directly to the landlord. The former obviously provides the franchisor greater protection in the event of the franchisee's financial difficulties and the latter obviously provides the franchisee greater protection in the event of the franchisor's financial difficulties.

The sublease and the franchise agreement should provide for cross default. A default under one will be a default under the other, giving rise to a host of remedies to the franchisor, including termination and the right to possession of the leased premises. Courts typically uphold such a cross-default provision.²⁴ Some franchisors use cross-default provisions to file a dispossession or eviction action to avoid an arbitration action, which may be required by the franchise agreement's dispute resolution provision. A summary dispossession action may limit counter-claims and affirmative defenses, as they are often limited to issues relating only to possession.

²³ *Italian Fisherman, Inc. v. Middlemas*, 545 A.2d 1, 4 (Md. Ct. App. 1988) (emphasis added).

²⁴ See *American Vision Ctr. of St. Louis, Inc. v. Carr Optical, Inc.*, 810 S.W. 2d 121 (Mo. Ct. App. 1991).

A sample of a franchisor-friendly Sublease is attached as Appendix 3.

III. Bankruptcy Issues

In a franchisee bankruptcy filing, the party controlling both the real estate and the business operations will usually exercise a great deal of control in the bankruptcy process. Therefore, a franchisor who is also the lessor or sublessor of its franchisee's premises is in a more favorable position than the franchisor who merely relies upon a collateral assignment to enforce its rights. Under the Bankruptcy Code,²⁵ being the landlord under a non-residential lease of real property has distinct advantages. When the franchisor is both the landlord and the licensor of the franchised system, it can exercise control over the timing and potential outcome of the bankruptcy process. Under the 2005 amendments to the Bankruptcy Code,²⁶ a debtor/tenant now has a maximum of 210 days (120 days, plus an optional 90-day extension for cause) to assume or reject non-residential real property leases.²⁷ This time period may not be extended without the landlord's prior written consent, which may be granted or denied in the landlord's sole discretion. Prior to assumption or rejection of the lease, the debtor/tenant is required to timely perform all obligations under the lease during the pendency of the bankruptcy case.²⁸ In order to assume the lease, the debtor/tenant is required to cure any defaults under the lease, compensate the landlord for any actual losses caused by prior defaults and provide adequate assurance of future performance.²⁹ Where there are cross-default provisions between the sublease and the franchise agreement, these requirements may be applicable to obligations under the franchise agreement as well.

In contrast, in the case where there is an unrelated landlord and the franchisor merely has the right to take an assignment of the lease, the controls that would be available to the franchisor are exercised by an unrelated third party landlord. Unlike a non-residential real estate lease, the time period for assumption of a franchise agreement may be extended until confirmation of the plan, a period likely to be greater than 210 days. Further, the franchisee may seek to assume the lease, but reject the franchise agreement. In such a case, the franchisor would seek enforcement of its rights under the collateral assignment or Lease Rider, which should state that upon termination, the franchisor has the right to exercise its right to take an assignment of the lease. There is a split in authority on whether the rejection of an executory contract is tantamount to termination.³⁰ If the collateral assignment or Lease Rider states that the franchisor's rights are triggered on termination, unless the landlord takes affirmative action to terminate the lease, the franchisor may be unable to exercise its assignment rights in a jurisdiction that does not consider rejection to be tantamount to termination. Further, the franchisor may have to take additional action to enforce the post-termination requirements in the franchise agreement to ensure a proper de-imaging and enforce non-competition rights. However, it will be more difficult for a franchisee to attempt to reject the franchise agreement and assume the lease in a shopping center context, if the collateral assignment specifically limits the use of the premises to operation of a XYZ Franchised Store.³¹ With such a use

²⁵ 11 U.S.C. § 101 et seq. (2004)

²⁶ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

²⁷ 11 U.S.C. § 365(d)(4) (2004).

²⁸ Id. § 365(d)(3).

²⁹ Id. § 365(b)(1).

³⁰ See, e.g., *In re Stoltz*, 315 F.2d 80, 86 (2d Cir. 2002) (rejection is not the same as termination); *In re Valentin*, 309 B.R. 715, 718 (Bankr. E.D.Pa. 2004) (rejection not synonymous with termination); cf. *In re Henderson*, 245 B.R. 449, 453 (Bankr. S.D.N.Y. 2000) (rejection of non-residential real property lease is tantamount to termination).

³¹ Bankruptcy courts must now enforce use restrictions in shopping center leases under the 11 U.S.C. § 365(b)(3). This change in the 2005 amendments overrules a line of case law which found that use restrictions in

restriction in a shopping center lease, the franchisee will be limited to the option of assigning to an approved system franchisee or the franchisor and, therefore, would probably not attempt to assume the lease without also assuming the franchise agreement.

Another advantage of a franchisor being the sublessor (as opposed to relying on a collateral assignment or Lease Rider) is that when the franchisee rejects the lease, the third party landlord may not honor the collateral assignment affixed to the rejected lease -- for legitimate reasons or for no reason.³² A landlord may argue that the lease was rejected and terminated, and therefore, the whole agreement is terminated without any surviving rights. The franchisor will argue that there was independent consideration and contractual obligations between the franchisor and the landlord; that the purpose of the collateral assignment was to ensure that franchisor has an option to take the lease upon default. Under this scenario, it is especially important that both the landlord and the franchisor sign the collateral assignment document to establish privity of contract, in addition to the existence of the implied rights of the franchisor as a named third party beneficiary.

Before a franchisee can assume a lease or a franchise agreement, it needs to cure all defaults and provide adequate assurance of future performance. As the sublessor, the franchisor will be able to directly participate in that analysis as it relates to the sublease. However, where there is an independent landlord, the franchisor will probably not be able to participate in the determination of whether the franchisee/tenant has provided adequate assurance of future performance as a prerequisite to the assumption of the lease. An exception may be where there is a cross-default provision in the franchise agreement (*i.e.*, a default under the lease is a default under the franchise agreement). In that case, the franchisor may have standing on the issue of whether the tenant may assume the lease, along with the third party landlord. Certainly, the franchise agreement can create an independent contractual obligation to satisfy the franchisor that the franchisee can adequately perform under its location lease.

IV. Site Selection Issues

The franchisee has "the chicken and the egg" timing problem with respect to the franchise agreement and the lease. On the one hand, the premises selection and the lease terms are subject to the franchisor's approval; on the other hand, the franchisee typically must select an appropriate site, sign an acceptable lease and commence the franchised business' operations by the deadlines contained in the franchise agreement. Otherwise, the franchisee's franchise fee, as well as other expenditures, may be lost.

Most franchisors attempt to limit their exposure to claims from franchisees that the franchisors selected sites for franchisees' locations, which contributed to the failure of the franchisees' franchised businesses, by requiring franchisees to select their own sites, but reserving the franchisor's right to approve or disapprove the site. To further insulate the franchisor from liability, the franchise agreement and the Franchise Offering Circular (soon to be the Franchise Disclosure Document) should clearly state that set of facts and expressly disclaim any representation or warranty of success arising out of the franchisor's approval of the franchisee's site.

shopping center leases held by a debtor are an improper restriction on free assignability, thus decreasing the value of the estate. This rule does not necessarily apply in non-shopping center leases. The Bankruptcy Code does not, however, define the term "Shopping Center."

³² Again, a bankruptcy court may not deem the rejection to be a termination, thus clouding the issue of whether a franchisor has enforceable rights under the Lease Rider.

At times, the documents pay lip service to this issue, regardless of the fact that the franchisor or its broker referred the franchisee to the site (or even has the site already tied up under a master lease). Where the franchise documents state one thing and the franchisor acts in an inconsistent manner, it exposes itself to liability.

For example, in *J&R Ice Cream v. California Smoothie*,³³ the franchise agreement specified that the franchisee was to negotiate a lease after franchisor approval of the site selection. Both the Franchise Agreement and Site Selection Agreement in essence granted the franchisee the right to obtain a franchise to establish and operate a restaurant if it identified a specific location for the restaurant within the Assigned Area and obtained the franchisor's approval of the site. The Site Selection Agreement also provided that within 30 days of the franchisor's approval of the site, the franchisee must negotiate a lease for the site and that the lease must be approved in writing by the franchisor. Finally, Site Selection Agreement provided that upon request from the franchisee, the franchisor will provide "any additional guidelines and reasonable site selection assistance and counseling." Therefore, the franchisee was contractually responsible for proposing a site, while the franchisor retained the right to reject the proposed site based on certain criteria identified in the agreement. The Site Selection Agreement did not impose a duty on the franchisor to select a site for the Franchisee or to negotiate a lease for their site.

The franchisor, however, selected and leased the site, with the intent to sublease it to a prospective franchisee. The franchisor specifically made reference to the site in its discussions with the plaintiff. In addition, the evidence indicated that the franchisor made a deliberate decision not to include the franchisee in negotiations for the lease. Prior to executing the agreements, the franchisee expressed concerns that the lease negotiated by the franchisor did not contain a cap on common area maintenance fees. The franchisor's guidelines indicated that common area maintenance fees for a food court should not exceed two percent of gross sales. The franchisor responded to this concern by stating that it had reached an oral agreement with the landlord providing that common area maintenance fees would not exceed three percent of gross sales. In reality the fees totaled more than the promised three percent. As a result, the franchisee sued the franchisor alleging, among other things, that the franchisor was negligent in its selection of the location and its negotiation of the lease.

The Court reasoned that where a relationship is "essentially contractual in nature," a party may be "subject to a negligence action if the act complained of was the direct result of duties voluntarily assumed ... in addition to the mere contract."³⁴ Here, the site selection and lease negotiation processes did not follow the pattern described in the Site Selection Agreement and the franchisor conceded that it already had selected the site and negotiated a lease prior to the execution of the Site Selection Agreement. The Court concluded that the franchisor assumed a duty to select the site for the franchisees and to negotiate the lease for them. As a result, the Court held that the franchisor was liable to the franchisee for negligently breaching that duty.

Another example of disregarded guidelines is *TCBY Systems, Inc. v. RSP Co.*,³⁵ where the franchisor disregarded its own stated demographic guidelines when it approved a franchisee-selected store site. The court found that bad motive existed because the site fell "woefully short" of the franchisor's own documented guidelines.³⁶ The franchisor employee who

³³ *J&R Ice Cream v. California Smoothie*, 31 F.3d 1259 (3d Cir. 1994).

³⁴ *Id.* at 1275.

³⁵ *TCBY Sys., Inc. v. RSP Co.*, 33 F.3d 925, 928 (8th Cir. 1994).

³⁶ *Id.* at 928.

evaluated franchisee's proposed sites was a manager without previous experience in conducting site evaluations. To make matters worse, the franchisor had demographic reports showing that the location failed to meet the franchisor's minimum guidelines for site approval. As this case illustrates, it is advisable to encourage and require the franchisee to make its own decision whether to select the particular site as the premises upon which it will operate the franchised business, rather than to pressure the franchisee to utilize the particular site because the franchisor requires it.

Oftentimes experienced and well-funded franchisors are selling not just the franchise system and product, but also their ability to select and gain access to the most desirable sites. With employees or independent contractors (frequently brokers) whose purpose it is to seek out and tie up desirable sites, as well as off-the-shelf or custom, proprietary demographic software, the franchisor is usually in a better position than the franchisee to perform site selection analyses and gain access. However, if franchisors undertake the responsibility to select sites for franchisees' locations and if the franchised businesses at those locations fail, the franchisors could be subject to liability based upon arguably poor selections and/or the failure to follow their own specified guidelines.

V. Franchisors and Vicarious Liability

Generally, a franchise relationship does not, in and of itself, give rise to vicarious liability.³⁷ However, the perception of the franchisor as the "deep pocket" behind the franchisee and the lack of clarity and consistency among the cases addressing the issue encourage plaintiffs and their attorneys to name franchisors as defendants in plaintiffs' lawsuits seeking recovery for franchisees' acts and omissions.³⁸

One of the key elements in vicarious liability is the presence of a legally sufficient relationship between the person who caused the plaintiff's injury and the vicariously liable defendant. Actual agency is typically the basis for satisfying the legally sufficient-relationship requirement; however, some courts apply the principle of apparent agency in lieu of, or as an exception to, the legally sufficient-relationship requirement.³⁹

In determining whether to impose vicarious liability upon a franchisor for a franchisee's act or omissions based upon the principle of actual agency, courts will generally examine the nature and extent of the franchisor's control, or right to control, the franchisee in its day-to-day operation of the franchised business, rather than the uniformity and standardization of the products and services.⁴⁰ Courts differ on whether the relevant analysis is the franchisor's control over the entire franchised business,⁴¹ the aspect of the business causing the injury⁴² or the franchisee.⁴³ Courts generally look at the entire agreement and the relationship between

³⁷ *Anderson v. Turton Dev., Inc.*, 483 S.E. 2d 597 (Ga. Ct. App. 1997).

³⁸ Joseph H. King, Jr., *Limiting the Vicarious Liability of Franchisors for the Torts of Their Franchisees*, 62 Wash & Lee L. Rev 417, 420, 434, 439 (2005).

³⁹ *Id.* at 429-430.

⁴⁰ *Kerl v. Dennis Rasmussen, Inc.*, 672 N.W. 2d 71, 75, 79 (Wis. Ct. App. 2003), *aff'd*, 682 N.W. 2d 328 (Wis. 2004); *McGuire v. Radisson Hotels Intl., Inc.*, 435 S.E. 2d 51, 53 (Ga. Ct. App. 1993); *Little v. Howard Johnson Co.*, 455 N.W. 2d 390, 394 (Mich. Ct. App. 1990).

⁴¹ *Ciup v. Chevron*, 928 P. 2d 263 (N.M. 1996).

⁴² *Kerl* at 682 N.W. 2d 328, 341

⁴³ *Martin v. Southland Corp.*, [1996-1997 Transfer Binder] Bus Franchise Guide (CCH) ¶ 11,019 (Cal. Ct. App. 1996).

the franchisor and the franchisee to determine the extent and nature of the franchisor's control, or right to control, the franchisee's operations.⁴⁴

In determining whether to impose vicarious liability upon a franchisor for a franchisee's act or omissions based upon the principle of apparent agency, two elements are critical: (1) that the franchisor created the appearance of an agency relationship between the franchisee and the franchisor and (2) that the plaintiff detrimentally relied upon the existence of an agency relationship.⁴⁵

A franchisor's imposition of lease terms through a Lease Rider is an element of control over the franchisee, the franchised business and, if the injury at issue relates to the franchised premises, over the aspect of the business causing the injury. Therefore, a franchisor's imposition of lease terms through a Lease Rider could contribute to a finding that the franchisor is vicariously liable for the injury caused by a franchisee's act or omission.

A franchisor's lease of premises from the landlord and subsequent sublease of the premises to the franchisee grants the franchisee a greater degree of control over the franchisee, the franchised business and, if the injury at issue relates to the franchised premises, over the aspect of the business causing the injury. Therefore, a franchisor's lease and sublease of the franchised premises could contribute to a greater extent to a finding that the franchisor is vicariously liable for the injury caused by a franchisee's act or omission.

If the relevant analysis is the control over the franchisee or the franchised business, the franchisor's imposition of lease terms through a Lease Rider or the franchisor's lease and sublease of the franchised premises would merely be one factor among others that a court would consider. If, however, the relevant analysis is the control over the aspect of the business causing the injury, and the injury relates to the franchised premises, a franchisor's imposition of lease terms through a Lease Rider or the franchisor's lease and sublease of the franchised premises would be more likely to result in a finding of vicarious liability against the franchisor.

VI. Practical Aspects of Transitioning Out Poor Operators

Where the franchisor has a direct interest in the leased premises by sublease, it will be in a stronger position to transition failed franchisees out of the space and the franchised system. It starts with being better able to recognize the warning signs. Rental payments and sales reporting to the franchisor, as landlord, will provide additional monitoring of the franchisee's financial health. When problems do arise, the franchisor will have the option of implementing a payment plan for rent, which it might not be able to do if rent is paid directly to an unrelated landlord. If the result is that the franchisee must exit the system, the direct landlord/tenant relationship gives the franchisor the right to commence an eviction action. As discussed in Section III, there are additional benefits of controlling the real estate in the bankruptcy context. Furthermore, as landlord, the franchisor may have a state statutory lien on the tenant's personal property.

However, evicting a sublessee results in the franchisor being liable for continuing rental obligations to the landlord. The franchisor should consider coordinating the timing of eviction and termination with the insertion of a new operator into the unit. Otherwise, the franchisor is both operating the unit and making the rental payments. As a practical matter, the franchisor

⁴⁴ *Butler v. McDonald's Corp.*, 110 F. Supp. 2d 62 (D.R.I. 2000) (sending issue of whether agency relationship exists to jury).

⁴⁵ *Sims v. Marriott Int'l, Inc.*, 184 F. Supp. 2d 616, 617 (W.D. Ky. 2001).

should avoid stepping into the operational chain and running the unit, especially if it intends to re-franchise the location. By inserting itself into the chain, it creates exposure for a host of liabilities. These include taxes and creditor claims under successor liability theories and environmental claims under operator liability theories. If the plan is to insert a new operator, the best advice is to transition from one operator to the next, and skip the interim step of having the franchisor operate in between the two.

VII. Conclusion

Successful franchisors work hard to maintain a level of control over valuable leased franchised locations. Through the use of a Lease Rider or a collateral assignment of lease, it will either negotiate directly with the landlord or indirectly through its franchisee for the provisions it deems most important. Some Lease Rider provisions are expendable - nice to have, but not essential - while others are imperative. Since the interests of the franchisor, franchisee and landlord, and sometimes the franchisee's lender and landlord's lender, diverge in these transactions, the resulting form of lease agreement will be determined by the parties' respective leverage and advocacy skills. The challenge for the franchisor is determining which provisions are expendable and which are essential, and at what point does it pass on a location because the essential provisions are rejected by the landlord. Most franchisees are more reactive than proactive in their relationships with the landlord. The franchisee is beholden to its franchisor and perhaps a lender. It is often advocating hardest for a party other than itself. The challenge for the franchisee is to sign a fair lease, in short order, that satisfies the requirements of its franchisor and, if applicable, its lender. Landlords seeking to attract franchised brands will be flexible in negotiating their leases and will permit insertion of many of the Lease Rider provisions. Their goals are to achieve a good mix of quality tenants who pay their rent on time and attract customers to the center. The challenge for the landlord is to ensure that it has a quality operator with the financial wherewithal to meet its rent obligations. If that operator fails or is terminated, the landlord needs to know that the franchisor will stand behind the unit and make the landlord whole by operating the unit as a company-owned store or by refranchising it to a known, quality franchisee. Each party's objectives are valid and deserve consideration.