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**Structuring the Development of the Franchise Units:
General Real Estate Issues**

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STRUCTURING THE DEVELOPMENT OF THE FRANCHISE UNITS GENERAL REAL ESTATE ISSUES

This seminar will address a variety of real estate related issues that will arise in the context of a franchise relationship. The areas to be discussed will include both business related and legal issues. These real estate issues are typically of a concern to both the franchisor and the franchisee.

A. CHOOSING A SUITABLE FRANCHISE LOCATION.

Choosing the location for the franchised unit is a decision that will have a dramatic impact on the potential success or failure of the franchised business. While the franchised name, logo and the products or services to be sold are crucial to the franchisee's success, their importance will be minimized if customers cannot find, or are unwilling to travel to, the franchised location. It is therefore, as true today as it ever was, that the three most important factors in selecting where your franchised business should be are "location," "location" and "location."

All too frequently, franchisees will base their decision as to what to rent on factors such as travel convenience, price and availability. While these should play a part in the decision making process, a franchisee must apply other criteria in deciding where his retail outlet is to be located. For example, the nature of the franchised business will play an important part in the choice of a location.

A fast food restaurant may call for a free standing location. It may be appropriate for a tax preparation service to be located in an office building. Shopping malls packed with pedestrians are ideal for stores stocking "impulse items" as well as for large retail outlets that require customers to make a pre-determined decision to drive to a particular location. A children's learning center needs to be located in an area where the demographics provide a certain minimum number of young families who are likely to have school aged children.

No decision regarding the location of your franchised business can be made without doing significant market research. In many instances, the franchisor will assist (or even take the lead) in carrying out this market research. Both the franchisor and the franchisee need to be aware of whom their customer is and the location to be chosen must fit the typical customer profile.

In some systems, the franchisor will find the location, negotiate the lease and then find a franchisee to own and operate its franchised business from that location. In other systems, the franchisor will enter into its agreement with a franchisee and then will leave the choice of finding the location to the franchisee. In either case, unless the location meets the needs of the franchise, the franchisee is starting off in business with two strikes against him.

1) **How Do You Determine Whether Or Not Your Location Is Suitable For Your Business?**
Many factors need to be evaluated before a real estate location can be chosen.

You will need to determine whether the nature of your product, e.g. is it an impulse item or not, requires that your site be visible to passing traffic, whether it be vehicular or pedestrian. Traffic patterns need to be analyzed and taken into account. Being on one side of a divided highway or proximate to a difficult intersection might be an impediment to getting access to your location. Is the neighborhood developing or regressing? Do you have adequate parking? Will your customers be parking on the street and need to walk to your location or will they be in an adjacent parking lot. Will parking spaces be reserved for you or not? Are you near public transportation? Is it necessary for your customers? Will your business face competition from other businesses located in the immediate vicinity? This may mean that your location is attractive but it may mean that your customers may be divided between you and the competition. How much space will you need? More space means higher cost. The franchisor may recommend more space since more space may lead to higher sales and higher royalties. Unfortunately it also leads to higher fixed rent. Does the term of your lease match that of your franchise agreement? How are the renewals structured? A shorter term lease with several renewal options may be preferable to a longer term commitment.

Consider the criteria described below as you compare and evaluate potential locations.

Accessibility and traffic patterns. Is it easy to exit and enter into traffic? Are there divided highways, difficult intersections, major road construction, or other impediments? What time of day is traffic heavy? Where is traffic going? Are people shopping or merely commuting to neighborhoods where they can purchase your product or service from a more convenient store? If the location is in a newer neighborhood, what kind of developments and traffic changes are planned for the future? In an evolving area, today's choice corner may be tomorrow's forgotten cul-de-sac.

Visibility. Is visibility important to the success of your business? If you've done your market research, you know the answer to that question. If your product is an impulse item, then you need to be where customers can see you and say, "Oh, I need one of those." But if your customer will come to you in the course of doing errands, you may need to give less weight to visibility and more weight to how well your business complements others in the vicinity. Visibility comes at a premium. Don't buy it if you don't need it.

Hours of operation. Do the hours of your location match the needs of your customers? You may not want to be the only store open at 8:30 PM in an area that is shuttered by 6:00 PM unless you have a good reason. A dance studio, for example, might want the daytime visibility of an early-to-close area but the convenience of a parking lot that is uncrowded during its evening classes. Again, this is where knowledge of your customers and how they shop can really pay off.

Parking layout. Determine how much parking you need, and select a location that offers it.

Public transportation. In urban settings, access to public transportation can be more important than access to parking. Such access is less important in suburban settings where virtually everyone owns a car.

Neighborhood development. Is the neighborhood stable or declining? Talk to local authorities, business groups, and others in the know to determine the economic trend.

Competing outlets. Are competing businesses located in the immediate vicinity? If so, the good news is that your location is attractive; the bad news is that you'll have competition. If you are not far from another outlet in your own system, you may benefit from group advertising and immediate name recognition.

Size. Do you require space for selling, storage, or maintenance of equipment? The larger your space, the higher your rent, electricity, insurance, and maintenance. The franchisor may recommend or require certain square footage. Don't rent more than you need!

Lease terms. Look for a lease whose term matches your franchise contract but can be renewed in shorter increments. Too long a term and you may find your-self paying rent for a business that no longer exists. Can you get a 2-year lease with three 3-year options to renew, creating in effect an 11-year lease? Or, a lease with yearly renewal options? With a professional, carefully examine the options before signing a lease. See Section D herein for an in-depth discussion of how to understand and negotiate a commercial real estate lease.

2) **Who's Credit Is On The Line?** Some franchisors will require their franchisees to negotiate their leases directly with the landlord. Other franchisors may choose the retail locations for their systems themselves, negotiate the lease with the landlord directly, and then sublet or assign the lease to the franchisee. Even if the franchisee becomes directly obligated on the lease, the franchisor may have to provide a guaranty to the landlord. Unless the franchisor is either on the lease or has provided a guaranty, the franchisee's credit will have to stand on its own with respect to the landlord. If the franchisor is the lessee and either sublets or assigns the lease to the franchisee, the landlord's credit may be instrumental in helping to secure the location for the franchisee. If the franchisor is the prime tenant, it is important for the subtenant to require that it receive notice of any default by the franchisor and that the franchisee have an opportunity to cure. In circumstances where the franchisee is paying rent directly to the landlord notwithstanding the fact that the Franchisor is the prime tenant, the franchisor will similarly require that it receive notice of any defaults and an opportunity to cure.

3) **The Lease As Security For The Franchisee's Default.** Frequently the franchisor will take back an assignment of the lease from the franchisee as security for the franchisee's default, either under the lease or under the franchise agreement. This arrangement will require the consent of the landlord. The franchisor may require that the landlord insert a provision in the lease which approves the franchisor as an assignee of the franchisee tenant. This arrangement can be utilized in the event that the franchisee defaults, either under the lease or under the franchise agreement. The franchisor would then effectuate the assignment so that it could continue to operate the retail location. The assignment provision may also give the franchisor the right to assign, sublet by the franchisee or otherwise transfer the lease to a third-party franchisee in the event of a default by the franchisee and a subsequent transfer of the location. Similarly, the franchisee should require such a provision in its lease so that, in the event that there is a sale of the franchised business, the lease can be assigned to the buyer without being "held up" by the landlord.

4) **The Build Out.** Many landlords will provide the construction of the franchised location while others will require that the tenant (whether it be the franchisee or the franchisor) undertake the construction directly. Some franchisors will require that they do the construction of the subject premises while others will insist that the franchisee be responsible. In any case, the Tenant will pay the cost. The responsibilities of the parties with respect to the construction of the subject premises are set forth in the **work letter**. Sometimes tenants do not pay close enough attention to the provisions in the work letter or do not arrange to have their plans and specifications for the work to be done at the subject premises approved by the landlord prior to or simultaneously with the execution of the lease. Tenants may be in for a rude awakening when they find that, after the lease has been signed, the landlord is unwilling to approve the configuration of the air conditioning ducts unless the tenant absorbs the cost. The work letter should also call for specific time frames within which the work is to be completed. If the landlord is doing the work, a penalty should be provided if the work is not done within the appropriate time. Similarly, the landlord may require a tenant who is constructing his own premises to be responsible for the payment of rent by a certain date irrespective of whether or not the work has been completed. Most tenants will require the services of an architect and a responsible contractor so that the specifications to be included in the work letter can be properly negotiated with the landlord.

If the landlord is doing some or all of the construction at your location, you will need to negotiate a work letter that sets forth in detail what the landlord's and tenant's responsibilities are with respect to the construction. If the landlord is to construct or demolish walls, install new electrical outlets, run water line to the premises, or provide a new air-conditioning unit, the work letter will set out the specifications. Because the work letter is really a part of the lease, the lease should not be signed until the work letter is fully agreed upon and incorporated into the lease by reference. The work letter should also include a clause penalizing the landlord if it does not complete its work in a timely manner.

Before you negotiate a work letter, retain an architect or a reliable contractor to advise you on the proper specifications for your premises. The landlord may suggest that you use its architect or contractor, who is familiar with the premises. Nice try, but use your own. You want someone on *your* side. In many instances, it is appropriate for your architect to prepare plans for the construction for your landlord's approval before the lease is signed. Once the lease is signed, many a tenant has found a previously friendly and cooperative landlord to be somewhat intransigent when construction arrangements are discussed. Rule number one is "get it in writing" before you sign the lease.

The landlord may require that the tenant's contractor agree to waive the right to place mechanics liens on the premises. You may want to your architect to approve payment requisitions before they are released so as to insure that the contractor's work has been properly completed. As a tenant you will undoubtedly want to hold back at least 10% of the payment to the contractor until the job is fully completed and has been approved by your architect and by the landlord as well.

Your lease should provide as to who is responsible for obtaining permits and other local licenses regarding the premises. It should be clear that the building certificate of occupancy and local

zoning permit the anticipated use. Signage should be approved in advance with plans and specifications signed off by the landlord prior to or simultaneously with the execution of the lease. The franchisor's signage requirements must be utilized in this regard.

Typically, a drawing of the signage, including specifications that apply to it, should be reviewed by the landlord as part of the lease finalization process. To get approval in writing, have the landlord initial a copy of the plans.

Some signs and some building modifications may need special permission from government authorities. In a number of municipalities, for example, an exterior (walk-up) window requires a variance or is not permitted at all. Therefore, your lease should provide that it does not become effective until you receive the required permits, approvals or variances, or allows you to terminate the lease if such permits, approvals or variances are not obtained by an outside date.

A good location is crucial to the success of your franchised business. If you proceed carefully and work tirelessly until that location is found, your chances of success will be greatly enhanced.

B. EXCLUSIVE MARKETING AREAS.

In most instances, franchisees will seek to maximize the geographic area within which they can maintain the exclusivity to sell, market or provide the goods or services which are to be available pursuant to the franchise agreement.

Perhaps the franchisee's greatest real estate concern, once it has established a successful location, is that the franchisor will open a unit (either company owned or franchised) within the franchisee's "marketing area" or "ADI" (area of dominant influence) and siphon off part of the franchisee's business. In order to protect itself against this "encroachment," franchisees will seek to negotiate an "exclusive" or "protected" marketing area within which the franchisor will not be permitted to open a competing unit. Most franchisors have an internal "impact policy" which they utilize in making decisions as to whether locations are suitable for their systems. Ideally, that same impact policy should determine the exclusive area which would protect the franchisee. This impact policy can be implemented by utilizing a variety of factors, which might include; a strict linear distance from the unit (for example a 3 mile radius); a "marked map" approach whereby a particular protected area is drawn on a map (or described) to take into account the specific "jigs and jags" surrounding a location; or a demographic approach which might include a certain number of members of the general population, families, population over a particular income level, families of child bearing age, etc. Problems may arise as the franchised location "matures" and the surrounding market area changes. The franchisor will want to protect itself against the possibility that the population within the protected area might expand and be suitable for more than one unit. Franchise agreements frequently provide that, upon renewal, the market area can be reconfigured to accommodate this possibility. This issue should be carefully addressed so that franchisees don't find that, upon renewal, they are left with a diminished marketing area which will do fifty (50%) percent of the business that their old protected marketing area was doing. Franchise agreements might provide for the carrying out of impact studies upon renewal so that, if a reconfigured marketing area

were to have an impact above a certain percentage on the franchisee's business, on either a predicted or an actual basis, the franchisor would be prohibited from reducing the area beyond that point or, in some cases, the franchisee might be compensated for its lost business. While the details of this fascinating topic are beyond the purview of this presentation, it provides practitioners with some of the most challenging areas for negotiation between franchisors and franchisees.

The franchisee's desire to maintain the widest exclusive marketing area that it can negotiate is based on franchisee's beliefs that the more available customers that there are within an area, the more business that franchisees will be able to generate and the more money that they will make as a result of their franchise activities.

The franchisor on the other hand is concerned that the general area within which his franchised products or services can be sold will not be maximized. The franchisor does not want one store in an area that should or that could support two or three stores. Since the franchisor makes its money (at least in part) as a result of royalties that are based on the total volume of sales from its franchised locations, its primary goal is to maximize the total sales from franchised locations within its system. While the Franchisor has an inherent interest in seeing that the franchisees' businesses are successful, it is reasonable to assume that the pure profitability of a franchised location is more important to the franchisee than it is to the franchisor. This subject then is an area where the franchisor and franchisee Association will have an opportunity to negotiate and the ability of franchisees to maintain exclusivity within an adequate marketing area may be crucial to the success of their franchises. The more people that the franchisee has to sell to, the more business he is likely to do, whereas the franchisor might feel that two or three franchisees can better market and expand a particular area than can a single franchisee.

Both franchisor and franchisee should contemplate the possibility of changes in the demographics with respect to the franchisee's marketing area. What might have been an area which could support one (1) location at the time the franchise agreement was entered into, may well be able to support four (4) locations fifteen or twenty years later. Of course, the reverse could also be true. It may not be unreasonable to provide that new demographic information can be utilized in reshaping a marketing area after a certain period of time in the event of a renewal of the franchise agreement. Both negotiation and, possibly mediation and/or arbitration might be appropriate methods of resolving these issues.

Where the franchisee has been a "pioneer" in that he has developed an area where there were no other company owned or franchised units, with the concomitant risks attendant thereto, he might feel that he is entitled to continue to develop that area even after population growth "catches up" with him as his franchise agreement is renewed. Is it reasonable for the franchisee to continue to maintain exclusivity in an area where additional locations can be developed merely because he had opened the area up for development some years earlier? This is a subject for negotiation between the franchisor and the franchisee. Perhaps the subject can be addressed by providing the franchisee with rights of first refusal as to new, proposed locations during renewal periods; or perhaps the franchisee will agree to open additional units during subsequent renewal

periods if the demographics of the area warrant it. It is regarding matters such as this that imagination and ingenuity may play a part in the negotiations between franchisor and franchisee since the provisions governing these issues are not as "cut and dried" as other provisions of the franchise agreement may be.

C. MULTI-UNIT DEVELOPMENT DEALS.

Franchisees sometimes negotiate deals with their franchisors which gives them the right to open a number of franchised locations over a period of time. It is important that the time frame within which the locations must be opened is realistic and that it provides the franchisee with sufficient time within which to find locations, negotiate leases, construct the new premises, get financing in place and open the premises for business. The franchisor on the other hand will require that the franchisee meet a relatively stringent schedule since, if the locations are not opened within the anticipated schedule, the franchisor will not be able to generate royalty income because there will be no sales on which to base it.

The franchisee may wish to negotiate that its obligations with respect to the timing applicable to new units will be met by either entering into good faith negotiations with a landlord for a particular location, identifying such a location or having a lease drawn and delivered to the franchisee. Sometimes a particular location is delayed because the tenant is unable to obtain zoning approval or a variance within the projected time frame. The franchisee tenant will not want to lose its development rights because it has not met this schedule.

When the franchisee has not met its development schedule the franchisor will want to reopen the development area to third-parties. This may require that "exclusive marketing areas" be made attributable to the locations which have already been opened by the franchisee. These areas should be negotiated in advance. In this way, while the franchisee may lose the entire marketing area set out under the development deal between the franchisor and franchisee, the franchisee will still retain the protection for its individual units that have already been opened (or which are under lease). This will raise other issues, for example whether or not the franchisor will be entitled to retain the development fees paid by the franchisee or whether some part of those fees will be returned.

As a result of the above consideration, many multi-unit development deals are burdened with an over optimistic development schedule that the franchisee/developer is hard pressed to meet. Locations are not easy to find and franchisees frequently are enmeshed in the process of finding new locations and negotiating multiple leases while they are simultaneously engaged in the construction of another unit. These factors can put a strain on the franchisee's time and emotional resources, to say nothing of his budget. It is therefore essential that the development schedule be realistic.

It is likely that the franchisee will have to enter into a new franchise agreement for each location. It is imperative that a separate entity (corporation, LLC, etc.) be utilized for each location so as to avoid putting a good location(s) at risk if a poor location fails and goes out of business. The franchisor may require a "cross default" clause that provides that if the franchisee defaults at one

location, it is deemed to be a default at his other locations, as well. An argument can be made that each location should stand on its own and that one failing location should not jeopardize a number of successful ones. On the other hand, one can reasonably argue that a franchisee who is not paying his royalties at one location (by “skimming,” underreporting, cheating, etc.) should be deemed to be in default under all of his franchise agreements.

Attention also must be paid to leases and franchise agreements that terminate at different times and how, amongst other things, this may impact on restrictive covenants and non-compete clauses. Multi-unit owners who wish to exit a franchise system may not want to have the franchise agreements for some units expiring while they are required to continue to operate others.

D. LEASE NEGOTIATIONS – SPECIAL CONSIDERATIONS

Every lease will have a variety of provisions which constitute “traps for the unwary.” The existence of the franchisor/franchisee relationship may create additional issues with respect to the lease for the franchised location.

1. **Abandonment.** The franchisee will want to have the right to continue to pay the rent without there being a default even if the leased location is closed. This will give the franchisee tenant an opportunity to sublet the premises or even sell the franchised business notwithstanding the fact that it has “gone dark.” The franchisor will want the premises to stay open under almost every circumstance since it is only by virtue of the sale of merchandise or services at the franchised location which generate the revenues on which the franchisor’s royalties are based. A key provision in every franchise agreement is the ability for the tenant to close its business if it is losing money.

2. **Acceleration of Rent.** Many leases will provide that, in the event of tenant’s default, the remaining rent due under the lease will be accelerated. Tenant should seek to limit its liability to the present value of the present rent (discounted at a percentage rate) or the difference between the total rent that may become due and the projected rental value of the premises. The landlord’s obligation to mitigate its damages by using its best efforts to relet the premises at a comparable rent should also be addressed in the lease.

3. **Improvements And Alterations.** The tenant should seek to reserve the right to make non-structural alterations or improvements to the premises provided that it obtains the landlord’s approval which should not be unreasonably withheld or delayed.

4. **Subletting And Assignment.** The franchisor will not want the franchisee to sublet the premises or assign its lease other than in conjunction with the sale of the franchised business. This of course, will require the approval of the franchisor in accordance with the terms of the franchise agreement. The franchisor may take back an assignment of the lease as security against the franchisee’s default. The time within which the landlord and/or the franchisor must approve any assignment or subletting must be short enough so as not to be an impediment against the ability of the franchisee assigning or subletting to a third person, perhaps in conjunction with the sale of the

franchised location. The landlord or the franchisor, or each of them, may provide that a transfer of an ownership interest in the franchisee greater than, for example, 49%, may be deemed to be a purported assignment or transfer of the lease and thus restricted. The franchisee should seek to obtain the right to make such transfers to existing partners or shareholders of the owning entity or to family members so long as they reasonably qualify to meet the franchisor's requirements for franchisees, generally, or if the franchisee has an on premises manager who has met the franchisor's reasonable requirements. The franchisee may seek to be released from obligations upon the assignment. Both the franchisor and the landlord, or either of them, may resist the franchisee's requests in this regard. If the assignee has financial responsibility comparable to that of the assignor, it is not unreasonable to expect that this request should be granted. Sometimes an otherwise permitted assignment is stymied by the fact that the "use" clause in the lease is limited to the franchised business. The use clause should be expanded to include any reasonable use not in conflict with either the character of the building or shopping center of which the demised premises forms a part or in conflict with any restrictions and other leases in said building or shopping center.

5. **Audit By Landlord Or Franchisor.** Subleases which provide for percentage rentals give the landlord the right to audit the tenant's books and records. Similarly, franchisors who are dependant on the sales of the franchisee for the determination of the amount of royalties to be paid to the franchisor will also require such rights to audit. The costs of either audit should only be borne by the franchisee tenant in the event that any deficiency, on an annualized basis (as opposed to with respect to a particular report or period) exceeds a certain percentage of the franchisee's annual sales. Three (3%) percent is not an unreasonable percentage in this regard. It should also be agreed that this information remains confidential except in connection with financing, the sale of the landlord's shopping center or buildings, tax proceedings etc.

6. **Commencement Date.** If the landlord fails to deliver the premises by the date and in the manner called for in the lease, the tenant should have the right to terminate the lease or, should the tenant not wish to terminate the lease, to receive a credit for rent. Sometimes tenants need to open their premises for business notwithstanding the fact that an anchor tenant at the shopping center has not yet opened. A rent reduction or credit can be negotiated under these circumstances. Notwithstanding the above, there are times when the tenant is not willing to open unless an anchor tenant or a particular number or percentage of satellite tenants have opened, and this should be provided for in the lease, as well.

7. **Contingencies.** If your lease is contingent on your entering into the franchise agreement with the franchisor or obtaining financing for the construction of the franchised location, these contingencies should be clearly stated in the lease and you should have a right to cancel if they are not timely achieved. Sometimes a zoning variance is required. This should also be spelled out in the lease together with the time within which the variance is to be obtained. Whether the landlord or the tenant is responsible for obtaining the zoning variance must be agreed upon.

8. **Cost of Living Adjustment.** Many leases include provisions which call for the increase of rent based on the increase in the Consumer Price Index (CPI) promulgated by the US Department of

Labor. While the tenant may seek to place a “cap” on these increases the landlord will similarly wish to place a “floor” beneath the CPI base so as to insure that the rent will not decrease.

9. **Damage As A Result Of Fire, Casualty Or Disaster.** The tenant will want to protect itself in the event that a percentage of either the demised premises or the building in which the demised premises are located is damaged or destroyed as a result of fire or other cause. The landlord also may seek to terminate the lease but does not always provide in its lease that the tenant will have the same right to do so. This should be negotiated. The tenant should require the landlord to repair the premises and/or the building and time within which the repairs should be completed. If not completed by the appropriate date the tenant should have the right to terminate the lease but should not be obligated to do so. In any event, there should be a rental abatement while the work is being completed. The landlord may seek to have the unilateral right to relocate the tenant within the building or shopping center but this should not be agreed to, if at all, without strict parameters regarding space, visibility etc. The lease should provide that the landlord and its lender should utilize insurance proceeds towards the reconstruction of the demised premises and the building of which it forms a part. The landlord may require that if a certain percentage of the building or shopping center is damaged or destroyed, it can terminate the tenant’s lease. Tenant should have a right to retain its lease if the landlord is going to rebuild. However, if construction has not commenced (or is not completed) by a certain date, then, tenant should have the right to terminate.

10. **Description Of Premises.** The lease should provide a clear description of the demised premises together with, if available, a drawing of the site. The exact location of the premises, and, where applicable, where it sits with respect to other tenants (especially important regarding new, unbuilt locations) should be included. The dimensions or square footage of the space should be included in the lease.

11 **Exclusivity.** It may be important for the tenant to require that the landlord refrain from leasing space to a competitive business within the shopping center or, where the landlord owns other properties near the location, in those properties as well. The franchisor may be equally interested in seeing that this type of provision is contained in the lease.

12. **Right To Expand.** If the tenants envisions the likelihood of expanding over the term of the lease and if there is adjacent space that may be suitable for this purpose, tenant should explore the possibility of negotiating an option to take such additional space, on agreed price and terms, when and if it becomes available (usually when the current lease expires unless the existing tenant renews).

13. **Who Will Be The Tenant.** It is essential that a new entity, possibly a corporation or a limited liability company, be formed for every location that the franchisee takes. If a franchisee is going to have more than one location, each location should have a separate entity. The franchisee should seek to limit any personal liability, whether by guaranty or otherwise. The landlord may require either additional cash security or a letter or credit in lieu of a personal guaranty. If a tenant has more than one franchised location, the franchisor may require a cross default clause which provides that a default under one franchise agreement (or lease) will be deemed to be a default under any other

franchise agreement existing between the franchisee and the franchisor. Franchisor may reasonably feel that it does not want to have a defaulting franchisee as part of its system. On the other hand, the franchisee might argue that merely because it has one bad location out of several should not require it to give up its other franchise operations. While all of this is going on, the landlord will want to be protected and will want to be assured that if the franchisor triggers a default under the franchise agreement that it will come in and operate the real estate location as a replacement for the franchisee.

14. **Hours Of Operation.** Frequently the franchisor will require that its franchisees be open and operating during certain, predefined business hours. The franchisee's lease must be consistent with these arrangements and the location should be amenable to the hours of operation. If the franchisor requires that its franchisees remain open until 9:00 p.m. every night, the franchisee would not want to be in a location where all of the other retail outlets close at 6:00 p.m.

15. **Landlord's Consent.** Wherever in the lease it is required that the landlord must provide its consent or approval it should be further provided that such consent and approval would not be unreasonably withheld or delayed. Some leases will provide that, in the event of the landlord's breach of such a provision the tenant's only remedy is that the landlord will be deemed to have given such consent. This will be small solace to a tenant who had sought to assign or sublet, couldn't get the landlord's approval on a timely basis, and then lost its deal. While landlord may be deemed to have consented, the proposed assignee or subtenant is long gone and what the franchisee tenant will need to make it whole, is damages.

16. **Leasehold Improvements.** Many leases require that at the termination thereof the tenant is obligated to restore the premises to the condition that they were in at the commencement of the term. This can be a very expensive proposition and tenant should not agree to make such restoration. Tenant can agree to remove all of its inventory and trade fixtures and to leave the premises in a broom clean condition. The restoration of the premises for the next tenant should be the responsibility of the landlord. At the commencement of the lease when the premises are being constructed, the landlord should agree that it will review and approve your plans and specifications promptly and that it will not unreasonably withhold or delay its consent. Any delays on the landlord's part beyond the applicable time periods should defer tenant's obligation to pay rent, extend the term of the lease and, where excessive, give the tenant the right to cancel the lease and receive back any deposits it has made with the landlord. Further the tenant may seek to be reimbursed for expenses that it may have incurred with respect to the preparation of the plans and specifications regarding the subject premises.

17. **Most Favored Nation Provision.** Certain provisions in the lease (e.g., common area maintenance percentages, tax clauses and even rental provisions) may be subject to the landlord agreeing that the tenant will receive a "deal" no less favorable than that given to any other tenant in the building or shopping center. While the tenant needs to be in a favorable negotiating position to effectuate such a clause, a strong franchisor may be able to negotiate such provision on the franchisee's behalf

18. **Non Recourse Clauses.** The lease may provide that any liability that the landlord may have will be limited to its equity in the shopping center or building in which the demised premises form a part. Of course, if the landlord has mortgaged the premises and taken out the equity, there may be nothing to which the tenant can look. The Landlord may be able to avoid the problem by utilizing a single property entity and not leaving any equity in the entity thus avoiding any exposure notwithstanding the lack of such a non recourse clause.

19. **Parking Arrangements.** The tenant will want to negotiate specific rights to have parking spaces, not only for its employees, but also for its customers. It is helpful to have a certain number of parking spaces set aside for the tenant's use. Further, the plans for the building or shopping center should clearly indicate the ratio of parking spaces to tenants so that the tenant does not find that, in the future, parking areas are eliminated in favor of more retail space.

20. **Percentage Rent.** Where the lease requires percentage rent it should be clear that the percentage "kicks in" above a certain break point. An ambiguous lease might require that the percentage rent is payable from the first dollar of sales rather than at a point where the applicable percentage multiplied by the gross revenues is equal to the base rent. The definition of "gross sales" needs to be clear in that it should be limited to sales made from the premises and is not to be construed as including sales made away from the premises or by mail order. Taxes should also be excluded from the definition of gross sales. The landlord should not have the right to audit the tenant's books if percentage rent is not included as part of the lease. The franchisor however, might require such a right for the reasons discussed above.

21. **Real Estate Taxes.** The means by which real estate taxes are paid directly or reimbursed to the landlord will vary greatly from lease to lease. Some leases provide that the tenants will pay all of the real estate taxes applicable to the building. Other leases provide that the tenant will pay increases in the real estate taxes above a certain base year. It is important for the tenant to do his "homework" in order to determine what the tax history of the particular location may be. Even then, it is prudent for the tenant to negotiate a "cap" with respect to the real estate taxes that it will pay since without it, the exposure may be virtually without limit. Sometimes landlords require that tenants pay real estate taxes in a lump sum whereas, at times, a tenant will have the right to pay those taxes over a 12 month period. In other leases, the landlord will estimate the amount of the taxes and require the tenants to pay them on a monthly basis in advance so that when they come due the taxes have already been paid. Where the leases call for the tenants paying for a "percentage" of the taxes, it is important that the percentage be based on the real and accurate numbers, both with respect to the square footage comprising the tenant's location and the square footage comprising the building or shopping center of which the demised premises form a part. It is sometimes interesting to find that, when a tenant requests that the landlord make a representation that the "figures" are based on the actual square footages, the landlord is unwilling to do so. Red flag? The lease should require that the landlord provide the tenant with copies of tax bills and that, perhaps, the landlord should be required to engage in tax certiorari proceedings to try to reduce the taxes. If taxes are reduced tenant should be entitled to a rebate of the taxes that it has paid. The tenant should seek to have the landlord agree that it will utilize whatever tax payment periods are available to it in the event of assessments. Further, tenant

should not be obligated to pay any share of such assessments unless they come due within the term of tenant's lease. The total leaseable square footage on which the taxes are based should include the landlord's unleased spaces at the building or shopping center. Here again, a "most favored nation" clause may be very helpful in reducing the tenant's obligations with respect to real estate taxes. The base period month for determining tax escalations should coincide with the commencement of the term of the tenant's lease and sometimes can be negotiated more favorably than that.

22. **Security Deposits.** Where security is deposited with the landlord, it should be deposited in an interest bearing account and interest should be paid to the tenant no less than annually. Some landlords may require that the security deposit must be replenished in the event that it is utilized because of a tenant's default. In addition, some leases may require that a security deposit will increase as the rent goes up over the term of the lease. On the other hand, tenant might seek to negotiate that the security deposit will be returned to it, in part, as the lease progresses provided that the tenant has not been in default and has proved to be more "credit worthy."

23. **Guaranties.** Some landlords will require what is referred to as a "good guy guaranty." This calls for the principal of the tenant to be personally responsible for payment of rent and other obligations to the landlord so long as the tenant is occupying the demised premises. The theory here is that the guarantor will not permit the corporate tenant to continue to occupy the demised premises knowing that it does not have the wherewithal to pay the rent and then, after the corporate tenant is evicted, leave the landlord "holding the bag." The guarantor is, in effect, saying to the landlord that he will be a "good guy" and make sure that the landlord is paid for whatever period of time the tenant has occupied the subject premises. This is a more favorable arrangement than the unlimited form of guaranty that many landlords will ask for or "demand."

24. **Subordination, Non-Disturbance And Attornment.** Most leases require that the tenant subordinate its interest in the leasehold to any mortgages on the shopping center or building in which the demised premises is located. If the landlord defaults on its mortgage, a subordinate tenant can be evicted unless it has provided for a non-disturbance provision in its lease. A non-disturbance provision will give the tenant the right to remain in the premises notwithstanding the default and foreclosure against the landlord's interest. The tenant cannot be in default under its lease, however, in order to enforce the non-disturbance agreement.

25. **Common Area Maintenance (CAM) Costs.** Many shopping center leases require that the tenants will contribute to the operating costs or common area maintenance (CAM) for the mall. These costs can be extensive and tenant should try to negotiate a cap on these contributions. One way of calculating such a cap is to base it on the tenant's gross sales. Of course, this gives the landlord access to the tenant's books and records, a sometimes undesirable result. The items that comprise the CAM fees need to be analyzed. Capital expenditures should not be included. Major costs should be amortized over their useful life, not expensed in a single year. Administrative or management fees should be capped especially if the management company is an affiliate of the landlord. Once again, the tenant's proportionate share of total operating costs should be based on the proportion that the square footage of the subject premises bears to the total leaseable areas in the building or shopping

center, not just with respect to areas that are actually leased. If the shopping center is not fully built, the percentage of CAM charges might be reduced as the center is completed. Of course, the CAM charges may go up as new maintenance charges are incurred for the expanded space. The landlord should provide the tenants with annual statements detailing the changes and how they are computed.

CONCLUSION. Real estate issues go to the heart of the relationship between the franchisor and the franchisee and, in addition, they will play a major role in the potential success of the franchisee's business or the lack thereof. The more carefully that these issues are scrutinized and addressed, the greater the likelihood of the franchisor's and franchisee's mutual success.