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Seminar 2

Three is a Party: Understanding the Parties and Key Issues in a Franchise Lease

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by:

Rosemarie Del Monte, Esq.
Del Monte Landblom Law, LLC
Denver, CO
rosemarie@rdelmontelaw.com

Alan Betus, Esq.
Associate Counsel
CBL Properties
CBL Center, Suite 500
2030 Hamilton Place Blvd.
Chattanooga, TN 37421-6000
Alan.Betus@cblproperties.com

I. Introduction: Understanding the Players, Their Roles and Challenges, and Legal Background

A developer negotiating a lease with a franchised concept cannot expect to successfully navigate the transaction without knowing the relevant players with interests in such lease. A failure to identify all relevant parties to the transaction often leads to delays towards the end of negotiations, or worse, frustration and animosity as material deal terms are modified in the eleventh hour. When this happens, occasionally the deal "dies" as a result, or perhaps worse, the franchisee begins a tenancy on bad terms with a landlord as a result of the animosity encountered during negotiation and drafting of that lease. Thankfully, the roster of participants in a franchise lease transaction is customarily stable: (i) franchisee/tenant and franchisee/tenant's legal counsel, (ii) landlord/landlord's legal counsel; (iii) franchisor/franchisor's legal counsel; and (iv) tenant's lender and/or landlord's lender. If franchisee/tenant discloses the franchisor-franchisee relationship to landlord at the inception of the transaction, and gives some notion as to the level of involvement the franchisor and any potential large issues (such as franchisor rider or addendum) negotiations generally are able to progress in an orderly and amicable manner.

While the players in the transaction are fairly standard, their interests are very different. And while all of the players' interests must be balanced, of the three, franchisee/tenant and franchisee/tenant's legal counsel are in the most complicated position. Franchisee/tenant and its counsel often find themselves in a "pickle" caught between trying to negotiate the lease requirements of the landlord while also having to fulfill the terms of their franchise agreement and satisfying franchisor and franchisor's counsel that the lease terms, as negotiated, adequately protect franchisor's interests and meet franchisor's requirements. The secret to being able to effectively "get the deal done" is knowing and understanding the positions and concerns of all the players, together with the motivations and reasons behind lease issues that are typically hot buttons for both landlords, tenants, and franchisors, and then creatively finding ways to successfully complete the transaction in a way that is ethical, effective and efficient.

The intent of this session is to help all the players involved understand the concerns and positions of the others while keeping in mind that while their interests may differ, at the end of the day, landlord, franchisee/tenant and franchisor all have one goal: getting the deal done, opening the store, and making money.

As with any deal, franchised or otherwise, it is always wise to remember two central concepts that almost go without repeating. First, most decisions come down to bargaining power and who needs the deal more. This will be a chief factor in determining how far a party can press an issue. Second, how a lease dispute is resolved depends on the motivations and actions of the parties involved. As with any contract, the language of the lease and any franchise rider are oftentimes a starting off point or guide to resolve an issue. However, what plays out in reality may be drastically different from what is actually in the lease.

A. The Players

1. Franchisee/Tenant and Franchisee/Tenant's Legal Counsel

The franchisee/tenant in a franchise lease transaction is typically the common thread for all parties involved in the negotiation and is involved from the commencement of negotiations of the letter of intent (the "LOI") through lease completion. The franchisee/tenant is customarily charged with identifying the site, negotiating all business terms, including the terms of the LOI (such as rental, term, financial security, etc.), and taking lead (along with franchisee/tenant's counsel) in negotiating the lease document. While some franchisors' real estate teams will act on the franchisee's behalf to help identify a location, many franchise agreements specifically disclaim any responsibility of franchisor for site selection and lease negotiation, placing the entire process squarely in franchisee's court. Even in these situations, however, the franchisee/tenant typically has to have any such site approved by the franchisor which is just the first of many instances in which the franchisee/tenant must navigate the transaction both with the developer/landlord on one side and the franchisor on the other. As the franchisee/tenant is ultimately the primary obligated party under any franchise-based lease, this allocation of responsibility is appropriate. Some franchisees, however, especially franchisees of emerging franchised concepts or those franchisees of concepts requiring a smaller franchise investment (and oftentimes a smaller square footage being leased), are occasionally relatively unsophisticated as compared to their respective landlord and franchisor brethren. Because of this, the contacts such franchisees have in the legal community are often limited, leading to franchisees engaging unsophisticated, inexperienced and/or unnecessarily fee-conscious counsel. The net result in such cases may be that the party steering the proverbial ship of lease negotiations – franchisee and his/her/its counsel – is actually the least qualified to do so.

2. Landlord and Landlord's Legal Counsel

A constant in any lease negotiation is landlord and landlord's legal counsel. Typically, a franchise-based lease is but one lease in a multi-tenant development, and more times than not, the franchise-based lease accounts for a very small, fractional part of overall leasing for the development at hand. Typically, landlords will have their own lease forms and will require that a franchise-based lease use such lease form as the basis for lease negotiations. Because of the limited square footage being leased, coupled with the deal volume of landlord and landlord's counsel, landlord's tolerance is often limited for negotiating material and significant changes to the proposed lease form and the franchisee's bargaining power is limited. This is especially true when franchisee/tenant is not financially strong, even if full-term personal guarantees from franchisee's principals are being provided. However, as many franchised systems have minimal leasing standards, landlords can be challenged to balance the lack of time/resources devoted to negotiating a small-shop, non-credit lease with the overall value of having a franchised brand in its development (which franchise brand carries name recognition and regional/national credibility – certainly components that franchisee/tenant would not bring to the transaction without the franchisor-franchisee relationship). As discussed later in this paper, nearly all franchisors have minimal leasing standards which must be addressed in order for franchisor to approve a lease for execution. These standards come in two forms (discussed later in this paper and which typically are outlined in the franchisee's franchise disclosure document): lease standards for provisions within the lease itself, and lease standards required to be incorporated in a lease/franchise rider. Landlord and landlord's counsel must be prepared to face and address franchisor in both arenas, including deviating from its standard small-shop leasing standards in recognition of the added value, financial and otherwise, in having a franchised brand within its development.

3. Franchisor and Franchisor's Legal Counsel

While exceptions exist, franchisor and its legal counsel typically do not become directly involved in lease negotiations until late in the process, and sometimes, franchisors do not get involved on the front line of negotiations at any time. The reason for this is two-fold – for one, as mentioned earlier, the franchise agreement and related documents typically make it clear that it is franchisee's obligation – not franchisor's – to identify the real estate and negotiate the business terms of the transaction, as the lease will ultimately be franchisee's – and not franchisor's – financial and legal responsibility. Second, most franchisors incorporate within the applicable franchise documents the lease requirements of franchisor, and hence, expect franchisee (and its legal counsel) to incorporate the lease terms which franchisee has previously contractually agreed with its franchisor to incorporate in every lease. Unfortunately, many franchisees either forget to inform their respective legal counsel of franchisor's requirements until late in negotiations (if at all), or alternatively, unsophisticated franchisee/tenant counsel will attempt to concede franchisor's requirements as bargaining chips in negotiating other terms of the lease. For this reason, franchisor and its legal counsel typically get involved, at a minimum, to review a franchisee's proposed final lease (prior to execution), and in many cases, will require modifications to the proposed lease in order to meet franchisor's minimum brand standards and the terms of the franchise agreement and related documents. Some franchisors elect to interject themselves into the lease negotiation process prior to the lease being in near final form so as to avoid frustrations and delays, but others refuse to do so out of fear of inappropriately interjecting themselves into lease/real estate negotiations. In any event, to avoid meaningful frustration, it is the responsibility of franchisee/tenant to disclose to landlord the existence of franchisor and its counsel early in the process.

4. The Lenders for Franchisee/Tenant and/or Landlord

The lenders for both franchisee/tenant and the landlord often loom in the background, and unlike franchisor and its legal counsel, there are many times in lease transactions where the respective lenders never become involved. However, landlord lenders often approve the lease forms used in developments (especially larger developments), which poses challenges in the event that the franchised concept requires material changes to the lease form to meet franchisor's brand standards. This is especially true in circumstances where franchisor is large enough to mandate that franchisor's lease form (as compared to landlord's lease form) be used. Additionally, it is a relatively common franchisor leasing standard that a subordination, non-disturbance and attornment agreement (an "SNDA") be afforded franchisee/ tenant, which can be inconsistent with institutional lenders' minimum square footage standards for issuance of SNDAs (note that this issue is addressed in greater detail in Article III of this paper). As for franchisee/tenant lenders, the most important requirement for such lenders is often a landlord waiver or subordination agreement or representation in the lease whereby landlord is asked to

waive or subordinate any interest it has in franchisee/tenant's personal property recognizing such lender's security interest in franchisee/tenant's furniture, fixtures and equipment. Most landlords (and franchisors) are accustomed (and acquiesce) to such request, but nonetheless the request should be made at the same time the lease is being negotiated so as to make the process as straightforward as possible for all interested parties.

B. The Documents

1. The Franchise Disclosure Document (the "FDD")

The FDD is not a contract, as it is not jointly executed by franchisor and franchisee. Instead, the FDD is a federally-mandated disclosure document, in which certain operational and economic facts are disclosed to potential franchisees at least fourteen (14) days in advance of such individuals becoming franchisees of a given system. As with most governmental documents, the FDD is form driven, meaning that all FDDs will be outlined the same and will generally look alike so as to allow potential franchisees to easily compare one brand to the next. Specifically, there are 23 items that are required to be disclosed in an FDD:

Item Number	**Summary**
Item 1	Franchisor and any parents, predecessors and affiliates
Item 2	Business expertise
Item 3	Litigation
Item 4	Bankruptcy
Item 5	Initial Fees
Item 6	Other Fees
Item 7	Estimated Initial Investment
Item 8	Restrictions on Sources of Products and Services
Item 9	Franchisee's Obligations
Item 10	Financing
Item 11	Franchisor's Assistance, Advertising, Computer Systems and Training
Item 12	Territory
Item 13	Trademarks
Item 14	Patents, Copyrights and Proprietary Information
Item 15	Obligation to Participate in the Actual Operation of the Franchise Business
Item 16	Restrictions on What Franchisees May Sell
Item 17	Renewal, Termination, Transfer and Dispute Resolution
Item 18	Public Figures
Item 19	Financial Performance Representations
Item 20	Outlets and Franchisee Information
Item 21	Financial Statements
Item 22	Contracts
Item 23	Receipts

Some, but not all, states require that franchisors register with such state as a pre-requisite to franchisor being allowed to sell franchises within that state. Penalties for failing to properly file with a state requiring registration can be monetary, or worse, can invalidate any franchise sales within the applicable state.

It is important to note that a franchisee does not have any private right of federal action arising from the FDD or errors contained therein. Governance of the FDD process is controlled by the Federal Trade Commission (the "FTC"), as well as specific state statutes and common law concepts governing enforcement. For the leasing practitioner, it is important to note that neither a franchisee nor its franchisor can "breach" the FDD as it is not a contract, and hence, other than knowing that the document exists and perhaps reviewing financial performance representations and market development plans, the FDD should not be overly relevant for a developer or leasing agent.

2. The Franchise Agreement

The franchise agreement is the contract which governs the relationship between franchisee and franchisor, and typically applies to one individual location for which franchisee is granted operational rights. It is the franchise agreement wherein franchisee is granted rights to use the process, trademarks and other

proprietary components of franchisor's system and agrees to abide by the operational requirements established by franchisor; it is the franchise agreement which establishes the royalties and other fees/expenses that franchisee must pay franchisor in exchange for such granting of rights; and it is the franchise agreement which outlines the recourse for both franchisee and franchisor in the event the relationship sours and legal or equitable action is required. For the leasing practitioner, it is critical to note that, absent the franchise agreement (and its being in good standing), franchisee has no right to use the trade name of the applicable franchise system, nor does franchisee generally have the right to provide the services synonymous with the franchise system. Simply stated, without a franchise agreement, a franchisee has no right to operate the franchised brand – notwithstanding the terms of any lease agreement.

Unlike the FDD, there is no mandated format for a franchise agreement. As with any arm's length contract between parties, so long as properly disclosed in the FDD (where applicable), franchisee and franchisor can generally contract for any desired allocation of rights and obligations. An example outline of a customary franchise agreement is as follows:

Section	Description
1	Grant of Franchise
2	Term and Renewal
3	Franchised Site and Territory
4	Initial Franchise Fee
5	Royalty Fee; Method of Payment; Late Payment
6	Records, Reports and Audits
7	Operations Manual
8	Modifications and Improvements to the System
9	Obligations of Franchisee
10	Point of Sale System, Information Technology Systems and Website
11	Advertising
12	Counseling and Advisory Services and Onsite Assistance
13	Opening Assistance
14	Training
15	Marks
16	Relationship of the Parties
17	Maintenance of Credit Standing
18	Indemnification, Insurance and Taxes
19	Assignment
20	Restrictive Covenants
21	Termination
22	Effects and Obligations Upon Termination
23	Right of First Refusal
24	Ownership of Franchisee
25	Notices
26	Governing Law and Enforcement
27	Miscellaneous
28	Franchisee's Acknowledgements

Some franchise agreements are deemed confidential by franchisors, and accordingly, not all franchisees are willing (or able) to provide copies of such franchise agreements to their potential landlords. As the performance by franchisee under any lease is dependent upon performance by franchisee under the franchise agreement, it is prudent practice for any landlord counsel to ask for a copy of such franchise agreement at the time of lease execution. However, in the absence of a copy, prudent landlord counsel should clarify that a default under the franchise agreement constitutes a default under the lease, and further must understand (and correlate, in the lease) key terms of the franchise agreement such as term, mandated operational and trademark requirements, and other issues which will are outlined with more specificity below in this paper. In a leasing situation, the tenant entity and the entity on the franchise agreement must be the same entity. Likewise, the term of the lease must be at least as long as the term of the franchise agreement (including renewal options). However, the terms of franchise agreements can be quite lengthy, whereas leases with terms of more than 10 or

15 years are less common today than in the recent past. In those situations, at the very least, the franchisor should require that the term of the Lease not expire before the franchise agreement does.

3. The Market Development Agreement / Area Development Agreement

While the franchise agreement is the document that governs the relationship between franchisor and franchisee as to a specific location, the Market Development Agreement/Area Development Agreement (the "MDA") is the document that governs the relationship between a franchisee and a franchisor with respect to expansion by franchisee. Indeed, it is more common than not in today's market for sophisticated franchisors to seek multi-unit operators, meaning operators who join the franchise system to open multiple stores/locations in one or several identified markets. The MDA is what governs the allocation of territories to franchisee from franchisor, and to draw a comparison to a lease, territories within the MDA are often defined similarly to the definition of a territory in a radius clause in favor of a landlord contained within the typical retail lease (though it should be noted that many territories granted within an MDA are non-exclusive, as compared to a radius, which usually establishes a non-competitive environment). The MDA is typically executed at the time of the initial franchise agreement, with the understanding that a new MDA will not be executed each time a new franchise agreement is executed. Instead, one MDA will typically govern the multi-store development by a franchisee of a given market, but separate franchise agreements will be executed for each unit opened.

The specific terms of each franchisor's MDA vary greatly – much more so than a franchise agreement – so that it would be counterproductive to provide an outline of contents for an MDA. However, the leasing practitioner needs to be aware of the existence of the MDA, and specifically, needs to understand that the MDA can impact several important areas of a lease, notwithstanding the negotiated terms and conditions of the lease, including:

a. **Construction Schedule**: The MDA often requires franchisee to develop "x" number of stores in "y" period, meaning that franchisee may sometimes need to get a location open by a date certain in order to avoid a default under the MDA. Accordingly, the outside date of delivery contained in a lease may have increased value to franchisee, and require the increased attention of the parties.

b. **Radius**: As discussed further below, franchisee may have little control over operations outside of the territory outlined for such franchisee in the MDA. Accordingly, franchisee may not be able to agree to an "x" mile radius if there are areas outside of the radius beyond franchisee's control. As noted later in this paper, Landlords will often require a radius restriction (especially in a percentage rent lease) and the tenant/franchisee may be required to capitulate on this issue despite any prohibition in any agreement with its franchisor.

c. **Cross Default**: It is possible that a default by a franchisee under franchisee's MDA may negatively impact franchisee's other operating stores. Accordingly, a prudent landlord may attempt to negotiate that any default by franchisee of <u>any</u> agreement with its franchisor constitute a default under the specific lease, even if the default does not directly apply to the specific location at hand.

4. The Lease

a. **Franchisee is Tenant.** While the lease and the terms of the lease are the primary focus of this paper, it is important to note that the lease is but one of several important legal documents involved in a franchise-based transaction. The lease is a direct contractual agreement between landlord and franchisee/tenant, but all parties should be aware that the lease is <u>not</u> typically a contractual agreement that binds franchisor. This is relevant for both franchisee/tenant and landlord to keep in mind because as will be discussed elsewhere in this paper, the franchisor has at its disposal several tools it can use in certain situations to attempt to gain tenant-type rights during the term of the Lease. As relates to franchisee/tenant, it should always be remembered that as between franchisee/tenant and the landlord the terms of the lease cannot allow an "escape hatch" for terms of the franchise agreement (which, as mentioned above, is often non-negotiable for franchisee.) Any requirements of the franchise agreement will be binding upon franchisee/tenant even if not mentioned – or contradicted – in the lease. For instance and as discussed later in this paper, even if the lease includes a provision allowing franchisee/tenant to

"go dark" so long as rental is continued to be paid, if the franchise agreement requires that franchisee/tenant continuously operate throughout the term of the franchise agreement, then the fact that the lease allows for a "go dark" right is not overly relevant to franchisee (indeed, in such case, if franchisee/tenant "went dark", franchisee/tenant would be in default of its franchise agreement and arguably in default of its lease as well if the lease is properly cross-defaulted with the franchise agreement.) Likewise, and also discussed later in this paper, to the extent the "permitted use" under the lease is limited to the operation of that specific franchise concept, in the event that tenant/franchisee defaults under its franchise agreement, franchisee does not have the right to continue to operate in the leased premises under that specific franchise concept and cannot, therefore, honor the permitted use as set forth in the lease. Similarly, landlord also must remember that the lease is generally not binding upon franchisor unless and until franchisor elects to assume operations as may be permitted pursuant to the terms of a collateral lease assignment or other lease terms. Hence, even though the lease may require franchisee/tenant to operate as "Brand X", including displaying signage with the "Brand X" name, if the franchise agreement allows franchisor to revoke franchisee/tenant's right to operate as "Brand X", the fact that the lease requires franchisee to operate under such name will be irrelevant.

b. **Franchisor is Tenant.** While rare, some franchisors desire enough control over the real estate (more specifically, the location) and operator that the franchisor itself is the tenant of the lease. In those cases the franchisee is a subtenant. One reason for this type of lease structure is the (perceived) efficiencies in the franchisor being in control of the franchisor, store operations, and brand. Another reason is that having the contractual obligation to the landlord does away with some of the more contested aspects of negotiating a lease (such as a lease rider, or the franchisor wanting to be a third party beneficiary to a lease between the franchisee/tenant and landlord). In the case of a below average franchisee the franchisor as tenant may be able to more quickly replace (evict) a subtenant than a landlord could evict a franchisee/tenant. And, at the end of the term of the lease the franchisor/tenant will have direct rights to access the premises to de-identify its logos and trade dress.

The two biggest challenges for the franchisor/tenant in negotiating a lease directly with the landlord as the tenant is avoiding (or limiting) liability under the lease since the franchisor/tenant will not be directly operating the store, and sublease and assignment rights since the franchisor will want to easily transfer the lease to a franchisee/subtenant and any replacement of the franchisee/subtenant. As it relates to liability avoidance, the most frequently used approach is to add language that is similar to a standard landlord exculpation clause found in almost every lease (…there will be no personal liability of the tenant…), sometimes stating clearly in the lease that the franchisor is thinly capitalized and is not "the money" behind the lease. In these cases the landlord will want to ensure that it receives a personal guarantee from an entity or person with sufficient financials (which it can do by making it a condition of any right of the franchisor/tenant to transfer the lease). Another approach franchisor/tenants take is to set a maximum dollar limit on its liability to the landlord. In these instances the franchisor can require the franchisee to pay to the franchisor any monies it spends on the lease (including damages paid to the landlord) – let's forget for a moment that collecting from a defaulting franchisee may be not be a realistic option for the franchisor - and the landlord should still insist on a guarantee so that it can recoup its full loss.

With respect to sublease and assignment, the franchisor/tenant will want the specific right, without landlord's consent, to sublease the premises or assign the lease to a franchisee (oftentimes with no other requirements) and without cost to the franchisor. For landlord this is no different if the franchisee is the tenant, and landlord will still insist on reasonable limits such as a net worth requirement of the franchisee, no release of liability of the franchisor/tenant, and a guarantee or other form of credit from the franchisee.

5. <u>The Lease Rider</u>

Most, but not all, franchisors have a lease rider attached as an exhibit or schedule to their respective franchise agreements. Lease riders vary in length, in tone (although most are heavily tilted towards the franchisor despite it not being a party to the lease) and in content, but generally incorporate certain rights and lease provisions required by franchisor as a condition to franchisor's approval of franchisee's lease. At a minimum,

these provisions usually include incorporation into the lease of certain remedies from the franchise agreement so that, for example, franchisor is allowed to assume operations of the business at the leased premises in the event franchisee/tenant defaults under its franchise agreement with franchisor. Other requested rights within the rider are tied to this fundamental right, including notice and cure rights for franchisor (in the event of franchisee default), the right to require franchisee to de-brand/de-identify (in the event of franchisee default), and the right of franchisor to consent to certain lease amendments prior to the same becoming effective (to ensure the ongoing compliance of the lease with franchisor's brand standards). Landlords are naturally loathe to condition any amendment on the consent of the franchisor because of the time involved to obtain the consent, and to the landlord, whether a franchisor is aware of or consents to an amendment is an issue between franchisor and franchisee and does not involve the landlord (it being up to the franchisee/tenant to obtain consent from the franchisor to enter in to the amendment before doing so). Almost universally, franchisors look to landlords to afford third-party beneficiary status to franchisor in order to enforce such rights as needed (as compared to having franchisor execute the rider and become immediately contractually bound to landlord, reason being that a direct contractual relationship by definition can cause franchisor to become more "involved" in negotiating franchisee's real estate transaction than is comfortable or prudent from a potential liability standpoint). And, almost as universally, landlords fight against having to name the franchisor a third party beneficiary or at least seek to limit instances where the third party beneficiary status is conferred.

Some franchisor riders go beyond merely incorporating franchisor rights and also seek to incorporate critical business terms into every lease within the franchised system. Such requested rights typically include exclusive use rights and remedies, specific permitted use and trade name clauses, requirements for SNDAs, waiver of certain landlord-friendly provisions such as radius restrictions and relocation, and pre-approval of signage and design packages. Nearly all such requests can be justified by franchisor as necessary to protect brand standards – for example, a radius restriction in a lease could contractually restrict a franchisee from growing the brand within a market, which directly cuts against franchisor's objectives in most cases. However, nearly all such requests are often "business" issues that are (or should be) negotiated as part of the LOI process, which again is a process from which most franchisors intentionally stay removed. These business terms, more so than franchisor rights mentioned in the prior paragraph, often pose some of the greatest points of tension between franchisors, franchisee/tenants and landlords in lease negotiations.

An additional point of tension arises when franchisor incorporates a rider into its franchise agreement (and franchisee/tenant signs such agreement), yet landlord and landlord's legal counsel refuse to incorporate a rider as an exhibit to its lease. Typically, the rationale provided for landlord's refusal is one of two reasons: (i) franchisee/tenant is too small of user to mandate adding a non-standard exhibit to landlord's standard lease form (a corollary being that the rights of franchisor can be adequately addressed in the body of the lease using landlord's form language), or (ii) the lease form has been previously approved by landlord's lender and cannot be modified to include the exhibit. In the event of landlord's blanket refusal to incorporate the rider, it is critical that franchisee/tenant bring franchisor and franchisor's legal counsel into the discussion immediately, as franchisee/tenant has previously contractually agreed with franchisor to incorporate the rider into the lease. In many occasions, franchisor will agree to allow critical rider provisions to be incorporated into the body of the lease itself (as compared to requiring a separate rider), though such process may require more time for lease negotiations and may result in franchisor passing through to franchisee additional fees and costs. If a landlord is making incorporation of the rider provisions into the body of the lease a requirement and approval by franchisor's counsel is a prerequisite to execution of the lease by franchisee, then in such event, franchisee/tenant's counsel should notify franchisor's counsel of that fact as soon as possible and make every effort to streamline review by franchisor's counsel (usually by drafting a separate memo or letter identifying each rider provision and the corresponding lease section) in order to expedite approval of the lease by franchisor.

6. SNDA

The requirement of a franchisor/franchisee for an SNDA, and the ability of landlord to provide one, will be further addressed in Article III of this paper, but to the extent that the lease rider and/or franchise agreement requires an SNDA from landlord's lender as part of lease approval, the SNDA by definition becomes an important document governing franchisor-franchisee-landlord relationship. Typically, the SNDA is only between franchisee/tenant, landlord and landlord's lender; franchisor does not execute the SNDA although franchisor needs to be an eligible successor-in-interest to franchisee/tenant's interest in the SNDA. Conceptually, the SNDA is important to franchisor because, ultimately, franchisor's motivation is securing revenue via royalties paid by franchisee, which royalties result from sales made from the leased premises. If the leased premises is closed due to acts outside of franchisee/tenant's control (i.e., a foreclosure due to landlord's failure to honor its obligations to

its lender), franchisor loses its income stream from the location, which is a bad result for franchisor. While franchisee's and franchisor's interests are not always the same in connection with a lease transaction, in the case of an SNDA, they are. If the leased premises is closed due to acts outside of franchisee/tenant's control, not only does the franchisor lose its royalty income stream, tenant/franchisee loses its entire income stream, as well.

7. Tenant's Lender's Lien Waiver

As briefly mentioned earlier, franchisee/tenant will typically secure financing to complete its construction obligations and to finance its furnishings, fixtures and equipment. As a condition to providing such financing, tenant's lender will typically require that landlord (and sometimes, franchisor) acknowledge that the lender has the right to (i) enter the premises, and (ii) remove the financed furnishings, fixtures and equipment in the event franchisee/tenant fails to timely tender payments to the lender. Such agreement further will provide that tenant's lender has a first priority interest from the proceeds of sale for any encumbered items, so that neither landlord nor franchisor can sell encumbered items for recovery of rents, royalties, etc. if there are proceeds otherwise owed to tenant's lender. So long as the lender's subordination request is provided to landlord in advance of lease execution (or promptly upon receipt, if financing occurs after lease execution), there usually are limited or no challenges to landlord's execution of such agreement, though some larger landlords have specific landlord-drafted forms for subordination which will be provided to tenant's lender and negotiated. Regardless of whether there is a tenant lender at the time of lease execution (and in such event a lender required form of subordination or waiver), prudent franchisor/tenant lease counsel should always request that a lease provision be inserted which states that landlord waives all statutory and contractual liens or any other so-called "landlord's lien" which it may be entitled to assert against any of tenant/franchisee's personal property as security for the payment of rent or the performance of any other obligation of tenant/franchisee under the lease. Landlords who will not agree to waive said rights will typically agree to subordinate them.

II. Playing Nice in the Sandbox: Issues Which Franchisor and Franchisee Need to Negotiate

Nearly all franchisor-required lease terms are incorporated expressly or implicitly into the franchise agreement which is signed, or at least pre-negotiated, prior to lease execution. Therefore, on an academic level, franchisor's requirements should be relatively black-and-white for franchisee/tenant to negotiate, and landlords should understand that such lease terms must be incorporated into the final lease document if landlord desires to transact business with franchisee/tenant and its franchised brand. Unfortunately, as the practice of law continually reminds all involved, nothing is black-and-white. Lease requirements/lease riders incorporated within franchise agreements are often drafted by corporate/regulatory attorneys, not real estate attorneys, and for this reason are often drafted less than ideally (read: heavy-handed) and are not practical. Further, due to the parties aligned motivations of profitability, franchisors are typically willing to accommodate certain requested modifications to the rider and franchisor's leasing standards, whether such requests originate from franchisee/tenant or landlord. While it can be difficult for franchisee/tenant's counsel to balance the interests of its client, landlord and franchisor when negotiating the certain provisions of the lease, franchisee/tenant's counsel is also often able to use the franchisor's requirements as a "hammer" because in many instances, without landlord's incorporation of certain provisions, many franchisors simply will not allow their franchisees to execute the lease. Before landlords can be approached to incorporate franchisor-mandated lease terms (even if modified), however, franchisor and franchisee must be on the same page as relates to the terms to be incorporated. This section of this paper outlines those areas which are most customarily negotiated between franchisor, franchisee and their respective legal counsel.

A. Collateral Assignment of Lease.

The collateral assignment of lease is perhaps the single most important remedy granted a franchisor in the franchise agreement with franchisee/tenant, and is ironically, the lease rider provision most often resisted by landlords. Simply stated, the collateral assignment of lease allows a franchisor, upon written notice to landlord, to immediately assume the lease and become the named "tenant" thereunder in the event of a default by franchisee/tenant under its franchise agreement or under the lease itself. Such collateral assignment (and franchisor takeover threat) is often the "hammer" used by franchisors in order to force noncompliant franchisees into compliance with various brand standards. To be effective, the collateral assignment right cannot be tied to a document being executed between franchisor, on the one hand, and franchisee/tenant on the other (logically, if there is a dispute under the franchise agreement, franchisee/tenant might not be willing to execute an assignment document at that time which grants all rights under the lease to its franchisor). Similarly, the collateral assignment cannot be conditioned upon landlord approval at the time of franchisor takeover (approval needs to occur in

advance at the time of execution of the lease/rider), and cannot be tied to any net worth requirements or other requirements on franchisor which might preclude franchisor from exercising its rights. Most, if not all, franchisors, are unwilling to negotiate or water down this fundamental right, even if a franchisee's real estate counsel seeks to do so. However, both franchisees and landlords are understandably reluctant to grant such blanket rights to franchisors. Franchisees are reluctant as it provides opportunity for an aggressive (or erroneous) franchisor to immediately cease franchisee's business operations without legal process, and forces franchisee to often submit itself into compliance with franchisor's demands, even if incorrect, in order to remain in business. Landlords are often reluctant because while the franchisor is bigger and financially stronger than the individual franchisee, franchisor is an unknown commodity as far as landlord is concerned. Unfortunately for both franchisee and landlord, there is not any customary compromise position(s) that are associated with collateral assignment rights – they are simply a necessary part of most franchise-based lease transactions. Typically when landlords learn that this provision is a "deal killer" in organizations where franchisor's counsel must specifically approve every lease prior to franchisee being permitted to sign, most landlords will capitulate to its inclusion, albeit often reluctantly. While a fact of life, landlords can still try to protect themselves to some extent. One way to do this is to only agree to the assignment if due to a bona fide breach of the franchise agreement or other franchise documents and franchisee/tenant agrees not to impose liability upon the landlord for recognizing the franchisor/assignee.

B. Franchisor Right of Entry

Equal with the collateral assignment, it is critical that a franchisor have the right to enter its franchisees' leased premises and inspect the same for compliance with brand operational standards. Most franchisees and landlords expect to grant such right of entry to a franchisor, and while landlords may occasionally require insurance certificates or indemnities from franchisor in the event of entry, the concept of a franchisor right of entry is typically not debated. However, as franchisee/tenant is the party operating its business and desires to avoid disruption whenever possible, a franchisee/tenant and its attorney will often seek to limit franchisor's right of entry into the leased premises parallel to limitations negotiated for landlord's right of entry within the body of the lease. On the other hand, franchisor, in a desire to protect its trademarks, brand standards and operational system, will contend that its interest in the business is much more significant and direct than landlord's interest (as landlord's interest is tied primarily to premises maintenance and receipt of rental payments). Further, franchisors believe that unplanned visits (without prior notice to franchisee/tenant) are essential for evaluating the true operations ongoing at the leased premises – after all, if notice is given of a planned inspection, franchisee/tenant can conceptually rectify any ongoing deficiencies in order to meet compliance standards for franchisor's inspection. So, franchisee and franchisor should negotiate the conditions and prerequisites for franchisor's entry into the premises, and specifically, under which circumstances (if any) advance notice is required and under which circumstances (if any) no notice is required. On a parallel note, both franchisor and franchisee should ensure that landlord's notice requirements for franchisor entry do not preclude the negotiated arrangements between franchisor and franchisee, both in the lease and in the franchise agreement.

C. Franchisor Notice and Cure Rights

A primary theme of franchisor's requested rights in the lease (including the lease rider) is that franchisor desires to protect the business operations being conducted at the specific real estate location. Presumptively, in approving the lease, franchisor determines that the specific location is a desirable place for the franchised brand to operate, and ideally, the specific location will serve as a springboard for further growth of the brand in the particular market. Obviously, if a franchisee/tenant default exists under the lease, the specific location immediately becomes at risk, as one of the most common landlord remedies for a tenant's default is a termination of possession and a cessation of operation of the business located in the leased premises. Accordingly, all franchisors are motivated to keep their respective franchisees out of default. In order to do so, franchisor must receive notice of any pending defaults, and nearly all landlords and franchisees are in agreement that franchisor has the right to receive such notice (and will agree to do so).

The more interesting question revolves around whether franchisor has the right to cure defaults of franchisee (without assuming the lease pursuant to collateral assignment rights), and if so, whether the cure has to be effectuated within the notice and cure period afforded tenant under the lease (or if a longer period of time is permissible for franchisor). As to the issue of franchisor's curing lease defaults of its franchisee, most landlords agree this is a desired result as compared to having uncured defaults and most franchisees acknowledge that this is a necessary franchisor right. That said, franchisor may not want to assume all ongoing liability under the lease simply by paying a month's rental which franchisee/tenant has failed to tender, or because franchisor makes a

repair that franchisee/tenant has neglected to make. Instead, in such circumstances, franchisor desires to cure the default on behalf of its franchisee, and then have its franchisee continue operating what hopefully is a successful business. Franchisees may object to such an approach, as ultimately it removes some of franchisee's leverage against franchisor: if a franchisee is in default and franchisor is forced to assume the lease in order to cure, franchisor may undertake a careful analysis as to the viability of the location; on the other hand, if franchisor can simply cure a default and otherwise make franchisee continue to operate and perhaps lose money, then franchisor has little "skin in the game" and is able to maintain the (presumptively) valuable real estate by not having to invest significant resources. Further, franchisees may be concerned that franchisor's entry and cure might damage leverage franchisee has with its landlord (with whom franchisee/tenant has a direct contractual relationship), or worse, such curing of defaults might harm franchisee's business operations by creating unsafe conditions such as performing repairs to a lesser standard than franchisee/tenant customarily requires.

As relates to whether or not franchisor should be afforded additional cure periods from landlord (in addition to franchisee/tenant's notice and cure rights under the lease), franchisor's perspective is that such added time is needed in order to preclude claims by franchisee that franchisor's curing of the lease default somehow damaged franchisee/tenant or its business operations. For example, if the lease affords a 30 day cure right for a tenant repair, and franchisor enters the premises to complete such repair on the 20th day (since franchisee/tenant has yet to complete the same), franchisee/tenant can then argue that it was intending to complete the repair on the 25th day (as permitted by the lease), and that franchisee/tenant will lose material amounts of income due to the repair being completed on the 20th day (perhaps a busy day for franchisee/tenant) rather than the 25th day (perhaps a slower day). Further, franchisee can contend it had strategic reasons in its relations with landlord for delaying completion, and that franchisor has no right to interfere with that strategy by implementing a cure of the pending default prior to the time required to cure such default under the lease. On the other hand, landlords almost uniformly do not like additional cure periods for franchisors (for obvious reasons), and franchisees are often at best indifferent on the topic and are not willing to (i) waive rights against franchisor for claims tied to interference with business operations due to franchisor's curing of defaults, or (ii) aggressively negotiate with landlord and landlord's legal counsel to secure the added notice and cure periods. Often franchisee's counsel reaches "lease fatigue" on this provision because they may have already had to negotiate for longer cure periods for their client and now they have to negotiate even further extended cure periods in order to have the franchisor approve the lease for execution.

D. Third Party Beneficiary Rights/Franchisor Liability

Third party beneficiary rights and franchisor liability go hand in hand. A leased franchise location is a valuable asset to a franchisor and as result, franchisor will want the ability to preserve and enforce its rights under the franchise agreement as they relate to the lease. The franchisor will not, however, want liability under the lease – either directly or vicariously -- unless it specifically accepts assignment thereof. As briefly discussed above, to accomplish this, franchisor will typically insist on having a collateral assignment of the lease included either as part of its standard lease rider or embedded in the terms of the lease. Accordingly, franchisor will also want a clause in the rider or the lease specifically designating it as a third party beneficiary of the lease by virtue of its holding the collateral assignment. The third party beneficiary designation is bolstered by the collateral assignment of the lease language and most franchisors will include these two provisions rather than being a party to the lease or the lease rider. One of the goals of having the third party beneficiary designation included in the rider is to allow franchisor to show standing to enforce its rights under the rider despite franchisor not being a party to the lease or the rider. Franchisee/tenants may seek to have this provision modified due to the fact that they are primarily liable under the lease and want to retain control over enforcement of the lease provisions and control over future business decisions such as walking away from the lease because of changing market conditions, poor sales, etc.; however, if franchisor continues to exercise its rights to cure defaults and enforce the provisions of the lease, tenant/franchisees are essentially unable to have such control. Where franchisor does exercise its enforcement rights, franchisee/tenants may argue that once franchisor does so via the designation of third party beneficiary, that tenant/franchisee is then relieved from its lease obligations to landlord. Franchisors will typically want to short-circuit this potential argument by including a statement that (a) franchisor has no liability under the lease until it formally accepts assignment of the lease in writing and (b) that tenant/franchisee shall remain liable to franchisor for reimbursement of any amounts paid by franchisor to cure lease defaults on behalf of tenant/franchisee. Franchisee/tenant counsel should be familiar with the broad body of case law showing that courts will generally enforce these types of lease rider provisions in favor of franchisors, particularly when the franchisor's enforcement rights are acknowledged by the landlord via execution of the rider, and will not waste time or run up their client's bill (not to mention squandering any goodwill it has with franchisor's counsel) by trying to heavily negotiate or limit this provision. In addition, landlords may seek to have the third party beneficiary

provision modified to list specific instances where the franchisor is a third party beneficiary. One such example is to state that the franchisor is a third party beneficiary for the sole and limited purpose of enforcing landlord's obligation to provide franchisor notice of any default and opportunity to cure such default and to accept franchisor's cure of such default as is already permitted in the lease.

E. Permitted Use

Of the provisions which are most customarily negotiated between franchisor, franchisee and their respective legal counsel, "permitted use" is typically the least contentious. While the tenant in any lease transaction will typically want the permitted use to be as broad as possible by having the phrase "and any other lawful use" inserted, as a franchisee, the strictest description of the permitted use is typically set forth directly in the franchise agreement and in order to obtain an exclusive use provision (discussed later), landlord will typically going to require that the permitted use be limited to the original franchise concept in order to ensure a particular tenant mix in a center. One trap for the landlord to avoid is to list the trade name as the use. Instead of saying that the premises will be used as a "Bob's Pizza Restaurant", the use provision should state that the use is for a pizza restaurant operating under the name "Bob's Pizza Restaurant." Typically, the only situation in which this becomes an issue between franchisor and franchisee is when the permitted use set forth in the LOI differs significantly from the permitted use set forth in the franchisor's lease rider, but even this is rare as most franchisors require approval of an LOI before the franchisee/tenant moves forward to lease and any discrepancy in the permitted use would typically be caught at this stage. Notwithstanding the foregoing, when the permitted use set forth in the LOI differs significantly from the permitted use set forth in the franchisor's lease rider, landlord may be reluctant to make the change because it was the wording of the LOI upon which the terms of the deal were agreed. This, however, is usually a losing battle for landlord as franchisor will rarely approve a permitted use provision that is materially different than the one set forth in their standard required terms and most sophisticated landlords have substantial experience dealing with franchised concepts and are aware of this. Another issue to consider when entering into a lease as a franchisee/tenant is that to the extent the "permitted use" under the lease is limited to the operation of a specific franchise concept, in the event that tenant/franchisee defaults under its franchise agreement, franchisee does not have the right to continue to operate in the leased premises as anything other than a franchised system unit and cannot, therefore, honor the permitted use as set forth in the lease. In such an instance, if franchisor does not exercise its right to take over operation of the store, franchisee/tenant is in a different kind of "pickle" being liable on a lease that it cannot operate under.

F. Continual Operations

A continual or continuous operations requires a tenant to continually remain open for business in the leased premises for the entire term of the lease while a "go dark" clause permits a tenant to cease operations in the leased premises, but does not excuse the tenant from continuing to pay rent. The benefit of a "go dark" provision, therefore, is primarily that it saves the tenant from having to pay operating costs (personnel, inventory, advertising, utilities, etc.) for a business operation which is otherwise failing. A continual or continuous operations clause is typically included in a franchisee's franchise agreement simply because in order to produce revenues upon which royalties are paid to franchisor, franchisee/tenant must be open for business. While larger, multi-unit franchisees in particular will want to negotiate a "go dark" provision in their leases, for small, single unit franchise operators, a "go dark" right seldom makes sense from a financial perspective simply because if such a franchisee cannot afford operating costs in the leased premises, it probably has even bigger problems and the right to cease operations, but to continue paying rent, likely will not solve those problems. As previously mentioned, even if franchisee/tenant is successful in negotiating the right for franchisee/tenant to "go dark", if the franchise agreement requires that franchisee/tenant continuously operate throughout the term of the franchise agreement (which is nearly always the case), then the fact that the lease allows for a "go dark" right is not overly relevant to franchisee. Indeed, in such an instance, if franchisee/tenant ceased operations, franchisee/tenant would be in default of its franchise agreement and arguably in default of its lease as well if the lease is properly cross-defaulted with the franchise agreement. Ironically, however, "go dark" provisions are not widely disputed or objected to by most franchisor's counsel (even if it is not permitted under the franchise agreement) primarily because franchisor will desire the right to "go dark" in the event franchisor ever assumes the franchisee's lease. In such an instance, franchisee/tenant's counsel should be familiar with their client's franchise agreement and, in the event it includes a continual or continuous operations clause, should at least advise their client about the potential of being in breach of their franchise agreement despite franchisor's lack of objection to franchisee's "right" to "go dark" under their lease. Similarly, franchisors should take steps to ensure that valuable rights set forth in the franchise agreement (i.e., the requirement for the franchisee/tenant to continuously operate) are not inadvertently waived via the franchisor's review and approval of the lease and any corresponding rider.

III. Meeting of the Minds: Issues Where the Franchisor and Franchisee Agree but the Landlord Does Not

While there are many provisions of the lease where the interests of franchisee and franchisor are different, there are also lease issues where franchisor's and franchisee's interests will align, but landlord's interests do not. In these instances, it is particularly helpful for tenant/franchisee's counsel to have the "franchisor club" to wield when trying to negotiate these provisions. In fact, for many franchisors, some of these provisions are "deal killers" and franchisors will not approve leases for signature by franchisee if landlord does not make at least minimal concessions in connection with such issues. While it happens rarely and should be reserved for completely intractable negotiations/issues, there are times when franchisee/tenant's counsel needs to request that franchisor's counsel negotiate certain provisions if the landlord's position is acceptable to franchisee, but not to franchisor (noting, however, that franchisors may be reluctant to take this step due to franchisor's desire to limit its direct involvement in the real estate/lease negotiation process as discussed earlier). Some of the most significant of these issues are set out below.

A. Radius Restrictions

Within the MDA, franchisees will generally negotiate for as large of a geographic radius as possible for the franchisee's operations, precluding franchisors and other franchisees from operating within that area. Not surprisingly, neither franchisors nor franchisees want landlords to dictate the expansion plans of a particular market. Accordingly, radius restrictions within leases are viewed universally by franchisees and franchisors as clauses to avoid, and indeed, many franchisor template LOIs specifically prohibit radius clauses within franchisee leases. The best case scenario, from the franchisee and franchisor perspective, would be to have all LOIs clearly state that no radius restrictions shall be contained in the lease. Landlords, on the other hand, desire to prevent cannibalization of sales, especially in circumstances where percentage rent is a component of the economic terms of the lease. For this reason, most typically in percentage rent scenarios, franchisors and franchisees are often forced to consent to a limited radius (agreed to by the franchisee but consented to by the franchisor) which limits operation by the specific franchisee of another location or locations within the stated geographic area. As another point of compromise, a landlord may agree to limit the radius restriction for a specified number of years. However, such radius restrictions typically exclude any stores that exist as of the date of the lease, any stores that violates the radius restriction due to a larger transaction (for example, the acquisition of a portfolio of locations), any stores opened by the franchisor (who does not want its brand growth dictated by any specific lease) or the acts of other franchisees (whom the franchisee/tenant has no right or ability to operationally control.) Landlords typically agree to such limitations on the parties governed by the radius restriction.

B. Relocation Prohibitions

In a best case scenario from the perspective of the franchisee and franchisor, the LOI will clearly state that landlord may not relocate the leased premises without the express consent of the tenant/franchisee and a representation from landlord that if tenant consents to a relocation, landlord will be responsible for all costs of relocating tenant and building out the new premises to reflect franchisor's then-current prototype (not simply to replicate tenant's then-existing premises improvements). Another option is for the parties to negotiate designated areas of a center that are acceptable for relocation, so that the franchisee and franchisor can be assured of similar visibility within the center even if the store is relocated. Franchisors and franchisees alike have a unique "value" placed upon a particular location, and even the threat of relocating a specific premises can significantly and negatively impact the value of the business operated in such location. This is especially critical to keep in mind in light of the fact that many franchisees' plan to sell their operating franchises to a third party. While landlords often justify relocation clauses by stating that flexibility must be maintained by landlord in order to accommodate future, larger tenants, ultimately landlords understand the complexities (and multiple interested parties) involved with relocating a franchised concept.

C. Assignments to Franchisor and Subsequent Franchisees without Landlord Consent

Franchisee/tenant and franchisor will want the right to freely assign the lease (and/or sublet the leased premises) to either franchisor or other franchisees without having to seek landlord's prior consent or pay a review or administrative fee. Landlords typically agree to a unilateral assignment right in favor of franchisor as franchisor is seen as a deeper pocket and more experienced operator than franchisee, but, unless certain financial and operational parameters are detailed in the lease, landlords will often object to an assignment or sublease to

another franchisee without landlord's prior consent to and approval of the new franchisee. Landlords have typically seen the financial statements of the leasing franchisee, but a future franchisee is an unknown commodity as far as landlord is concerned. Consequently, many landlords will seek to place qualifications and limitations upon pre-approved assignments to subsequent franchisees. Franchisor and franchisee will both want the minimum requirement to be something along the lines of "to a qualified franchisee of franchisor" or "to a franchisee which has executed franchisor's standard franchise agreement", but most landlords will want to insert a specific net worth and operating experience requirements for the future franchisee, as well, along with a requirement that the tenant/franchisee is not released from liability under the lease. While a landlord may be comfortable with franchisor's current standards, the franchisor could lower those standards in the future, so a prudent landlord will not want to rely on the franchisor's standards alone. Operating experience requirements may be in the form of past experience operating similar concepts, or require that the future franchisee already operate a set number of other existing franchise locations. Net worth requirements commonly state that the future franchisee must have a tangible net worth equal to or greater than the original franchisee/tenant. However, in the case of a particularly well-financed franchisee/tenant, franchisor may prefer to set a stipulated minimum net worth requirement rather than attempt to find a future franchisee having similar net worth.

D. Alterations and Remodeling Rights

The franchisee/tenant may be obligated under the franchise agreement to remodel the leased premises periodically or at such times as a new prototype is introduced by franchisor. However, landlord's standard lease form likely prevents franchisee/tenant from making alterations to the leased premises without first obtaining landlord's consent, which leaves the franchisee/tenant unable to satisfy its obligations under both the franchise agreement and the lease. Typically, landlords will agree to a franchisee/tenant right to make interior, non-structural alterations to the leased premises without landlord's prior consent, so long as these alterations are capped at a specified not-to-exceed amount. Additionally, a landlord may push to limit the frequency of remodels, for example, not more than once every five years, to prevent frequent closures that may disrupt the operations of the overall center. Finally, a landlord may seek to limit remodels only to then-current prototypes that are in use at a majority or even higher percentage of franchised stores (either nationally or in a specified region) to ensure that the franchise location at landlord's center is consistent and easily recognizable to consumers. While such limitations requested by landlord are customary, the franchisee/tenant and franchisor should seek to ensure that the most current "look and feel" of the franchised operations (including specifically exterior signage and décor) can be incorporated into the specific leased location from time to time, on an as needed basis, as brand consistency is critical for all franchised brands.

E. SNDA requirements

As stated above, it is a relatively common franchisor leasing standard that a subordination, non-disturbance and attornment agreement (an "SNDA") be afforded franchisee/tenant. This requirement, however, can be inconsistent with landlord's lenders' minimum square footage standards for issuance of SNDAs. Franchise locations having 2,500 rentable square feet or less typically struggle to secure SNDAs from institutional lenders. Occasionally, institutional lenders will agree to issue a small-shop tenant an SNDA for an additional cost to franchisee/tenant, or franchisee/tenant may be able to get the lender to agree to issue an SNDA if franchisee/tenant agrees to accept lender's standard form without modification. Some franchisors and franchisees will accept a representation that landlord will use "commercially reasonable efforts" to obtain an SNDA for franchisee/tenant, but other franchisors/franchisees make the delivery of an SNDA a condition precedent to the execution of the lease by franchisee/tenant. Even franchisors and franchisees that do not require an SNDA typically require a representation that while failure by landlord to obtain an SNDA will not be deemed a default under the lease, landlord must covenant and agree that any subordination of the lease shall only be effective if landlord's lender/mortgagee agrees not to disturb tenant/franchisee's leasehold interest in the leased premises so long as tenant/franchisee is operating in compliance with the terms of the lease. It should be noted, however, that such a covenant from the landlord is substantively useless in a foreclosure setting, as the occurrence of the foreclosure generally eliminates all lease clauses as a matter of law, including covenants such as the one mentioned above (which is in no way binding upon a lender not party to the lease). The parties may be able to compromise by saying that landlord will use commercially reasonable efforts to obtain an SNDA from an existing lender, but will agree to make it a condition of any future transfer of the center that a transferee provide an SNDA as a condition of transfer. Again, this is a provision where it is helpful to franchisee's counsel to have the "franchisor club" to wield.

F. Condition of Premises Upon Vacation/Termination

Both franchisee and franchisor want the option to either remove or leave behind tenant improvements at the end of the term, rather than any specific obligation to remove or leave certain tenant improvements. Ideally, the franchisee will only be required to surrender the premises "in broom clean condition, ordinary wear and tear excepted." There are a number of reasons for this, both financial in nature as well as accounting-based. Landlord, on the other hand, typically wants tenant/franchisee to restore the premises to "the condition in which it was delivered" giving the landlord a "clean slate" with which to start for a subsequent tenant. However, in instances where landlord delivered a cold dark shell or a vanilla box to tenant, requiring the tenant/franchisee to restore the premises to its "delivery condition" would be prohibitively expensive. This is true in even non-franchise leases and as such is rarely an issue. While most tenant/franchisees will want to remove their personal property at the end of the lease term, very few franchisees have any interest in expending the funds necessary to remove millwork, flooring, etc. While franchisors do have an interest in having the right to de-identify the premises following vacation by tenant in order to maintain the integrity of the brand, franchisors typically will not agree to a requirement to remove any improvements from the premises following surrender of the premises. If a franchisor is given the right to de-identify the leased premises, a prudent landlord will want to include an obligation to repair any damage caused by the de-identification, or at least the right to recover landlord's costs to repair any such damage. Franchisors will, however, insist that landlord have no right to sell or retain any personal property of tenant bearing any of franchisor's trade names, trademarks, service marks, designs, logos, corporate names or any other service or business identifier, signs or identifiable decorative items or other movable trade fixtures installed in or on the premises by franchisee/tenant. If tenant/franchisee or franchisor fails to retrieve any such items at the end of the lease term, franchisors will typically permit landlord to destroy such items, but will not grant the right to sell any such items. If landlord does have to remove and destroy any of these items, landlord will want to be reimbursed by either tenant/franchisee or franchisor for the costs and expenses of removing and destroying such items. Again, having a common interest with franchisor in having the right, but not the obligation, to remove tenant improvements, works to the advantage of tenant/franchisee's counsel in negotiating this provision.

G. Survival of Options to Extend the Term

Landlords typically want to make options to renew or extend the term of the lease personal to franchisee/tenant (and to any assignee or subtenant permitted without consent – such as transfers to related entities and other franchisees) and not to a successor in interest, based on the rationale that landlord is comfortable having this particular franchisee/tenant as an operator in its center, but may not want to have such a long term relationship with a future franchisee. Franchisee/tenants and franchisor are aligned in the view that options to renew or extend the term of the lease act as locational goodwill and a desirable attribute when marketing the premises to a potential successor franchisee, subtenant or assignee. Both franchisee/tenant and franchisor have a vested interest in seeing franchisee/tenant prosper in a franchised location, however, franchisor also has an additional interest in retaining control of what it considers to be desirable real estate even if a particular franchisee is not successful in a particular location. For this reason, franchisor will want the right to assign the premises to a subsequent franchisee even if the current franchisee/tenant fails in the location, as franchisor will want to locate a new franchisee that may be a more experienced and better operator for the site. Even landlords that want to restrict survival of options to renew or extend the term of the lease will typically agree to extend said options to any "permitted transferee" with that term being defined as any subtenant or assignee to whom landlord's prior consent is not required, or that meets specified operational and net worth requirements, as discussed above.

H. Exclusive Use and Remedies for Violation

Of all the provisions where franchisee/tenant's interest and franchisor's interest align in opposition to landlord's interests, the exclusive use provision is perhaps the most important and the most difficult to negotiate unless it has been outlined in detail in the LOI. There are two types of exclusivity clauses: an exclusive right to conduct a certain type of business (i.e. a pizza restaurant) and an exclusive right to sell specific products (i.e. the exclusive right to sell pizza). While landlords have a strong interest in preserving a diverse mix of tenants in a center (so they typically have no interest in leasing to three different pizza restaurants in the same center), landlords have an even stronger interest in not having any empty storefronts in a development, so landlords desire the broadest rights to lease to a variety of tenants. In contrast, franchisee/tenants and franchisors do not want their potential sales poached by virtue of landlord leasing another space in a center to a competing use. Typically, except in circumstances where landlords blanketly refuse to grant exclusive use rights to any tenant in a particular center, landlords will agree to grant a franchisee/tenant an exclusive use for a particular primary product

or products although a minimum threshold is often outlined when describing what a "competing use" is, so that landlords are not completely restricted in their leasing. For example, a landlord would agree to "not more than X% of its gross sales/sales floor area shall be attributed to the sale of pizza", etc., noting that "X" percent is typically somewhere between 10 and 50%, depending on the product and the negotiating leverage of the franchisee/tenant, rather than "no sales of pizza", as this allows landlord far more flexibility in future leasing. Depending on the particular use of the leased premises, the franchisee/tenant may prefer to base the exclusive use on menu items or name specific competing users that are prohibited instead of basing the exclusive use on a percentage of gross sales or a percentage of sales floor area. Landlords will seek to preclude liability for a breach of a franchisee/tenant's exclusive use provision if the breach is due to a "rogue tenant" (a tenant whose lease is properly drafted to preclude a violation of the exclusive use, yet the tenant has chosen to violate its lease and violate the franchisee/tenant's exclusive, anyway). Thus, there is often a distinction between remedies for a breach of the exclusive use provision by landlord's actions and a breach by virtue of a rogue tenant. In either instance, many landlords prefer not to outline a specific remedy in the lease so that tenant/franchisee is left to pursue its remedies at law and equity in an attempt to address the breach. This is ironic since except in the instance of a rogue tenant, compliance with or violation of an exclusive use provision is entirely within landlord's control. Unlike landlord, tenant/franchisees and franchisors prefer to have the remedy for a violation spelled out in the lease. The preferred remedy by franchisee/tenant and franchisor is a reduction in rent for the duration of the breach (such as "tenant will be permitted to pay 50% of the minimum rent that would otherwise be due but for the breach for the duration of the violation"). Variations and limitations on this are reduced rent for the duration of the breach or a specified period of time, typically one year, whichever is less, or X% of gross sales in lieu of minimum rent that would otherwise be due. Basing the remedy on a percentage of gross sales is more of a burden for tenant to administer because it involves submitting statements of gross sales to landlord. Regardless of a specific remedy being spelled out in the lease, both franchisor and franchisee/tenant will want that remedy to be in addition to any other remedies that tenant may have "at law or in equity" up to, and including, termination of the lease. However, with increasing frequency, franchisee/tenants and franchisors are objecting to any "call" rights in favor of landlord on the exclusive remedy, where landlords require that after "x" months of reduced rent payments, the franchisee/tenant must elect to either (i) resume full payment of rental, or (ii) terminate the lease. Similarly, franchisee/tenants and franchisors object to provisions whereby if a franchisee/tenant is paying reduced rent and elects to exercise an option to extend the term of the lease, the franchisee/tenant must revert to the payment of full rent. Such "call" rights allow landlords to effectively monetize a violation of the stated exclusive and make a business decision as to whether such exclusive can be afforded to be violated in a particular circumstance. Landlords, however, cannot afford tenants a perpetual rent reduction for a violation of an exclusive use which, more often than not, was not intentionally created by landlord but instead created by clerical error or lack of foresight by landlord's leasing representatives. Further, landlord's financing documentation generally prevents or severely limits the ability of landlord to grant ongoing rent reduction/abatement under such circumstances.

I. Prohibited Uses

While less commonly requested than exclusive use provisions, certain tenant/franchisees and franchisors may request that a list of prohibited uses be included in leases. The rationale for including prohibited uses is typically one of two things: the prohibited use is considered a noxious or incompatible use, or the prohibited use is a heavy user of parking. Depending on a tenant/franchisee's use, there may be a very compelling argument for including certain prohibited uses. For example, a religious bookstore would have a very good argument for prohibiting bars, tattoo parlors, or similar uses as they may be objectionable to the religious bookstore's target customer. A restaurant franchisee that relies heavily on take-out orders may want to restrict movie theaters or bowling alleys based on the fact that customers of those establishments will take up parking spaces for hours, interfering with the ability of the restaurant's potential customers to easily access the leased space. As opposed to an exclusive use, landlords are generally more amenable to including a list of certain prohibited uses in a lease; however, more frequently landlords are negotiating the list of prohibited uses to be drafted even more narrowly to allow for flexibility in future leasing.

J. Logo's, Trademarks, and Trade Dress

Franchisors and franchisee/tenants are rightly concerned about the logos, colors, trademarks, and trade dress – the look and feel of the brand - and the right to ensure that the franchisee/tenant has the right without consent to use these marks. In addition, a franchisor will want to ensure that the lease has language prohibiting the landlord from using or coopting its trademarks, logos, and the like. Generally, the landlord is agreeable to such provisions (while still reserving the right to approve site-specific signage as to dimensions, methods of

attachment, etc., and reject any logo, mark, or signage that violates a specific prohibition or that is not in good taste) because one of the reasons that a landlord wants to lease to that specific franchise is because of the brand recognition it brings to the center.

The bottom line is this: while the three parties in a franchise lease transaction often have competing interests, they are all incentivized to get the deal done. So as long as counsel for franchisee and franchisor can set their egos aside and work together to accomplish the best result for their respective clients, they can typically work together when negotiating a lease with landlord in order to arrive at a lease with which all three parties can live.