Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

2 Reports Raise Real Estate Concerns For Franchisors

By **Terrence Dunn** (September 3, 2019, 3:20 PM EDT)

Terrence Dunn

Franchise law focuses on disclosure and agreements designed to facilitate business development. Many franchise agreements pay little attention to real estate concerns and yet, for franchise systems built on physical locations, real estate inevitably becomes a vital concern.

Two recent news articles concerning franchisers are interesting because of their grounding in real estate concerns.

The first article concerns Yum! Brands Inc. and its appointment of a new CEO.[1] Yum! Brands has over 48,000 restaurants in more than 145 countries and territories primarily operating the company's restaurant brands — KFC, Pizza Hut Inc. and Taco Bell, global leaders of the chicken, pizza and Mexican-style food categories.

The new CEO is credited with being "the chief architect of Yum! Brands' financial, refranchising and restaurant development strategy to transform the company into a capital-light, pure-play franchisor."[2]

The desire of franchisers to become nimbler and less capital intensive is an oft-cited goal these days.

Of course, one way to achieve this mythical status is for a franchiser to disassociate itself from the time consuming, expensive and idiosyncratic side of the business that involves the actual physical plants in which the franchisees operate and the real estate they occupy.

The second article concerns a lawsuit between Jack in the Box Inc. and its franchisees.[3] Some claims in the lawsuit involve the franchiser's required remodel program. Jack in the Box controls many of its franchisees' leases and is therefore responsible for some maintenance costs such as roof repairs and replacement. Structural costs such as these are not typically assumed by tenants/franchisees.

The franchisees claim that the franchiser is requiring remodeling of the locations as a means of passing on the costs of structural work that would otherwise be the franchiser's responsibility. Franchisees want financial reimbursement for those structural costs as part of the lawsuit.

Why would a franchiser want to be involved in its franchisees' leases to the extent of Jack in the Box? Why wouldn't they want to be "capital-light?" Capital-light sounds good and may even be desirable, but it is difficult to truly achieve this in an expanding system where location is a crucial concern.

Franchisers should become involved on varying levels with the real estate occupancy of its franchisees. This can be done in a number of ways and for a number of reasons that could be defined as falling into the general categories of site selection and site control, or sometimes a combination of the two, and what is sometimes called site uniformity.

As to site selection, there are different ways the franchiser can be involved. A franchiser can actually locate a site and lease it from the owner in order to sublease the location to the franchisee, or even acquire the property outright to lease it to a franchisee.

Alternatively, franchisers can be intensively involved in the site selection process and impose guidelines or requirements that enable them to assure themselves that the franchisee is establishing the unit franchise in a location that meets the franchiser's recommendations as to demographics, geography, neighborhood, traffic and a host of other issues that the franchiser is in a better position to assess than the franchisee. Not all franchisers go to this full extent, but many do at least to some degree.

Concerning site control, franchisers can require the franchisee in the franchise agreement to provide for certain provisions in its lease agreement that will protect the franchiser.

These provisions can include clauses that require a landlord to give the franchiser any notices that the franchisee receives, particularly notices of default. Franchisers can also require the franchisees to negotiate for inclusion of conditional or collateral assignments as part of the lease.

Some franchisers may additionally or alternatively require franchisees to include specific language in the lease permitting the landlord to step in and exercise control over the site in the event of a franchisee failure.

A franchiser would do this to retain some degree of control over the location so that in the event the franchisee fails or falters, the franchiser can step in and take over the operation or arrange for an assignment of the occupancy to a new franchisee. This allows a franchiser to maintain control over its system to the maximum extent. Franchisers who take a hands-off approach to the franchisee's occupancy may find themselves unable to preserve and protect a valuable location or be unable to avoid an unsightly failure of the brand in a high visibility location.

However, the exercise of this control carries risks and liabilities, in varying degrees depending upon the extent of the control and the skill with which it is created.

In an ideal world, the franchiser would simply step in when it needs to, remove the failing franchisee and either run the location as a company outlet or assign the location to a more promising franchisee. This ideal world scenario fails to take into account a third party, the landlord (we will discuss the franchiser as landlord below).

Assuming we are dealing with a third-party landlord, unless the franchiser's rights were carefully negotiated at the time the lease was entered into, the landlord will expect that the franchiser will make the landlord whole before it permits the franchiser to step in and take over or assign to another franchisee.

That inevitably means payment of the failed franchisee's past due rent. This added liability on top of the costs of resurrecting a failed franchise may make the location more trouble than it is worth to a franchiser, regardless of how attractive the site is. However, if the site is important enough to protect, the franchiser may find itself facing a hefty bill with the landlord in order to save the location.

A savvy franchiser will hope to require its franchisees to only enter into a lease with a landlord who is willing to give an assignment of the lease triggered by the franchisee's failure or exercised at the franchiser's option, which does not require the franchiser to make up for the lost rent. This unicorn landlord may be hard to find, however, and the franchiser may find itself giving on that point in the interest of the franchisee obtaining a good location.

Some larger franchisers have actually become the landlord, either by leasing locations and subleasing or by actually acquiring properties to lease directly to franchisees. McDonald's Corp. has been doing this for years.

This obviously grants a great deal of control, but it also puts a franchiser into the real property management business, which is expensive, time consuming and distracts from their primary business.

It seems as if efforts to create rights for the franchiser to protect a location are legally complicated and potentially expensive. So, should all franchisers look to become capital-light and avoid getting their hands dirty at all?

The problem with that approach for systems dependent on prime locations is in the event a franchisee runs into trouble, the franchiser's only option is to shut it down, require the franchisee to de-identify and move on. Without any control over the location, they have no means of stepping in and salvaging what might have been an invaluable location.

There are other reasons why a franchiser would be wise to take a more hands-on approach to the real estate. There is a significant benefit in trying to create some system uniformity in the leasehold holdings of the individual franchisees.

As a system expands, having clearly established criteria that are being applied and enforced at the operations level makes it easier to manage the franchise development side of the business.

Moreover, having a recognized set of conditions in the event of any franchisee default makes it much easier to deal with what needs to be done in the event of a franchisee failure. A local unit crisis is not the time to be reinventing the wheel.

Additionally, if the franchiser becomes sizable enough to be considering institutional borrowing or private equity investment, the transparency and predictability of its system's operation, particularly when there are the inevitable unit failures, is a strong selling point.

A franchiser's uniform ability to step in and control troubled or defaulting franchisees will be viewed as strong sign of dependable management by an inquiring investor.

Practical Tips

Franchiser attorneys are recommended to include requirements within the franchise agreement that franchisees must comply with specific provisions with respect to the lease for the location that they propose to enter into and that the lease must be provided to the franchiser for approval. Those requirements should include a lease rider that the franchisee must undertake to have added to the lease and a collateral assignment of lease that the franchisee agrees to have the landlord enter into with the franchiser, permitting the franchiser, at its option and without curing past defaults, to take an assignment of the lease for the purpose of operating the approved business or assigning or subleasing the premises to an approved replacement assignee.

Terrence M. Dunn is a founding partner of Einbinder & Dunn LLP.

[1] Yum! Brands, Yum Brands Announces CEO Succession Plan To Drive Next Chapter Of Global Growth Effective January 1, 2020, (August 13, 2019), https://www.franchising.com/news/20190813_yum_brands_announces_ceo_succession_plan_to_drive_.html.

[2] Id.

[3] Jonathan Maze, Jack In The Box Franchisees Sue The Company, (December 4, 2018), https://www.restaurantbusinessonline.com/financing/jack-box-franchisees-sue-company.