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## 3 may be a crowd when leasing to franchises (and its franchisor)

Some of the largest and most well recognized companies are made up of hundreds (even thousands) of franchises scattered across the country. Commercial landlords often are glad when a franchised business wants to lease space in their project. After all, a franchise has immediate name recognition and usually brings the support of a large, well established company. However, landlords should be mindful of the possible complications that can arise when leasing to a franchise. While a typical commercial lease is between two parties, a lease to a franchise will involve a landlord, a franchisee and a franchisor.

■ **What is a franchise?** A franchisor and a franchisee will often enter into an agreement in which the franchisor gives the franchisee the right to operate a business using the franchisor's trademark or trade name, business model and operating methods. In exchange, the franchisee will be obligated to pay the franchisor, sometimes in the form of an initial start-up fee and subsequent fees, either by a percentage of revenues or a flat monthly fee. Also, franchisees may be obligated to meet certain requirements in order to maintain a uniform franchise system. Franchising allows large companies to expand more rapidly and inexpensively, while giving individuals the opportunity to buy into an established business.

■ **Who will be the tenant under the lease?** In some instances, the franchisor will sign the lease as the tenant and subsequently assign the lease or sublease the space to the franchisee. If that is the case, the franchisor usually remains obligated under



**Christopher T. Toll**  
Attorney, Otten Johnson Robinson Neff + Ragonetti PC, Denver

the lease, thus providing the landlord with greater comfort.

However, it is more frequently the case that both the franchisor and franchisee will negotiate the lease but only the franchisee will sign as the tenant.

In this arrangement, a landlord may find that it owes obligations to the franchisor under the lease, but the franchisor is not a party to the lease and therefore not obligated to the landlord.

■ **What issues should the landlord consider?** Assuming that the tenant is the franchisee, how can the landlord protect itself?

1. Assess financial strength. The landlord should not simply rely on the recognized name of the franchise when assessing the financial strength of the franchisee, especially when the franchisor is not obligated under the lease. Rather, the landlord should determine the financial strength of the tenant by reviewing the financials of the individuals who own the franchisee.

2. Obtain a guaranty. Depending on the landlord's bargaining power, the landlord should ask the franchisor to guaranty the franchisee's obligations under the lease. Alternatively, the landlord may seek a personal guaranty from the individuals who own the franchisee. Even if the individuals do not have substantial financial strength, a guaranty



**Heather H. Park**  
Attorney, Otten Johnson Robinson Neff + Ragonetti PC, Denver

may increase their personal commitment to the lease.

3. Understand the franchisor's involvement. The extent to which the franchisor will be involved in the franchisee's lease will vary.

Does the franchisor want copies of any notices to the franchisee? Does the franchisor want notice of, or even the right of consent to, any amendments to the lease? Does the franchisor want the option to cure franchisee defaults under the lease? Will the franchisor be permitted to enter the premises in order to make inspections and make alterations to the space?

4. Beware of the lease rider. The franchisor may request that a lease rider is attached to the lease. The landlord should carefully review any such lease rider in order to make sure that it does not contradict any of the landlord's lease provisions. This can be crucial for terms related to defaults, cure periods and lease assignments. Instead of just attaching the franchisor's form, it may be more prudent to integrate the provisions from the lease rider into the applicable sections of the lease to avoid unanticipated conflicts in language.

5. Ask for the franchise agreement. To conduct further due diligence, the landlord also may want to request a copy of the franchise agreement prior to the

execution of the lease. The franchisor's rights under the franchise agreement may undercut the landlord's rights under the lease. For example, the franchisor may have a security interest in the franchisee's fixtures and equipment, which may supersede the landlord's security interest, if any, in such equipment.

6. Avoid future conflicts. The landlord could find itself stuck in the middle if disagreements arise between the franchisor and the franchisee. Therefore, the landlord should protect its rights in advance by clearly defining any rights of the franchisor and obligations of the landlord to the franchisor under the lease.

7. Prepare for Plan B. In the case of a failing franchisee, the franchisor may want the option to take over the lease – especially if the space is located in a prime location. The franchisor will often want the right (but not the obligation) to assume the lease and subsequently assign the lease to another franchisee entity. In such cases, the landlord should ensure that the franchisor and the original franchisee will remain obligated under the lease. Additionally, any subsequent franchisee tenant should be required to meet the landlord's financial requirements just like any other tenant in the project.

Having a franchise as a tenant will likely offer infrastructure and continued support to the franchisee – increasing the likelihood of success of the business and continued performance by the tenant under the lease. Landlords should just be aware of the risks that come with those benefits.▲