

IBA/IFA 27TH ANNUAL JOINT CONFERENCE

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NEW APPROACHES AND CHALLENGES IN INTERNATIONAL FRANCHISING

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**HOW REAL ESTATE LAW AND LEASING PRACTICES AFFECT INTERNATIONAL
RETAIL FRANCHISING**

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1. GENERAL

In most retail franchise programs, real estate is a critical determinant of a franchisee's success or failure. One needs only examine typical terms of a retail franchise agreement to get a sense of a franchisor's concerns.

- Area within which a site must be found
- Time to find a site
- Property specifications -- size
- Demographics
- Hours and days of operation
- Mandatory lease terms
- Lease riders or conditional lease assignments
- Subleases
- Franchisor approval of lease
- No franchisor guarantees of lease
- Lease duration tied to franchise term
- Premises limited to operation of franchise
- Franchisee duty to assign to franchisor or its designee upon termination or expiration
- Franchisee may not compete from the location following termination or expiration

Local law and practice will often dictate whether a franchisor's real estate policies are enforceable. Moreover, even if they are enforceable, a franchisor may suffer considerable consequences from either retaining the rights or trying to enforce them. Thus, market and legal research – due diligence should -- be undertaken before, rather than after, agreements are executed.

To highlight a few issues:

1. Availability of locations with physical characteristics for prices on which the profitability model is based must be determined.
2. How long it will take to locate, lease, build out and open a typical store or restaurant must be compared with opening requirements in franchise agreements and with development schedules.
3. The duration of a lease term and the landlord's and tenant's rights at the end may be controlled by mandatory requirements of national lease laws, e.g., in Italy. The terms may be much shorter than the period specified in some standard franchise agreements.

Although common in the U.S., conditioned lease assignments are not widely used in many countries.

Besides the traditional risks of subleasing, franchisors must determine whether:

1. they wish to be subject to mandatory lease laws in a foreign country;
2. they are prepared for the taxation nexus and other jurisdictional issues that come with ownership of a leasehold interest in real estate;

3. they may lawfully engage in a retail or restaurant business in the country, e.g. Panama, India, Indonesia;
4. arbitration clauses used to resolve most disputes may be used to efficiently lease enforcement and eviction actions; and
5. the rent charged the franchisee tenant may be higher than rent paid by the franchisor sublessor, e.g. Brazil.

Whether contract provisions prohibiting franchisees from assigning their premises without franchisor approval will be enforceable also must be investigated.

Because some mandatory laws grant tenants a right to renew their leases, e.g. Portugal, franchisors must evaluate whether a post-term non-compete covenant will preempt this right.

Exercising a right in a lease or conditional lease assignment may require a franchisor to establish a business entity in the country, and be subject to taxation on its local business activities, e.g. Brazil.

As more international franchisors adopt area development, rather than master franchising growth strategies, the more important it is that they understand how leasing laws and practices will affect the operation of their franchisees and their ability to enforce their franchise agreements.

2. HYPOTHETICAL – CASE STUDIES

AZOR, a franchisor of retail stores specializing in the sale of sporting memorabilia and logoed team merchandise and apparel has 150 locations in its home market which are mostly located in regional shopping malls. The stores are typically 2500 square feet (232 sqm), with rents between \$35-40/sq ft, and the lease terms are typically 5 years with 1 or 2 5-year renewal options. Franchise agreements are for terms of 10 years, but may be terminated if the franchisee loses its right to possession of the premises. AZOR wants to franchise abroad and is considering options in Germany and the United States:

When the company began franchising, it required franchisees to lease directly from landlords. It later required franchisees to try to negotiate conditional lease assignments or lease riders which give the franchisor the right to receive notices of any lease defaults from the store landlords, and to have the option to assume the lease (or to assign it to another franchisee) if either the lease or the franchise will terminate or expire. All leases which the franchisor has approved for franchisees restrict use of the store premises to the operation of the franchised business, and they require the leased premises only to be identified by the franchisor's brand, even if the lease is assigned by the tenant. For the last two years, the franchisor has found that landlords in the best malls want the franchisor to either lease the premises directly from the landlord and sublease to franchisees, or to guaranty franchisees' leases. AZOR has found that this latter approach enables it to acquire locations it could not get for franchisees in the past, and, frequently to obtain the leases under better terms and conditions.

Because of the impact of either a lease guaranty or sublease on its balance sheet, Azor prefers to sublease premises, and to mark up the rent to generate a return which should compensate it for the risks it incurs by being a landlord. Also, if locations are profitable, AZOR wants to be able to increase its base rents or collect a higher percentage rent when subleases are renewed.

Under AZOR's franchise agreement, AZOR may exercise a right of first refusal to acquire a franchisee's business if a franchisee proposes to assign or transfer it to a third party. Upon termination or expiration of the franchise agreement, the franchisee is subject to a post termination non-compete

covenant prohibiting the franchisee from engaging in a competitive business within two miles of the former store location. Moreover, AZOR retains the option to acquire the assets of the franchisee's business upon the termination or expiration of the franchise.

All disputes arising under the franchise agreement are to be resolved in arbitration in the city where AZOR's headquarters are located, except for claims to enforce AZOR's intellectual property rights.

How will commercial landlord-tenant laws and practices in Germany and the United States affect AZOR's standard franchise program?

3. HOW ISSUES ARE ADDRESSED IN GERMANY AND THE UNITED STATES

Germany

If AZOR will only grant franchises for a term which is equal to the store lease term and any renewal terms, will AZOR be able to use its standard franchise agreement term of 10 years?

It is possible to agree on 10 years lease term. It is also possible to link the existence of the lease agreement to the existence of the franchise agreement.

Are rental rates comparable to other countries' rates?

Probably not, but comparative indicators apply, e.g. micro- and macro location, industry, competition and power if brand or brand mix.

Are conditional lease assignments used? Enforceable?

Conditional lease assignments are not very common. Either all three parties complete the contract to allow the franchisor to succeed the franchisee, or the franchisor and the franchisee conclude a transfer agreement with the consent of the lessor. The succeeding party has the same rights and duties out of the original contract.

Would a foreign company (AZOR) be able to become a tenant and operate the store under local law?

Yes.

Will local law allow AZOR, a foreign corporation, to sublease the store premises?

Yes. The conditions for subleasing are regulated in § 540 German Civil Code.

The sublessor needs the permission of the landlord. In contrast to private leasing, there is no claim to permission except it is provided in the agreement. A clause that forbids the termination of the contract in case the landlord does not give the permission is void.

The tenant is liable for the subtenant (§ 540 II German Civil Code). The tenant also can not sublet the premises to a franchisee if there is a competitor in the same renting object (mall, etc).

What are the tax consequences of subleasing a store in your country for AZOR

Tax may apply on profits generated in the country of the property, e.g. withholding tax.

Are clauses prohibiting the landlord from renting space in the same mall to competing business common? Enforceable?

If there is no clause in the contract, the competitive protection might apply (i.d.) on a case-by-case basis, but rarely. The tenant could claim competitive protection in its specific assortment, but rarely for an industry (e.g. “food” or “fashion”) which is typically represented by more than one competitor in a mall.

If the landlord violates an applicable competitive protection, the tenant can terminate the lease, reduce the rent or claim compensation.

Would your country’s law permit AZOR to mark up the rent it charges to its franchisee/tenant?

Yes, but there are restrictions, e.g., the rent increase is limited by the local comparative rent and must not be an immoral gouging.

Would AZOR be allowed to acquire the premises from franchisee and either operate the business there or re-assign its rights to another franchisee?

As long as the lease agreement is effective, AZOR would not be allowed to enter the franchisee’s premises without its prior consent or even take over the operation rights or re-assign these rights to another franchisee.

May AZOR operate temporarily for the purpose of finding a new franchisee?

AZOR may operate temporarily the business if the franchisee and the landlord agree in doing so or if the franchise agreement as well as the lease agreement are terminated and AZOR has the right to enter into the lease agreement.

Therefore, it is recommendable to incorporate a clause into the lease agreement between franchisee and landlord that allows AZOR to enter into the lease agreement if the lease agreement with the franchisee is terminated.

Are there other ways for AZOR to control franchisees’ premises so that they are not converted to other uses by breakaway franchisees or competitors?

AZOR may lease the premises itself and sub-lease these premises to franchisee. Another option is to oblige the franchisee to incorporate a clause into the lease agreement that allows AZOR to enter into the lease agreement.

United States

Are commercial leasing practices regulated by both national and local law? Please explain.

In the U.S., leasing practices are regulated by state laws. Local laws control land use, zoning and building and occupancy permits. Although states typically regulate residential landlord-tenant practices, parties to commercial leases are usually able to negotiate whatever terms they like, provided the uses of the premises are not unlawful. Federal and state environmental laws will regulate certain uses of property.

If AZOR will only grant franchises for a term which is equal to the store lease term and any renewal terms, will AZOR be able to use its standard franchise agreement term of 10 years?

In the U.S., 5 year lease terms are most common, but often they are renewable for 5 years terms. The duration of a lease term is not regulated by law.

Are rental rates comparable to rates charged in the franchisor's home market?

Rental rates vary considerably depending upon the location of the property. Rents in prime retail locations in densely populated urban areas are typically much higher than the rent charged for warehouse space in small towns.

Are conditional lease assignments used? Enforceable?

In the U.S., conditional lease assignments are the preferred way for franchisors to control the locations from which franchisees operate. They are enforceable if the lessor, franchisee and franchisor are all parties to them. Although McDonald's and some other large, established franchisors have subleased premises to franchisees so that they can control their locations, most franchisors avoid the risks and administrative burdens that subleasing requires.

Would a foreign company (AZOR) be able to become a tenant and operate the store under local law?

U.S. laws do not restrict foreign persons from owning or leasing real estate or from engaging in most businesses, other than those which have national security implications.

Will local law allow AZOR, to sublease the store premises? If not, could it form a local affiliated company to do so?

Neither federal nor state laws prohibit foreign persons from leasing or subleasing real estate.

What are the tax consequences of subleasing a store in your country for AZOR?

Rental income is subject to taxation at the federal, state, and perhaps, local levels. Unless properly structured, a foreign sublandlord could be subject to as much as a 30% withholding tax on gross rental income.

Are clauses prohibiting the landlord from renting space in the same mall to competing businesses common? Enforceable?

Whether a mall landlord will agree not to lease premises in or near the mall to a business which competes with a tenant depends first upon the bargaining power of the tenant. U.S. shopping malls often offer shoppers access to several direct competitors. If a tenant has market power in the products it sells, the lawfulness of a landlord agreeing to a noncompete agreements could be subject to challenges under federal and state antitrust (competition) laws.

Would your country's law permit AZOR to mark up the rent it charges to its franchisee/tenant?

The only restrictions on the rent a landlord or sublandlord may charge to tenants is the law of supply and demand. Most sublessors mark up the rent they are charged by prime landlords to at least cover the administrative expenses they incur.

Would AZOR be allowed to acquire the premises from the former franchisee and either operate the business there or re-assign its rights to another franchisee?

AZOR's right would depend upon whether the landlord was willing to agree to such terms in either a rider to the lease with the franchisee or in a conditional lease assignment. Landlords often are reluctant to agree that a franchisor could take over a franchisee's lease without paying past due rent or without being subject to paying higher, market rate rent. A franchisor's rights are ultimately based upon negotiation with a landlord which result in an agreement which is executed by the landlord and the franchisee-tenant.

May AZOR operate the store temporarily for the purpose of finding a new franchisee?

Yes, so long as the lease permits it to do so. However, even temporary operation of a store may subject a franchisor to state and local taxes for which it may not otherwise be liable.

Are there other ways for AZOR to control franchisees' premises so that they are not converted to other uses by breakaway franchisees or competitors?

Franchisor often use post termination noncompete covenants to preclude former franchisees from engaging in the same business after the franchise relationship ends. In some states, e.g., California, those covenants are not enforceable. Franchisors sometimes require franchisees to grant them an option to purchase the franchisee's business or business assets upon termination or expiration of a franchise agreement. This gives franchisors the ability to control use of the premises. However, the option to acquire a store lease is only effective with the consent of the landlord.

4. OVERVIEW OF LEASING LAWS AND PRACTICES

Germany

Are commercial leasing practices regulated by both national and local law?

Residential and commercial leases are treated differently under applicable laws is the purpose of the contract. In mixed used leases, i.e., where a franchisee operates from a home-based office, the predominant use is controlling.

a. Form

Commercial lease contracts have to be completed in written form if their duration is more than one year. Both parties (or their representatives) have to sign personally. If the written form is not observed, the contract is not void, but is effective for indeterminate time and can be terminated in due time according to the applicable law.

b. Rental property

The property and the rental purpose have to be described in detail. Before completion of the contract, the use for commercial purpose in general and for the tenant's business purpose in particular, has to be approved by the responsible authority. Usually, it is the landlord's business to obtain the permission.

c. Rent

Rent has to be paid according to the terms and conditions of the lease, usually monthly in advance at the beginning of every month.

d. Rent increase/adaptation

The rent can be agreed freely until violation of morality. This can be the case when the rent exceeds the average local rent for a comparable location by 100 %. The rent only increases or reduces if the landlord and the tenant have agreed. Common in practice are indexation clauses which allow rent modification if the cost of living index changes. Often the parties agree to graduated rent, so that the rent increases automatically after a certain time period.

1. Deposit

Usually the parties agree to a deposit. In contrast to private leasing, the landlord is free in setting the amount of deposit. The landlord must pay to charge interest on the deposit

2. Competitive Protection

Competitive protection is common in commercial leasing, although not regulated by local law. Even if there is no particular regulation in the agreement, the landlord may grant competitive protection so that the landlord is usually not allowed to rent property in the same building or in the direct neighbourhood to tenant's competitors. Nonetheless, the interests of both parties – the landlord's economical interests as well as the tenant's interest of competitive protection – are to be taken into account. If the parties do not want competitive protection, it has to be excluded in the contract.

e. Defects

A tenant may refuse to pay rent or reduce the rent it pays adequately if there are any defects in the property that affect the agreed use of the property in a significant way. The tenant is entitled to reduce the rent regardless of whether the landlord is responsible for the complained defect. The landlords' responsibility for the defects is no condition of entitlement for the rent reduction. In addition, the tenant can claim compensation, if the defect already existed at the time the agreement was signed. The landlord has, by default, the obligation to remove the defect. The compensation includes lost profits, investment expenses, moving costs etc.

f. Termination

Permanent lease agreements can be terminated latest on the 3rd working day of every quarter year for the end of the next quarter year (§ 580a II German Civil Code (Bürgerliches Gesetzbuch/BGB)). Nevertheless, the parties can agree on alternative terms.

For good cause, both parties can terminate a lease without notice. Good causes are circumstances that are serious in that way that one party can not be expected to continue the agreement. The law gives examples for good causes, e.g.

- culpable default of payment, or
- other serious breach of contract.

Economical difficulties of the tenant are usually not a good cause. The termination of a commercial agreement does not require written form unless required in the lease agreement. But for reasons of evidence, it is recommended.

United States

Leases are regulated by state law, and sometimes local laws. No agency regulates leasing commercial activities.

- Landlords search for concepts in malls with highest volume (turnover) per square foot/sqm
- Retail lease – 5 years, perhaps 10 years (with renewal). Most common is 5 year lease, with 1 or 2 5-year options. Rent is set in 1st option, floating to “market” in 2nd option.
- Security deposit – 1 months rent, plus prepay first month’s rent and sometimes last month.
- Space conveyed often is a “shell,” and must be built out to meet franchisor’s specifications and specifications acceptable to lessor
- Sometimes landlord will pay all or part of the build-out – which on the tenant’s balance sheet is capitalized over lease term and built into rent (costs must be reimbursed in case of early termination)
- Rents are expressed in lease as an annual total, e.g. if monthly rent is \$1,000, lease would state that the rent is \$12,000 per year, payable in \$1,000 monthly installments. If lease terminates before end of term, present value of balance of rent is due.
- Landlords may have no duty to mitigate damages by finding a new tenant, unless the duty to mitigate is negotiated into the lease.
- Rent may be expressed as a base amount, plus a percentage of the tenant’s gross revenues which exceed a base amount, e.g. \$1,000 per month plus 5% of all revenue exceeding \$20,000 per month.
- Rent is often described as “triple net.” In addition to paying base rent, the tenant must pay insurance, property taxes and common area maintenance charges applicable to the space (as well as all utilities).
- Tenants in malls often must pay marketing fees to the landlord to be used to promote shopping at the mall
- Some landlords or their tenants will negotiate “non-compete” clauses which prohibit tenants from selling products or services which compete with tenants, either at the mall, or sometimes, nearby.
- Some tenants are able to negotiate “exclusives,” which prohibit the landlord from leasing to a competing brand in the mall or in any shopping centers controlled by the same landlord within a certain radius.
- Some landlords will insist on a noncompete that will prevent the tenant from opening another outlet nearby, in an effort to support the landlord’s percentage rent clause in this lease.
- Broker or “finder” fees typically paid by landlord, unless tenant hires broker to act as tenant’s agent to negotiate terms of lease.
- Landlords may or may not require financial statement reporting. They typically will require reporting of gross sales and insist upon audit rights.
- Landlords will often require guarantees if tenant is not strong financially and for most franchise leases.
- Landlords may require lien on fixtures and personal property in space, but this can typically be negotiated away.
- Typically there will be restrictions on exterior signage.
- Leases generally prohibit assignments or subleases without landlord approval.
- Upon an assignment, lessors often reserve the right to enter into a new lease with the assignee at market rents.
- Leases often limit use of the space to the business carried on by tenant when lease is signed (“use clause”).

- Leases sometimes require the premises to be operated under a specified brand name (“name clause”).
- Real estate rights are matters of state law. Land use, zoning and occupancy permits are usually governed by local laws
- Disputes relating to leases must typically be resolved in local state courts.