The Intersection of Franchise and Real Estate Law

Mark D. Shapiro, Esquire
Hyland Levin LLP
Marlton, NJ

and

Anne P. Caiola, Esquire
Caiola & Rose, LLC
Decatur, GA

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Table Of Contents

I. INTRODUCTION .................................................................................................................................................. 1

II. FRANCHISE-SPECIFIC LEASE TERMS ................................................................................................................. 1
    A. Key Lease Provisions ........................................................................................................................................... 1
        1. Use Clause ..................................................................................................................................................... 1
        2. Use of Marks and Trade Dress .................................................................................................................... 2
        3. Remodel Rights ........................................................................................................................................... 3
        4. Radius Restrictions ....................................................................................................................................... 3
        5. Exclusive Use ............................................................................................................................................... 4
        6. Lease Term .................................................................................................................................................... 4
        7. Non-Disturbance ......................................................................................................................................... 5
    B. Franchisor’s Lease Rider ....................................................................................................................................... 5
        1. Lease Assignment .......................................................................................................................................... 5
        2. Notice and Opportunity to Cure ................................................................................................................... 6
        3. Access to Protect System ............................................................................................................................ 7
        4. Right to Receive Reports .............................................................................................................................. 7
        5. Refranchising ............................................................................................................................................... 7
        6. No Amendment ............................................................................................................................................ 8
        7. No Other Assignments ................................................................................................................................ 8

III. REAL ESTATE SPECIFIC FRANCHISE AGREEMENT TERMS ................................................................. 8
    A. Lease Related Issues ......................................................................................................................................... 8
        1. Mandatory Lease Provisions ......................................................................................................................... 8
        2. Counsel and Negotiations of Lease ............................................................................................................... 8
        3. Review and Approval of Lease .................................................................................................................... 9
        4. Cross-Default with Lease ...........................................................................................................................10
        5. Alignment of Entities between Lease and Franchise Agreement ..............................................................10
APPENDIX 2 - Franchisor’s Right to Purchase ................................................................. 39
APPENDIX 3 - Franchisor’s Right of First Refusal .......................................................... 41
APPENDIX 4 - Huddle House, Inc. Case ........................................................................ 43
BIOGRAPHIES .............................................................................................................. 46
I. INTRODUCTION

Great franchise systems have great locations, which is a key to success. Franchise lawyers sometimes take for granted the complexities involved when a franchisee enters into a lease agreement with a landlord for the site where the franchisee will operate its business. The issues become even more complicated when the franchisee obtains a loan to be secured by the assets of the franchised business. Each of the franchisor, landlord and lender have distinct interests to protect, sometimes in alignment with the other parties and sometimes not. Where interests are incompatible, negotiations ensue, and when instead the issues are ignored, disputes arise if the business fails. This paper addresses the more significant real estate issues franchisors and franchisees face. Specifically, in Sections II and III, this paper breaks down the key franchise provisions in retail leases, the terms of a franchisor's lease rider or addendum to be attached to that lease, and the real estate provisions in a franchise agreement. Section IV discusses how the franchisor's protective provisions are enforced. Sections V and VI describe the conflicting landlord position and lender position, respectively. Finally, Section VII summarizes the issues in dealing with these divergent agendas and how to address the differences.

II. FRANCHISE-SPECIFIC LEASE TERMS

A. Key Lease Provisions

Certain lease terms are more important to franchisors than others. When reviewing a lease for approval, in addition to the basic economic terms, the franchisor will focus on many of the provisions described in this Section II. The common themes among these provisions are maintaining system-wide uniformity and control over the unit's operations. Where obligations to or limitations in favor of the landlord are in conflict with the franchise agreement, the franchisor works to reconcile the inconsistencies. When those inconsistencies go unrecognized or unresolved, disputes likely follow. Examples of these instances are described in some of the cases in Section IV. A basic illustration is matching the lease term to the franchise agreement's term, so there is no rental obligation without a franchise agreement, and alternatively, there is no franchise operations covenant with no approved space to occupy. Separate from the standard lease agreement provisions, franchisors often have a lease rider setting forth rights regarding control of the space, especially following a franchisee default. Those provisions are discussed in Section III. Franchisees are generally neutral regarding the following lease provisions, but may be obligated to accept them under the franchise agreement. The pain for the franchisee is in the franchisor slowing down the lease negotiation process when advocating for modifications or additional terms to the franchisee's lease agreement.

1. Use Clause

A use clause describes the particular purposes for which the leased premises may be used by the tenant. Landlords and franchisors are aligned in desiring a narrowly crafted permitted use clause in the lease, whereas a franchisee seeks a broader permitted use clause. Landlords will have an easier time granting and monitoring exclusive use rights at a shopping center where a limited use is permitted. In contrast, a broad use clause, like operation of a restaurant or even a deli, limit a landlord from granting future exclusive use provisions to other tenants. For example, a cheesesteak specialty concept could not be granted an exclusive right

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1 For purposes of Sections II and III.A., we are assuming that the "lease" is for a retail site between franchisee and a landlord, unrelated to franchisee and franchisor.
to operate if an existing tenant has a use clause permitting operation of a “restaurant.” Similarly, the franchisor would like to see operations restricted to the franchised business, including by trade name only. Franchisors, however, need to avoid too narrowly drafting the use clause, and then limiting future franchise offerings to the public. There may be, for example, menu items or personal care services not among the approved products or services at the franchise company when the lease is signed, but as franchise systems evolve, the offerings are expanded. Franchisors therefore desire language like “including such products or services that are being offered by the franchise system, which may change from time to time.” Limiting the use to the franchised business (and even better, limiting operations under the specific trade name only) provides another layer of protection against the franchisee operating in violation of the franchise agreement by selling unauthorized products, using non-permitted marks or trade dress, or violating the franchise agreement’s non-compete provisions. Finally, the franchisor appreciates a tight use provision -- one that limits the use to the franchised business. That way, in the event of a franchisee bankruptcy, the lease can only be assigned to franchisor or a replacement franchisee, as opposed to a trustee selling the lease to a competitor who may capitalize on the locational goodwill.

Conversely, a forward-looking franchisee may want a broader use clause especially if it has an unsophisticated franchisor. This will make it easier for the franchisee to assign the lease to a third party, who may or may not be a franchisee. And, the former franchisee may be able to operate a different business at the same space following termination or expiration of the franchise agreement. When well-crafted, the lease use clause may be the most underrated franchisor control provision.

A related lease provision is tenant’s obligation to continuously operate its business during the lease term. Both landlord and franchisor will want the franchisee to be obligated to remain open for business in compliance with the use clause. Where the lease permits the tenant-franchisee to “go dark” but continue to pay rent, the franchisor should seek to reconcile the inconsistency between the obligation to continuously operate and its right to close up shop, but still pay rent.

2. **Use of Marks and Trade Dress**

Franchise systems are defined by their distinctive trade dress, the look and feel of the concept. Therefore, the franchisee-tenant and the franchisor would like the landlord to confirm in the lease that the use of the system’s marks and the signage are approved and permitted. Most landlords will place the burden on the tenant to determine whether the use and the sign criteria will be permitted under local law. At a minimum, the landlord should provide consent to the use of the franchise’s marks, signage and trade dress. For example, a provision may read: “Landlord consents to Tenant’s use and installation of the marks, trade dress, signage and related features associated with the franchised system that its franchisor may prescribe from time to time. Landlord makes no representation regarding tenant’s use or whether tenant’s sign package complies with law. Tenant shall be responsible for compliance with all municipal or county requirements regarding its alterations.” As part of due diligence, the franchisee should examine the restrictions regarding construction and operations. Zoning ordinances or land use approvals governing the real estate may impact a tenant’s ability to meet the franchisor’s build-out specifications. When granting land use approval for construction, a municipality may require that there be uniformity at the shopping center’s facade, there may be, for example, a color
theme that causes a conflict with the franchise system. Municipalities have caused registered marks to be altered in signage.³

3. Remodel Rights

Since the franchise agreement may require the tenant-franchisee to remodel after a period of time, as a result of re-branding or upgrade decisions by the franchisor or as a condition of renewal or consent to a sale, the tenant needs this flexibility under the lease. From the tenant’s and franchisor’s standpoint, the landlord should agree in advance that these alterations are expressly permitted. And, if a required remodel is taking place, ceasing operations during such time should not violate any continuous operations requirement on the renovating tenant. In contrast, the landlord will want to review all modifications at the time of the proposed work, and will otherwise want to rely on the alterations provision of the lease, which sets forth the process for approval. Any modifications to the property’s systems (i.e., plumbing, electrical, heating, ventilation and air conditioning) or to the structure will require plans to be submitted for landlord review and approval, and the landlord may even try to dictate which contractors may be used for the work.

4. Radius Restrictions

The tenant’s lease agreement may impose a radius restriction. A radius restriction is a covenant that the tenant will not operate a similar or competitive business within a certain distance, usually expressed as a radius of miles from the leased premises. The purpose of the clause is to focus the tenant on succeeding, and driving traffic exclusively to the landlord’s center. An example is:

During the lease term, neither tenant nor tenant's management, nor any person or entity controlled by tenant or controlling tenant shall own, operate or maintain, or have any significant affiliation, investment or interest, directly or indirectly, through or with any other person, partnership, corporation, agent or employee in any similar or competing business as that being operated at the Premises, within a radius of three (3) miles from the outside boundary of the Shopping Center (which distance shall be measured in a straight line without reference to road mileage); provided, however, such radius restriction shall not apply to the tenant’s franchisor.

The franchisor and franchisee should make sure that this covenant is limited only to the franchisee so that if another operator in the system -- a different franchisee or the franchisor itself -- opens another unit within the radius restrictions it is not a default under the franchisee’s lease. Especially if broadly worded, this clause may impose an unreasonable restriction on the franchisor, who takes a future assignment of the lease. As franchisor, it may operate company-owned units or be in the business of licensing additional units in close proximity of one another, which may be a violation of the lease’s radius restriction. Franchisors should not be restricted in their territory development by a franchisee’s lease covenant to a landlord. Accordingly,

³ In Payless Shoesource, Inc. v. Town of Penfield, 934 F. Supp. 540 (W.D.N.Y. 1996), the court enforced a municipal sign ordinance that required all signs to be one color. Payless’ federally registered mark contained both yellow and orange. The Payless court naively reasoned that the town was simply imposing a uniform sign ordinance and that the sign and trademark were two different concepts. In contrast, the court in Blockbuster Videos, Inc. v. City of Tempe, 141 F.3d 1295 (9th Cir. 1998), found the Lanham Act prohibited the municipality from requiring the mark owner to alter its registered service marks, but that the municipality could preclude display of the marks.
franchisors who may have units in close proximity to one another seek to have this clause automatically deleted should the franchisor take an assignment of the lease.

5. **Exclusive Use**

While a radius restriction protects the landlord from competitive activities by the tenant, an exclusive use provision protects the franchisee from having to compete with other tenants in the shopping center. One of the areas where a franchisor can be particularly helpful to its franchisee is in crafting a broad exclusivity provision. A franchisor is better positioned to know what types of businesses and what lines of products are competitive with its franchised business. Exclusivity clauses generally fall into one of two categories: (1) an exclusive right to conduct a specified business, which is not literally directed against specific products, and (2) an exclusive right to sell specified products.³ A right to be the only pizza shop in the shopping center may permit other restaurant or food-providing tenants to sell products also sold in the pizza shop, whereas, the exclusive right to sell pizza and pizza-related products would be a true exclusive. Where the lease specifically lists the restricted items, the franchisee has greater protection. Landlords are generally more willing to limit any restrictions to a select number of primary or core items being offered by the franchised business at the time of lease execution. For instance, Dunkin Donuts® may have an exclusive on coffee and donuts as primary or core products, subject to other restaurants being permitted to sell coffee and pastries so long as the sales from these products do not exceed 15% of their total sales.

An aggressive franchisee may propose that it receive an exclusive right to sell the items then being sold by the franchise system. The problem with evolving or expanding exclusive use provisions is that they limit the landlord’s future leasing possibilities and increase the possibility of a violation. And, the problem with very specific exclusivity provisions may be that the related use clause is narrowed in a way that may impair a franchisee’s ability to offer new franchise system products or services. Where the landlord is flexible and grants exclusivity for items to be offered in the future, expect the landlord to insist on advance notice of the new items and no exclusivity rights for items already protected in another tenant’s existing exclusivity clause.

6. **Lease Term**

Both the franchisor and the franchisee should want to see the lease term match the franchise agreement term or have the ability to be coterminous. It cannot have the situation where there is term remaining under the franchise agreement and there is no property from which the franchisee may operate. Having no approved location is an event of default under the franchise agreement. Conversely, neither the franchisor nor the franchisee wants the situation where the franchisee has no right to operate the franchise, but an obligation to operate and pay rent under its lease. That conflicting scenario may result in the franchisee attempting to operate at the former franchised location in violation of post-term covenants, including non-compete and confidentiality obligations. Initial lease terms may not match the franchise agreement terms, but may match if renewal terms are exercised. For example, a five-year lease term, with five-year renewals, is consistent with a ten-year franchise agreement term. New franchisees may seek shorter terms to provide flexibility and limitation of damages if there is an early termination. Also, if the franchisee has been fortunate enough to negotiate an early termination right with its franchisor (e.g., for failure to achieve a certain level of sales), it will want a similar right with its landlord (or otherwise limit its damages for an unpermitted early termination). Flexible franchisors will permit their franchisees to operate at approved relocated premises. In

California, where post-term non-competes are typically unenforceable, the franchisor is especially well-served in preventing the franchisee from having its lease term extend beyond expiration of termination of the franchise agreement.⁴

7. **Non-Disturbance**

Well-counseled tenants will seek a non-disturbance agreement from their landlord’s lender. That is, an agreement from the lender that in the event of a foreclosure, the lender will not disturb the franchisee’s tenancy. In turn, the lender should offer a subordination, non-disturbance and attornment agreement (“SNDA”). An SNDA subordinates the lease to the landlord’s mortgage; has the lender agreeing to recognize the tenant’s lease in a foreclosure; and has the tenant agreeing to attorn to the lender by making payment of rent to it as the new landlord. The SNDA only works for the tenant if it is not in default at the time of foreclosure or delivery of a deed in lieu of foreclosure. Subordination is sought by the lender when the tenant’s lease is prior in time to recording of lender’s mortgage. By contractually subordinating its interest, the tenant allows the lender to take title free of the lease, but with the obligation to not disturb the lease by terminating it. SNDAs are often subject to heavy negotiations and often without the franchisor being interested in (or willing to devote the resources to) the back and forth. The most hotly contested SNDA provisions are protections the lender seeks, such as: no liability for defaults of the prior landlord; no liability for construction obligations or tenant allowances; the lender’s right to receive notice of defaults and an extended right to cure landlord’s defaults under the lease; no obligations for security deposits or to recognize payment of more than one month’s rent; and no lease amendment, assignment or sublet without lender’s consent. That last provision may trip up a franchisor who negotiates a lease rider with a free assignment right only to learn that the lender must provide its advance consent. A careful franchisor will not permit a SNDA provision to undo a protective provision negotiated with the landlord. This is another example of an inconsistency between documents and conflicting rights that may lead to litigation.

B. **Franchisor’s Lease Rider**

The provisions described in Section II.A. typically appear in a lease agreement between a retail tenant and landlord. The franchisor may also seek to obtain a number of beneficial rights through an addendum or lease rider. Ideally, for the franchisor, these rights will be set forth in a tri-party agreement among franchisor, landlord and tenant. If not set forth in a tri-party agreement and incorporated solely in the lease between landlord and tenant, franchisor should be expressly named as an intended third-party beneficiary, with the independent right to enforce the terms of the lease. The lease rider may contain some or all of the following:

1. **Lease Assignment**

The franchisor will want to include lease assignment rights in the lease or a rider to the lease. These types of provisions provide the franchisor an option to take an assignment of the franchisee’s lease in the event of a tenant default under the lease. The assignment right may also be triggered if the tenant fails to exercise a renewal option under the lease or if there is a default under the franchise agreement. It is critical that the franchisor make sure that it will still have the ample time to exercise the renewal option if the tenant fails to timely do so.

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⁴ California Business and Professions Code Section 16600 states: “Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.” **CAL. BUS. & PROF. CODE § 16600**.
Franchisors try to limit their liability in the event they assume the lease. For example, a franchisor will try to avoid the obligation to pay delinquent rent and other charges owed by the tenant at the time of assignment. Franchisors do so by attempting to cap the required cure amount at two months' rent or only requiring rental obligations incurred from 90 days following landlord's written notice of the tenant's default to franchisor. The franchisor will seek to include the right to receive written notice from the landlord when it provides notice of default to the tenant. Landlords resist these requests. They argue that a condition of assignment must include the cure of all outstanding defaults – monetary and non-monetary, and the obligation to provide additional notices and extended rights are unduly burdensome. Another contentious assignment issue is the franchisor's ability to designate a replacement franchisee and refranchise the unit, without the franchisor directly assuming the lease. Landlords justifiably seek to retain approval rights over who its tenant will be. Just because the franchisor approves the franchisee does not mean that the landlord will be satisfied with the designee's operational experience, character and creditworthiness, especially if units in the system are regularly refranchised – typically a bad sign. One way to address this conflict is to permit the pre-approval of a new franchisee that meets described net worth requirements or to limit assignment to an existing operator within the system who has a minimum number of years of experience.

However, a franchisor may face successor liability issues if it exercises its right to take an assignment of the lease and related operating assets. In addition to curing lease defaults, exposure may include third party liabilities, such as tax liabilities, utility charges, vendor liens and other obligations. These same concerns exist for the next franchisee as well. Research on applicable state successor liability laws is warranted to assess the risk of becoming responsible for the prior franchisee's liabilities. The practical issues of unpaid vendors continuing to deliver products, services and utilities to the premises, in light of delinquencies, should also be analyzed. Franchisors should consider whether the failure was more the result of poor operational performance than site selection or a negative change in the area, and whether the right replacement operator can be identified and timely inserted in the premises. A related issue is the importance of maintaining continuity of operations. If the tenant-franchisee is removed or has vacated the location, the franchisor will consider whether it is prepared to immediately take over, even if only on a temporary basis to ensure continuous operations until a more permanent operator is selected.5 Some franchisors are hesitant to place themselves into the chain of title, even for a short period of time, for the fear of successor liability. Where the franchisor places itself in the chain of title, franchisee's creditors may see a potential deep pocket for recovery, regardless of the merits of the claim.

2. Notice and Opportunity to Cure

A notice clause provides the franchisor with the right to receive copies of all written communications from the landlord at the same time the notice is sent to the tenant. This way, the franchisor may monitor the tenant's compliance with its lease. Coupled with a notice provision is the franchisor's opportunity to cure alleged defaults. Detailed provisions provide that if the notice involves a default, the landlord must advise the franchisor of the failure to cure before it may exercise its remedies. The franchisor may have an agreed upon period of time to effect a cure following receipt of the default notice. This cure right should be an option and not an obligation. If such cure is made by the franchisor, it should not be deemed to have assumed

the lease obligations unless it expressly agrees to do so in writing. Franchisors usually will not
step in to cure only technical defaults, as they are obviously more concerned where there is a
likelihood of the tenant’s default resulting in a termination of the lease. The right to receive
notice of default allows a franchisor to prevent the landlord from terminating the lease. By
curing a default giving rise to termination, a franchisor may avoid eviction and the prospect of a
replacement tenant capitalizing on its locational goodwill.

3. **Access to Protect System**

Most franchise agreements provide that the franchisor has the right to inspect the
franchised business to ascertain compliance with the franchise system’s requirements. To
bolster this right, the landlord is asked to acknowledge that the franchisor has the ability to gain
unrestricted access to the leased premises, without being guilty of trespass. This inspection
right is especially important if the franchise agreement has terminated or expired and the
franchisor needs to insure a proper de-identification of the premises, including the removal of its
marks, signage and fixtures. A sample provision is:

Upon expiration or termination of this Franchise Agreement, you must
cease using our trademarks and trade dress and make such alterations to
the franchised premises as we may require to meet this obligation. If your
fail to promptly comply with these requirements, we will have the right to
enter upon the franchised premises without being guilty of trespass or any
other tort, and without liability to you or your landlord, or any third party,
for the purpose of causing the changes required to comply with these
obligations, at your expense.

If a landlord agrees to this provision, it will typically require the franchisor to repair any
damage to the structure or other property caused by the franchisor’s entry and evidence of
appropriate insurance coverage. Some landlords will also permit entry only if the franchisor has
in fact assumed the lease obligations with permission. In any event, franchisors will want to
reserve the right to pursue the tenant for reimbursement resulting from any costs incurred from
franchisee’s failure to affect proper de-identification.

4. **Right to Receive Reports**

Some franchisors seek to obtain a franchisee’s revenue or sales information that may be
submitted to the landlord, although this is not a primary rider provision. If there is a percentage
rent clause in the lease, gross sales figures will be required to be submitted by the tenant to the
landlord to calculate the amount of the percentage rent. Franchisors appreciate an additional
check on the financial information being submitted from the tenant to the landlord to reconcile
against the reports it receives from the franchise in connection with payment of royalty fees
under the franchise agreement. This is an administratively cumbersome requirement for a
landlord and most are not willing to take on the responsibility of forwarding the gross sales
reports to the franchisor.

5. **Refranchising**

Franchisors, especially those who are not inclined to operate company-owned units,
seek to reserve the right to refinance a unit where the tenant has lost the right to occupy the
space, either through termination of the franchise agreement or the lease. As described in
Section II.B.1., disputes occur over the qualifications of the next franchisee who, according to
the landlord, should at least meet the same requirements as the originally approved franchisee.
The landlord will want to keep the franchisor on the hook for the lease obligations and will want to examine the experience and creditworthiness of the replacement franchisee. The franchisor, in turn, will want to be released from any obligations under the lease that arise after its assignment to a new franchisee, and will want the landlord to approve any franchisee, including those who have been pre-approved by the franchisor.

6. **No Amendment**

When expending considerable time and effort reviewing, negotiating and approving an acceptable form of lease and rider, the franchisor needs assurance that the lease cannot be amended – or at least not in any respect that may adversely affect its negotiated rights. Without a “no-amendment” provision, the protective rights could be undone without the franchisor’s knowledge. Further, the tenant may not be allowed to renew or terminate the lease, or extend or shorten the term without the franchisor’s consent. As discussed in Section II.A.6. above, franchisors require that the term of the lease (including renewal options) match the term of the franchise agreement to ensure that the franchisee has a physical location from which to operate during the entire franchise agreement term and preclude the tenant from being able to operate at the premises following expiration of the franchise agreement.

7. **No Other Assignments**

If the permitted use under the lease agreement is restricted to the operation of the franchised business, this provision is less important. However, a no assignment or subletting provision will preclude a tenant from assigning or subletting the leased premises, or any portion of it, to a third party without the prior written consent of the franchisor. Again, the franchisor will seek to prohibit the lease of the premises to a competitor who may capitalize on the locational goodwill.

III. **REAL ESTATE SPECIFIC FRANCHISE AGREEMENT TERMS**

A. **Lease Related Issues**

1. **Mandatory Lease Provisions**

Franchise agreements dictate certain required lease terms that must be contained in the franchisee’s lease in order for the franchisor to grant approval of the lease. The most popular mandatory lease provisions listed in a franchise agreement are lease assignment rights to franchisor, a lease term that matches the term of the franchise agreement and an appropriate permitted use provision. Some franchisors are more fastidious than others in reviewing leases for compliance. Attached at Appendix I is an example of a broad mandatory lease terms provision in a franchise agreement.

2. **Counsel and Negotiations of Lease**

Usually, the franchisee will negotiate the terms of its own lease, subject to the franchisor’s approval. Stronger systems have in-house or outside expertise to lend advice on negotiating points and techniques, including what may be considered market terms for economic and legal issues in the particular locale. The more the franchisor is involved in lease negotiations, the greater its risk of exposure in the event of failure. Some franchisors allow their own in-house or outside real estate attorneys to be engaged by the franchisee to assist in its lease negotiations, often at a fixed fee. In such case, counsel must carefully analyze the conflict of interest involved, make appropriate disclosures regarding representation and obtain
appropriate conflict waivers. There can be efficiencies when the franchisor’s real estate counsel negotiates the lease. For example, landlords appreciate receiving the tenant’s and franchisor’s lease comments at the same time. Landlords complain that after the lease has been painstakingly negotiated over the course of several months and at great expense, the franchisor chimes in with a host of additional issues. These new comments delay and complicate lease execution and therefore frustrate landlords. When lease comments are coordinated between tenant and franchisor through common real estate counsel, they may be sent contemporaneously to the landlord. Further, the coordinated process ensures that the franchisor lease rider provisions are properly handled. Franchisees, though, should be wary as to where the real estate attorney’s allegiance lies and allocation of negotiating chips. More time and negotiating capital may be expended on the lease rider for the benefit of the franchisor than is warranted, as opposed to negotiation of the lease provisions for the benefit of the franchisee.

3. **Review and Approval of Lease**

Real estate is approved by franchisors as to site selection and the form of the lease. The franchisee may be granted a license for a site that has been identified or it may have an area within which it needs to find a location acceptable to franchisor, within a set period of time. Real estate focused franchise systems have talented site selection specialists to assist with finding great locations. These professionals examine factors such as demographics, parking, competition, visibility, access, tenant mix and traffic patterns. Sophisticated software may be used to analyze the market and provide an opinion about the quality of the prospective site. Franchisees who file actions against their franchisors due to a lack of success will often claim that the franchisor set them up for failure by finding or approving a bad location. Most franchisors use disclaimer language attempting to limit exposure for its role in selecting a poor site. In order for a franchisor to avoid liability for poor site selection, it must follow its own stated guidelines. In *TCBY Systems, Inc. v. RSP Co.*, the franchisor disregarded its enumerated demographic guidelines when it approved a site its franchisee selected. In that case, the franchisor's employee who evaluated the proposed site was a manager without previous experience in conducting site evaluations. Moreover, the franchisor had a demographic report that showed that the location did not meet the minimum guidelines for site approval. Counsel for franchisees should expect to see franchisor disclaimers regarding the potential success of sites it approves. The more involved the franchisor is in selecting and leasing the site, the more likely exposure may exist for bad site selection. In *J&R Ice Cream v. California Smoothie*, even though the franchise documents disclaimed any representation of success based on the franchisor’s approval of the site, the court found the franchisor liable for negligently breaching its duty to select the site and negotiate the lease for the franchisee. In that case, the franchisor had in fact selected and leased the site, with the intent to sublet it to the franchisee.

When reviewing a lease for approval, the franchisor wants to know that the lease is fair, that it contains the provisions it requires and that its new franchisee will have the opportunity to succeed under the economics terms in the lease.

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6 *TCBY Sys. v. RSP Co.*, 33 F.3d 925, 928 (8th Cir. 1994).

7 *J & R Ice Cream Corp. v. California Smoothie Licensing Corp.*, 31 F.3d 1259 (3d Cir. 1994).
4. **Cross-Default with Lease**

In the event that there is a breach under the lease, franchise agreements usually deem such a breach a default under the franchise agreement. And if the franchisee loses its right to occupy the leased premises, it will be grounds for termination of the franchise agreement. An example of a franchise agreement's cross-default provision is: “If you breach or default under the Lease, or if we pay your landlord any money as a result of your breach of the Lease, then you will be in breach of this Franchise Agreement, and we will be entitled to possession of the leased premises, and to all of your rights, title and interest in the Lease, without limitation on any other remedies available to us under this Franchise Agreement, at law or in equity, or under any other agreements between you and us.”

5. **Alignment of Entities between Lease and Franchise Agreement**

An easily overlooked diligence item is confirmation that the tenant entity on the lease is the same entity that is the franchisee under the franchise agreement. From the franchisor's perspective, the same person or entity must be the tenant and the franchisee. Where the franchisee owns its own real estate, it is especially important that the franchisee entity and the real estate owner are the same entity. Sometimes they are not, and where there is a purchase option or a right of first refusal regarding the real estate in the franchise agreement to which the real estate owner is not a party, the rights may not be enforceable. For example, franchisees may seek to limit exposure by creating different entities to act as tenant and franchisee. In order for the franchisor to enforce all of its rights, it will want the ability to enforce against both the tenant entity and the franchisee entity. In that event, the franchisor will want to have the tenant entity guaranty the franchisee’s obligations under the franchise agreement by executing an unconditional guaranty of all of the franchisee’s obligations.

B. **Franchisee As Real Estate Owner**

Some larger franchisees own the real estate where the franchised business operates. They will want to retain the real estate after the franchised business no longer operates and will work hard to limit the post-term, non-compete provisions at the location. While most franchisees will not have the capital or the opportunity to own the real estate where the franchises business operates, for larger format concepts like stand-alone restaurants, which may operate on their own lots, or travel centers, which require several acres of space, franchisees may be well-served in owning the real estate. When considering the amount of rent to be paid to a third party over the term of a lease agreement and franchise agreement, owning the property may be less expensive. Given the size of the investment in the enterprise, it therefore may make economic sense to buy the real estate, an appreciating asset, and retain the right to earn income from the property after the franchise relationship ends. On the other side, the franchisor seeks to capitalize on the strength of its brand and will try to negotiate certain purchase rights for the valuable real estate.

1. **Right to Purchase and Right of First Refusal**

A right to purchase provides the franchisor with the option, at its election, to buy the real estate upon termination or expiration of the franchise agreement. This right is typically coupled with the right to buy the franchised business assets as well. Typically, the franchisor will have a time period within which it must decide whether it will exercise its option, like thirty or sixty days from expiration or termination. The most difficult provision to negotiate is the amount of the purchase price. There are myriad alternatives to arrive at a number, but they often involve the
concept of “fair market value” and use of qualified appraisers. The provisions should set forth any due diligence period and a date for closing, as well as condition of title to be delivered and closing deliveries. Attached at Appendix 2 is an example of a franchisor purchase right.

If the franchisor is unable to negotiate a purchase right, it may be able to extract a right of first refusal (“ROFR”) from the franchisee, which would allow the franchisor an opportunity to match any future purchaser’s offer to buy the franchisee’s real estate (and franchise assets). Rights of first refusal slow down the sales process and are burdensome from the franchisee’s perspective. A ROFR typically provides that if the franchisee decides to sell the real estate or the ownership interests in the owner entity of the real estate to a third party, it must provide a full copy of any such third party offer to the franchisor. The franchisor then has a period of time to purchase the property on the terms as set forth in the offer. If the franchisor fails to exercise its purchase right, the franchisee may only complete the sale if consummated within a set period of time and be on close (within around 10%) economic terms set forth in the offer presented to franchisor. And, if the franchisee fails to timely close on the original terms, then the ROFR process would repeat itself. Attached at Appendix 3 is an example of a franchisor ROFR. The franchisee will want to avoid a ROFR as it is cumbersome and slows down the sales process. Sometimes, as a compromise, the parties agree on a right of first offer where the franchisee would need to offer franchisor the right to purchase the real estate (and franchise assets) prior to soliciting offers on the open market.

Where the franchise agreement provides for a right of first refusal or a purchase option in favor of the franchisor, the franchisor may record a memorandum of such rights in the county records where the property is located. Placing third parties on notice through recording provides protection against the franchisee selling in violation of these rights.

Another issue to consider where a purchase right exists, is the franchisee’s mortgage loan encumbering its real estate. Presumably, the franchisee who owns its real estate borrowed money to purchase the property and that loan is secured by the real estate. That loan is also likely secured by franchisee’s other assets, the same assets which may be pledged under the franchise agreement. Many franchise agreements provide that although the franchisor is granted a security interest in the franchisee’s business assets, the franchisor will subordinate its lien rights to a franchisee’s lender. In order to clarify the respective rights of the franchisor and lender, the parties may enter into a subordination or recognition agreement (the “Subordination Agreement”). Under the Subordination Agreement, the franchisor will subordinate its rights in the franchisee’s collateral to the lender, and the lender will recognize franchisor’s purchase rights. If the franchisor exercises its purchase rights, it unconditionally agrees to make payment to a lender designated account. The lender then would remit excess funds over the outstanding balance to be paid to the franchisee. Further, the lender agrees to provide written notice to the franchisor before defaulting the franchisee, with the franchisor having extended cure rights. The franchisor may also be able to negotiate the purchase right surviving a lender’s foreclosure for, say, twenty days after the later of (i) franchisee’s right of redemption, or (ii) transfer of a foreclosure deed to the lender.

2. **Right to Lease**

If the franchisee has the leverage to avoid granting any purchase rights, the franchisor may be able to obtain a right to lease the franchisee’s real estate following expiration or

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8 See Huddle House, Inc. v. RPB Enterprises, Inc., infra note 133, for an example of the thorniness of determining purchase price.
termination. The franchisee may appreciate receiving a steady stream of rental income after operating the franchised business for many years and therefore may be willing to grant this right. Alternatively, the franchisee may view the franchise relationship as temporal and want to reserve the right to lease to the best user, not necessarily the franchisor or its designee. Furthermore, it is an uncomfortable situation where the franchise relationship ends badly, but the parties must continue on in a landlord/tenant relationship. From the franchisor’s perspective, it may want to maintain the locational goodwill and does not want to see its favorable sites in the hands of a competitor. As discussed in Section IV.D., courts will generally enforce such rights.

C. Franchisor As Real Estate Owner or Sublessor

Section II addresses the situation where the real estate owner is an unrelated third party leasing space to the franchisee. Section III.B. discusses the scenario where the franchisee owns the real estate. This Section briefly describes pertinent issues where the franchisor is also the landlord. A franchisor may choose to directly control the real estate where it has the financial capacity to do so. This will permit it to avoid the uncertainty in taking back the unit if its franchisee fails. The costs for direct control are high in terms of dollars and contingent liabilities. When the franchisor is also the landlord, courts have treated the franchise agreement and lease agreement as a single, indivisible agreement complicating termination issues.

When there is a termination of a lease that effectively terminates the franchise agreement, the franchisor must comply with applicable relationship statutes. In Southland Corp. v. Pulsirisaroth, Southland filed an action seeking judgment that it was entitled to possession of the franchised locations after defaults by the franchisee under its leases for the franchised businesses. In dismissing the action, the court reasoned that a landlord/franchisor may not sue for possession until notice and opportunity to cure was provided to the franchisee in accordance with the District of Columbia Franchising Act of 1988 (since repealed) relationship law.

Connecticut’s franchise statute is an example of a franchise relationship law that directly addresses the scenario where the terminating franchisor is also the landlord terminating a lease with the franchisee. This statute, like many other relationship laws, provides that a franchise may not be terminated without sixty days’ notice and may only be terminated for good cause. If the franchise being terminated is operated on premises leased by the franchisor, in order to also terminate the lease, the notice must follow the specifications set forth in the statute, including rules for service and disclosures.

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9 See Kathryn Kotel, Mark D. Shapiro and Joseph J. Fittante, Field of Dreams: Controlling the Real Estate, ABA 26th Annual Forum on Franchising (2003) for an in-depth discussion of franchisor direct control of real estate.

10 See e.g., In re Karfakis, 162 B.R. 719 (E.D. Pa. 1993) (holding that where a franchise agreement was terminated prior to the filing of a bankruptcy petition, but the lease agreement was not, one indivisible agreement could be assumable on a post-petition basis); In re Maxwell, 40 B.R. 231 (N.D. Ill. 1984) (holding that termination of the sublease would also serve to terminate the franchise agreement because of their functional interdependence). Compare In re 717 Grad Street Corp., 259 B.R. 1 (E.D. N.Y. 2000) (holding that the lease and franchise agreement are not a single indivisible agreement, where franchisor and lessor were separate legal entities and the two agreements were executed 10 years apart).


Before taking action to terminate a franchisee who is leasing property from the franchisor, the franchisor must analyze the state relationship laws on restrictions regarding lease termination. The franchisor should also be prepared to absorb the financial burden of the non-payment of rent during a long notice and cure period and the pendency of an eviction proceeding. Section IV.F. describes the traps franchisors may face when acting as landlord through case studies.

IV. ENFORCEMENT OF FRANCHISOR’S LEASE AND FRANCHISE AGREEMENT RIGHTS

A. Lease Assignment Upon Termination of Franchise Agreement

The seminal case on franchisor lease assignments is Snelling and Snelling, Inc. v. Martin where the court enforced provisions in three franchise agreements requiring the franchisee to assign its leases to the franchisor upon termination of the franchise agreement.13 In doing so, the court flatly rejected the franchisee’s arguments that the assignment provisions should not be enforced because they were “punitive and would serve no useful purpose.”14 The court also found that the franchisor presented evidence that “it would suffer irremediable loss of locational goodwill if the injunction were not entered,” finding that the loss of goodwill “is often held to be irreparable.”15 The court explained: “[t]he lease assignment provision in this case is apparently intended to allow [the franchisor] to retain clients who are familiar with the precise location of the business; if defendants remain in the premises and [the franchisor] is forced to operate elsewhere, it loses the intangible benefit of that location.”16 Accordingly, the court ordered the franchisee to assign its leases to the franchisor.

A similar result occurred in JTH Tax, Inc. v. Aime.17 In that case, franchisor JTH Tax, Inc. sued several franchisees over nine franchise agreements for tax preparation services in New York. Upon the IRS revoking the franchisees’ EIN numbers, the franchisor terminated the franchise agreements for the franchisees’ material breach.18 The parties then entered into a Purchase and Sale Agreement that terminated the franchise agreements and set forth the franchisees’ post-termination obligations.19 The franchisor sought injunctive relief against the franchisees for their failure to (among other things) assign the leases for the franchise locations to the franchisor.20

In finding in favor of the franchisor, the court found that the franchisees had in fact violated their post-termination obligation to assign their leases to the franchisor.21 In finding

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14 Id. at *4.
15 Id. (internal quotations and citation omitted).
16 Id.
18 Id. at *1.
19 Id.
20 Id.
21 Id. at *2.
likelihood of irreparable harm, the court determined that the franchisees’ control of the franchise locations “misuses [the franchisor’s] trademarks and violates the non-compete provisions in the agreements, demonstrating irreparable harm.”\textsuperscript{22} The court also found that the franchisees’ “ongoing interference at the franchise locations not only violates the post-termination obligations in the franchise agreements, but impacts plaintiff’s ability to adequately operate its tax preparation business.”\textsuperscript{23} After finding the balance of equities also tipped in the franchisor’s favor and that it served the public interest to require that the franchisees comply with their post-termination obligations, the court ordered the franchisees to (among other things) assign all the leases and corresponding telephone numbers for the franchise locations to the franchisor.\textsuperscript{24}

Where a landlord agrees that it will not unreasonably withhold its consent to a tenant’s assignment of a lease, the landlord must abide by that agreement and cannot withhold its consent based on arbitrary reasons. This was the conclusion of the Tennessee Court of Appeals in \textit{Shree Krishna, LLC v. Broadmoor Investment Corp.}\textsuperscript{25} Although not a case where a franchisor was seeking to enforce its assignment rights, this case is still instructive on interpretation of lease assignment provisions. In \textit{Shree Krishna}, a franchisee leased property from a landlord for a Quizno’s sub shop franchise. The lease was for an initial term of five years and included a renewal option to extend the term of the lease for two additional five-year periods.\textsuperscript{26} The lease prohibited the assignment of the renewal option.\textsuperscript{27}

Quizno’s required the franchisee to include an addendum (the “Quizno’s Addendum”) to the lease.\textsuperscript{28} The Quizno’s Addendum stated that it overrode any contrary provisions in the body of the lease, and permitted the franchisee to assign the lease.\textsuperscript{29} With respect to the assignment, the Quizno’s Addendum provided that the lease was assignable, including any options to extend the term of the lease.\textsuperscript{30} The franchisee had the right to assign the lease to Quizno’s without the landlord’s consent, and also permitted the franchisee to assign the lease to another Quizno’s franchisee “with Landlord’s consent not to be unreasonably withheld or delayed.”\textsuperscript{31} Both the landlord and the franchisee signed the Quizno’s Addendum, and it was part of the original lease.\textsuperscript{32}

\begin{thebibliography}{9}
\bibitem{22} \textit{Id.}
\bibitem{23} \textit{Id.}
\bibitem{24} \textit{Id. at *3.} The court declined to extend the injunctive relief to two of the franchise locations where the franchisees had previously obtained a temporary restraining court in a New York state court enjoining the franchisor from interfering with those locations. \textit{Id. at *3 n.2.}
\bibitem{26} \textit{Id. at *1.}
\bibitem{27} \textit{Id.}
\bibitem{28} \textit{Id.}
\bibitem{29} \textit{Id.}
\bibitem{30} \textit{Id. at *2.}
\bibitem{31} \textit{Id.}
\bibitem{32} \textit{Id.}
\end{thebibliography}
Several years into the five-year lease, the franchisee decided to sell the franchise and found a buyer.\textsuperscript{33} The sale of the business was made contingent upon the assignment of the lease.\textsuperscript{34} The franchisee sought the landlord’s consent to assign the lease to the new Quizno’s franchisee, but the landlord initially stated that, with only 10 months remaining on the initial term of the lease, it was not required to give its consent to the assignment and disputed that the renewal provisions of the lease could be transferred citing to the body of the lease.\textsuperscript{35} The landlord then sought to negotiate directly with the prospective buyer for a new lease, but these negotiations led to a stalemate.\textsuperscript{36} The prospective buyer then withdrew its offer to purchase the franchise, forcing the franchisee to sell the franchise at a reduced price.\textsuperscript{37} The franchisee then sued the landlord for breach of contract, contending that the landlord unreasonably withheld its consent to the original proposed assignment, causing damages in the form of a reduced purchase price.

The trial court held in favor of the franchisee after a bench trial. In affirming the trial court’s judgment, the appellate court held that “a landlord cannot withhold consent based on personal whim, taste, or other arbitrary reasons, or on convenience or sensibility, or to extract an economic concession.”\textsuperscript{38} Rather, “in determining whether to consent to the assignment, the landlord must focus on whether the proposed assignee poses financial or other risks.”\textsuperscript{39} The court found it was unreasonable for a landlord to refuse consent to an assignment to try to make a better deal for itself.\textsuperscript{40} In this case, the court found that:

\begin{quote}
a contract term giving Landlord the right to withhold consent on a reasonable basis does not provide Landlord with an opportunity to force the assignee into renegotiating the terms of the Lease or to extract an economic concession from the assignee. Nor was Landlord permitted to withhold consent based on personal whim or taste, or on the perception that the assignee was ‘difficult’ to work with on a personal level.\textsuperscript{41}
\end{quote}

Accordingly, the appeals court agreed that the landlord breached the lease when it withheld its consent to the assignment to the prospective buyer.

Lease assignment rights sometimes cause unintentional lease obligations for franchisors, who may be deemed successors. The Texas appellate court’s decision in \textit{Cottman Transmission Systems, LLC v. FVLR Enterprises} demonstrates how a franchisor may become liable under a franchisee’s lease, despite the fact that the franchisor is not a party to the lease.\textsuperscript{42}

\textsuperscript{33} \textit{Id.} at *3.
\textsuperscript{34} \textit{Id.}
\textsuperscript{35} \textit{Id.}
\textsuperscript{36} \textit{Id.}
\textsuperscript{37} \textit{Id.} at *4.
\textsuperscript{38} \textit{Id.} at *13 (internal quotations and citations omitted).
\textsuperscript{39} \textit{Id.} (internal quotations and citations omitted).
\textsuperscript{40} \textit{Id.}
\textsuperscript{41} \textit{Id.}
In *Cottman*, a franchisee entered into a lease agreement to operate a transmission repair shop under the Cottman Transmission Systems franchise system. The franchisee and the landlord also executed a lease rider, upon the insistence of Cottman, giving Cottman the option to assume the lease either upon its termination or expiration.

The franchisee abandoned the leased premises in early March of 2003, and the landlord informed Cottman of the franchisee’s abandonment. Cottman then terminated the franchisee’s licensing agreement, sent a representative to the premises to manage the repair shop on an interim basis, and paid one month’s rent. Shortly thereafter, Cottman moved out of the premises. The landlord then sued Cottman for breach of contract, promissory estoppel, fraud, and negligent misrepresentation. After a jury found in favor of the landlord, the franchisor appealed, arguing that it was not bound by the franchisee’s lease agreement nor lease rider and that the jury had been improperly instructed on partial performance.

In affirming the jury’s award to the landlord, the Texas appellate court found that while the lease agreement and the lease rider were subject to the statute of frauds, the doctrine of partial performance would avoid the statute of frauds. The court found not only was Cottman a beneficiary of the lease rider, but that the evidence was sufficient for the jury to find that Cottman assumed the lease. On that point, the court found that Cottman paid rent to the landlord within the 30-day period it had under the lease rider to assume the lease and that payment of that rent “was a good indication that Cottman was assuming the lease.” The court also considered that Cottman “accepted the premises after the locks were changed, placed a manager at the premises to run the shop, secured water and electricity from the City of Irving in its name, entered into service contracts with local vendors, purchased equipment and had it installed at the premises, and conducted its transmission repair business with the public at the premises” in affirming the jury’s award.

**B. Franchisor’s Right of First Refusal to Assume Lease**

Instead of requiring a franchisee to assign its lease to the franchisor upon termination of the franchise agreement, a franchise agreement may provide the franchisor with the right of first refusal to assume the franchisee’s lease in the event the franchise agreement is terminated.

The facts in *Pearle Vision, Inc. v. Adler* illustrate why it is of utmost importance for franchisors to review a franchisee’s lease if the franchise agreement provides for such a right of

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43 *Id.* at 375.
44 *Id.*
45 *Id.*
46 *Id.*
47 *Id.*
48 *Id.* at 375-76.
49 *Id.* at 376.
50 *Id.* at 377.
51 *Id.* at 378.
52 *Id.* at 379.
first refusal.\textsuperscript{53} In this case, franchisor Pearle Vision sought a preliminary injunction from the court after its franchisee continued to operate a Pearle Vision store after termination of the franchise agreement. At the time the parties signed the franchise agreement, Pearle Vision had a lease for the Jackson Heights, New York location, which it sublet to its franchisee.\textsuperscript{54} Approximately one year before the franchise agreement and sublease were set to expire, Pearle Vision implemented a system-wide policy requiring franchisees to enter into direct lease agreements with property owners.\textsuperscript{55} Pearle Vision informed the franchisee that he would be required to negotiate a direct lease with the property owner of the Jackson Heights location before Pearle Vision would renew his franchise agreement.\textsuperscript{56}

The franchisee complied with Pearle Vision’s request and, several months prior to the expiration of the franchise agreement, entered into an Assignment, Consent and Modification Agreement with the landlord, whereby Pearle Vision’s lease was assigned to the franchisee.\textsuperscript{57} Shortly after assuming the lease, the franchisee informed Pearle Vision that he did not intend to renew the franchise agreement and, instead, intended to operate an independent optical store out of the Jackson Heights location.\textsuperscript{58} Pearle Vision then sued the franchisee, seeking injunctive relief on the grounds that the franchise agreement permitted Pearle Vision to assume the franchisee’s lease because the franchise agreement was expiring.\textsuperscript{59} After learning that the franchisee intended to assign the lease to a third party, Pearle Vision moved for both a temporary restraining order and preliminary injunctive relief.

Ultimately the court granted Pearle Vision’s request for injunctive relief, preliminarily enjoining the franchisee from assigning the Jackson Heights lease to any third party prior to offering to assign the lease to Pearle Vision.\textsuperscript{60} But an issue highlighted by the court in its decision was the fact that the lease assignment between the franchisee and the landlord provided that “[t]here shall be no further assignments of the Lease or sublettings without the express written consent of the Landlord, as set forth in the Lease.”\textsuperscript{61} This language conflicted with language in the franchise agreement that required any lease between the franchisee and a landlord to permit Pearle Vision to assume the lease upon termination or expiration of the franchise agreement.\textsuperscript{62}

Recognizing that the landlord was not a party to the franchise agreement, the court found that the landlord was not bound by the provisions in the franchise agreement requiring the landlord to give its consent to Pearle Vision’s assumption of the franchisee’s lease.\textsuperscript{63} Because


\textsuperscript{54} Id. at *1.

\textsuperscript{55} Id.

\textsuperscript{56} Id.

\textsuperscript{57} Id.

\textsuperscript{58} Id. at *2.

\textsuperscript{59} Id.

\textsuperscript{60} Id. at *8.

\textsuperscript{61} Id. at *4.

\textsuperscript{62} Id.

\textsuperscript{63} Id. at *6.
Pearle Vision, who was a signatory of the lease assignment agreement, failed to ensure that the terms from the franchise agreement were included in the lease assignment, the court found that Pearle Vision had a right to assume the lease but that right was conditioned upon the landlord’s approval.\textsuperscript{64} Thus, while the court enjoined the franchisee from assigning the lease without first offering to assign the lease to Pearle Vision, the court recognized that if the landlord failed to approve the assignment to Pearle Vision within thirty days of the franchisee’s request, the franchisee was free to assign the lease to a third party or to remain in possession of the premises.\textsuperscript{65} This case is an example of a franchisor failing to reconcile inconsistent lease and franchise agreement terms.

C. Franchisor’s Right to Notice of Franchisee’s Default

Section II.B.2 discusses the importance of the franchisor receiving notice and an opportunity to cure its franchisee’s default, and thus preserve a great location. The court in \textit{Galardi Group Franchise and Leasing, LLC v. Barstow Town Square} examined the potential effects of corporate restructuring during the term of a lease and franchise agreement.\textsuperscript{66} In \textit{Galardi}, the franchisee leased a commercial property to operate a Der Wienerschnitzel franchise from the predecessors in interest of Barstow Town Square, LLC (“Barstow”). Mohan’s (the franchisee) lease agreement only identified the franchisor as “Der Wienerschnitzel” and did not specify “who owned and franchised the Der Wienerschnitzel brand” at the time the franchise agreement was executed.\textsuperscript{67} The lease agreement provided that the landlord was to send copies of any notices to Der Wienerschnitzel at the same time any such notices were sent to Mohan. However, the lease failed to identify a notice address for Der Wienerschnitzel. The lease further allowed Der Wienerschnitzel the right “to cure any default under the lease” and “to assume [Mohan’s] occupancy rights...upon [Mohan’s] default or termination under” the lease.\textsuperscript{68}

The lease prohibited the franchisee from assigning its interest in the lease to a third party without written consent of the landlord. The landlord was prohibited from unreasonably withholding or denying its consent to any assignment so long as Der Wienerschnitzel consented to the assignment, the assignee consented in writing to be bound under the lease and, “to [the landlord’s] reasonable satisfaction,” the assignee (i) had “prior experience operating a full service restaurant,” (ii) had “adequate financial resources to meet the obligations of a tenant under the lease,” and (iii) had “the ability to reinvest sufficient capital from time to time in order to maintain the quality, level of service, character and condition of the business operated” at the property.\textsuperscript{69}

With the consent of the landlord, the franchisee assigned its interest in the lease to Rosa Jun (“Jun”). At that time, “an entity called Galardi Group Franchise Corp. (“Galardi Franchising”) was in charge of granting franchises for [Der Wienerschnitzel], while an entity called Galardi Group Franchise & Leasing, LLC (“Galardi Leasing”) was in charge of overseeing a franchise

\begin{itemize}
\item \textsuperscript{64} \textit{Id.}
\item \textsuperscript{65} \textit{Id.} at *8.
\item \textsuperscript{66} \textit{Galardi Grp. Franchise & Leasing, LLC v. Barstow Town Square, LLC}, No. E064289, 2016 WL 4733231 (Cal. Ct. App. Sept. 12, 2016). This appeal was ultimately dismissed due to the parties settling prior to the entry of an opinion.
\item \textsuperscript{67} \textit{Id.} at *1.
\item \textsuperscript{68} \textit{Id.} at *2 (Capitalization altered).
\item \textsuperscript{69} \textit{Id.}
\end{itemize}
after it was granted.”

Galardi Franchising and Galardi Leasing were both owned by an entity named Galardi Group, Inc. At the time of the assignment of the lease to Jun, Galardi Franchising, Galardi Leasing, and Jun entered into a franchise agreement. The franchise agreement defined Galardi Franchising as the franchisor and Galardi Leasing as “Service LLC.” Galardi Franchising was responsible for the initial establishment and training of the Jun franchise, while Galardi Leasing was responsible for continued training, oversight, and collection of franchise fees.

Approximately eight years after the execution of the Jun franchise agreement, Barstow purchased the property from its predecessor in interest. Shortly thereafter, it sent a 30-day default notice to Jun. The landlord did not send notice to Galardi Franchising, Galardi Leasing, or Galardi Group. After failing to cure the default, the landlord filed for and received an unlawful detainer in its favor. Jun notified Galardi Leasing, who contacted Barstow. Galardi Leasing and Barstow agreed to extend the deadline for Barstow to evict Jun from the premises. Before that time expired, Galardi Leasing cured the default. Despite this, Barstow maintained it was still entitled to evict Jun. Galardi Leasing filed suit against the landlord for breach of contract and specific performance. Additionally, Galardi Leasing filed a motion for preliminary injunction.

The court found that “when the lease referred to ‘Der Wienschnitzel’ or ‘Franchisor,’ it meant the entity that was the Der Wienschnitzel franchisor at any relevant time.” The court pointed out that the parties’ use of the generic term “Franchisor” appeared to contemplate a company’s potential to “go through all sorts of corporate reorganizations—particularly over the life of a 25-year lease.” The court further noted that while Galardi Leasing may not have been defined as a party to the contract, it was a third-party beneficiary and, as such, was not required to give consideration in order to be benefited by the contract. The court held that, “while the lease did not expressly give the franchisor a right to cure for the benefit of the [existing] tenant, the franchisor’s right to notice, when combined with the tenant’s right to cure, gave the franchisor this right impliedly.” The court saved the franchisor from a bad result, which could have easily occurred due to inartful drafting.

D. Franchisor Right to Lease from Franchisee Upon Termination of Franchise Agreement

Section III.B.2 discusses a franchisor’s right to cause its franchisee/real estate owner to lease the site to the franchisor upon termination or expiration of the franchise agreement. Dunkin’ Donuts Inc. v. Taseski provides an example of enforcement of these provisions. There, the defendants were operators of a Dunkin’ Donuts franchise in Michigan who also owned the premises where the store was located. In addition to the franchise agreement, the parties also executed a lease option agreement, giving Dunkin’ Donuts thirty days after the termination of the franchise agreement to notify the franchisee that it wished to exercise its

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70 Id. at *1.
71 Galardi Leasing also filed an application for temporary restraining order, which was granted by the trial court.
72 Id. at *6.
73 Id. at *5.
74 Id. at *7.
rights under the lease option agreement. If Dunkin’ Donuts exercised its rights, the franchisee agreed that it would then execute a lease for the premises and deliver possession of the premises to Dunkin’ Donuts. The franchisee defaulted under the franchise agreement, and Dunkin’ Donuts ultimately terminated the agreement. Within thirty days of terminating the franchise agreement, Dunkin’ Donuts sent the franchisee a notice of election under the lease option agreement. After the franchisee failed to execute a new lease and surrender possession of the premises, Dunkin’ Donuts sued the franchisee seeking specific performance of the lease option.

Ultimately, the court granted Dunkin’ Donuts the requested specific performance, requiring the franchisee to comply with the terms of the lease option agreement. The court found that specific performance was appropriate, “especially due to [the franchisee’s] failure to abide by their promise to lease the shop to [the franchisor] upon termination of the franchise agreement.” The court found that Dunkin’ Donuts showed that “an inability to preserve the goodwill already accumulated at the location would result in irreparable harm to [it].” This case is another example of a court recognizing a franchisor’s protectable interest in the brand’s locational goodwill.

E. Franchisor Access to De-Identification Rights

Section II.B.3 discusses the importance of protecting the brand and especially the system’s marks and reputation. The court in American Dairy Queen Corporation v. YS & J Enterprises, Inc. granted injunctive relief to Dairy Queen when a franchisee continued to use Dairy Queen® and Orange Julius® trademarks after Dairy Queen terminated YS & J’s franchise agreement for failure to cure a default. The parties ultimately entered into a Mutual Cancellation and Release of the franchise agreement. After the termination of the franchise agreement, the franchisee continued to operate as a Dairy Queen®/Orange Julius® store and continued to display Dairy Queen’s signs, proprietary products, and other materials.

In determining whether a preliminary injunction was warranted, the court examined the following factors that the moving party must establish: (1) a clear showing that it will likely succeed on the merits; (2) a clear showing that it is likely to be irreparably harmed absent

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76 Id. at 869.
77 Id.
78 Id.
79 Id.
80 Id. at 878.
81 Id.
82 Id.
84 Id. at *1.
85 Id. at *1.
preliminary relief; (3) the balance of equities tips in favor of the moving party; and (4) a preliminary injunction is in the public interest.\textsuperscript{86}

As to Dairy Queen’s likelihood of success on the merits of its trademark infringement claim, the court recognized, with respect to a holdover franchisee,

\textit{[t]here is a high risk of consumer confusion when a terminated franchisee continues to use the former franchisor’s trademarks. Consumers will associate the trademark with the registrant and assume that they are affiliated. Any shortcomings of the franchise would therefore be attributed to the franchisor . . . . Because of this risk, many courts have held that continued trademark use by one whose trademark license has been canceled satisfies the likelihood of confusion test and constitutes trademark infringement.}\textsuperscript{87}

Based on the undisputed evidence submitted by Dairy Queen—clearly showing the franchisee continuing to use without authorization the Dairy Queen\textsuperscript{®} and Orange Julius\textsuperscript{®} trademarks while operating the store—the court found that Dairy Queen established a likelihood of success on the merits of its trademark infringement claim.\textsuperscript{88} The court also found that Dairy Queen showed a likelihood of success on the merits of its breach of contract claim based on the post-termination obligations agreed to by the franchisee and the non-compete provision in the franchise agreement.\textsuperscript{89}

The court further found that Dairy Queen would suffer irreparable harm without court intervention.

\textit{‘[D]efendants’ unauthorized use of plaintiff’s trademarks gives rise to irreparable injury, in that plaintiff has lost control of its business reputation to this extent, there is a substantial likelihood of confusion of the purchasing public, there may be no meaningful monetary recovery available, and there is an inherent injury to the good will and reputation of the plaintiff. Such infringement is difficult to quantify and thus lends itself to injunctive relief.’}\textsuperscript{90}

As to the balance of equities, the court did recognize that the defendants might suffer some financial loss as a result of the entry of a preliminary injunction, but found this harm “largely self-inflicted.”\textsuperscript{91} As the defendants willingly entered into the Mutual Cancellation and Release, the court found it was “not unjust to hold [the] defendants to these mutually agreed

\begin{footnotesize}
\begin{enumerate}
\item Id. at *2 (internal quotations omitted).
\item Id. at *2 (internal quotations omitted) (quoting Merry Maids Ltd. P’ship v. Kamara, 33 F. Supp. 2d 443, 445 (D. Md. 1998)).
\item Id. at *3.
\item Id. at *3.
\item Id. at *4 (quoting Merry Maids, 33 F. Supp. 2d at 445).
\item Id. at *4.
\end{enumerate}
\end{footnotesize}
upon obligations, particularly when weighed against the harm [the] plaintiff is suffering from the continued, unauthorized operation of the Store with its trademarks.\(^9\)

Finally, the court held that the public interest also favored granting the requested injunctive relief.

'Preventing infringement and enforcing legitimate non-compete obligations serves the public interest in preventing consumer confusion. A licensee or franchisee who once possessed authorization to use the trademarks of its licensor or franchisor becomes associated in the public’s mind with the trademark holder. When such party, as defendants here, loses its authorization yet continues to use the mark, the potential for customer confusion is greater than in the case of a random infringer. Consumers have already associated some significant source identification with the licensor. In this way the use of a mark by a former licensee confuses and defrauds the public.'\(^9\)

F. Franchisor as Landlord and Cross-Default

Franchisors who lease property to franchisees may include language in the franchise agreement indicating that breach of the sublease also constitutes a breach of the franchise agreement, entitling the franchisor to terminate both the sublease and the franchise agreement solely for the franchisee’s failure to pay rent (or other breach of the sublease). In IHOP Franchising, LLC v. Tabel, IHOP sought injunctive relief from the court after IHOP terminated a franchise agreement for a franchisee that was subleasing the restaurant premises and equipment from IHOP.\(^9\) IHOP terminated the franchise agreement, sublease, and equipment lease after the franchisee gave notice of its intent to assign the franchise agreement to a third party and then refused to recognize IHOP’s exercising of its right of first refusal under the franchise agreement to acquire the restaurant on the terms provided in the assignment agreement.\(^9\) Despite this, the franchisee continued to operate the restaurant as an IHOP and also continued using IHOP’s trademarks.

Ultimately the court found that IHOP was entitled to the injunctive relief it sought, including requiring the franchisee to immediately surrender to IHOP possession of the restaurant premises and the inventory, trademarks, service marks, logos, signs, marketing materials, and proceeds of the restaurant.\(^9\) Using the traditional four-factor test for a request for preliminary injunctive relief, the court found that IHOP presented evidence sufficient to show that it was likely to succeed on the merits of its breach of contract and trademark infringement claims against the franchisee.\(^9\) This was due to the court’s finding that IHOP had properly terminated the franchise agreement based on the franchisee’s failure to honor IHOP’s right of

\(^9\) Id. at *4.
\(^9\) Id. at *4 (quoting Merry Maids, 33 F. Supp. 2d at 446).
\(^9\) Id. at *5.
\(^9\) Id. at *13.
\(^9\) Id. at *6-10.
first refusal and the franchisee’s assignment of his rights in the franchise agreement without IHOP’s consent—both of which were incurable breaches of the franchise agreement. With respect to the trademark infringement claim, the court found the franchisee’s continued, unauthorized use of IHOP’s marks would likely cause consumer confusion and, thus, constituted trademark infringement under the Lanham Act.

Given the strong evidence that IHOP was entitled to terminate the franchise agreement, sublease, and equipment lease based on the franchisee’s conduct, the court found that the other three factors—incurable breaches of the franchise agreement, irreplaceable harm, balance of hardships, and public interest—all went in favor of issuing the requested injunctive relief. The driver in the court’s analysis was the strong likelihood of confusion if the franchisee was permitted to continue operating as an IHOP restaurant and the lack of evidence that the franchisee was legally permitted to do so.

Similar facts were also present in Dunkin’ Donuts Franchising, LLC v. Claudia I, LLC. In Claudia I, the court found in favor of franchisor Dunkin’ Donuts on its claims of breach of contract against a franchisee for, among other things, the franchisee’s failure to pay rent, which permitted Dunkin’ Donuts to terminate the franchise agreement. Specifically, the court found that the franchisee’s failure to pay rent was a default under the sublease between Dunkin’ Donuts and the franchisee. The franchise agreement provided that upon the franchisee’s loss of “the use and enjoyment of the premises before the end of the Term [of the franchise agreement], this [franchise] Agreement will automatically terminate without further notice.” Thus, the franchisee’s breach of the sublease permitted Dunkin’ Donuts to immediately terminate the franchise agreement.

Another example of a lease termination as a result of a franchise agreement breach is 7-Eleven, Inc. v. Spear. In Spear, franchisor 7-Eleven, as owner, leased the franchise premises to its franchisee, Spear, in connection with the franchise agreement, along with the fixtures, equipment, and signs needed to operate the store. 7-Eleven also provided financing to the franchisee, including financing for the store’s inventory. The franchisee’s store inventory and other assets were subject to a perfected security interest in 7-Eleven’s favor, securing the indebtedness of the franchisee to 7-Eleven. The franchise agreement required the franchisee to maintain a minimum of $15,000 financial net worth in the store at all times and stated that failure to do so was a material breach.

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98 Id. at *8.
99 Id. at *10.
100 Id. at *11-13.
102 Id. at *6.
103 Id. at *7.
105 Id. at *1.
106 Id.
107 Id.
of the agreement.\textsuperscript{108} The franchise agreement provided that upon termination of the agreement for cause, the franchisee agreed to (among other things) immediately surrender possession of the premises.\textsuperscript{109}

Approximately one year after execution of the franchise agreement, the franchisee’s net worth fell below the $15,000 minimum requirement.\textsuperscript{110} Six months later, after several more instances of the franchisee’s failure to maintain the $15,000 net worth, 7-Eleven terminated the franchise agreement.\textsuperscript{111} After the franchisee failed to surrender possession of the store, 7-Eleven filed suit in federal court seeking injunctive relief.\textsuperscript{112}

In granting 7-Eleven the requested preliminary injunctive relief, including requiring the franchisee to immediately surrender possession and control of the premises, the court found that all four factors analyzed for preliminary injunctive relief—likelihood of success on the merits, lack of an adequate remedy at law/irreparable harm, the balance of equities, and the public interest—weighed in favor of granting the requested relief.\textsuperscript{113} Specifically, with regard to the irreparable harm on 7-Eleven’s trademark infringement claim, the court noted that

\begin{quote}
[t]his willingness to find irreparable harm in trademark cases stems from an understanding that the “most corrosive and irreparable harm attributable to trademark infringement is the inability of the victim to control the nature and quality of the defendants’ goods. Even if the infringer’s products are of high quality, the plaintiff can properly insist that its reputation should not be imperiled by the acts of another.”\textsuperscript{114}
\end{quote}

The court further found that, “if deprived of its contractual right to possession of the Store during the pendency of the litigation, 7-Eleven could lose the customers and goodwill associated with that location.”\textsuperscript{115}

In balancing the harms, the court rejected the franchisee’s argument that the denial of the franchisee’s ability to continue operating the store and earn profits during the pendency of the litigation outweighed the franchisor’s interests. Specifically, the court found that the lost profits that the franchisee may suffer “merit little equitable consideration since they are not entitled to profits garnered from the misrepresentation of their status” as a franchisee.\textsuperscript{116} On the other hand, the court recognized that “the customer confusion, dilution of trademark, and loss of goodwill that 7-Eleven is presumed to suffer due to [the franchisee’s] post-termination use of 7-Eleven’s Marks and property threaten irreparable harm to 7-Eleven.”\textsuperscript{117} The court found that

\begin{itemize}
\item \textsuperscript{108} Id. at *2.
\item \textsuperscript{109} Id.
\item \textsuperscript{110} Id.
\item \textsuperscript{111} Id.
\item \textsuperscript{112} Id.
\item \textsuperscript{113} Id. at *4-8.
\item \textsuperscript{114} Id. at *6 (quoting Int’l Kennel Club of Chi., Inc. v. Mighty Star, Inc., 846 F.2d 1079, 1092 (7th Cir. 1988)).
\item \textsuperscript{115} Id. at *6.
\item \textsuperscript{116} Id. (alteration, internal quotations, and citation omitted).
\item \textsuperscript{117} Id. at *7.
\end{itemize}
this harm also ultimately harms 7-Eleven’s other franchisees. In sum, the court found that, “applying the sliding scale as would a chancellor in equity,” 7-Eleven made a “sufficiently strong and clear showing of entitlement to immediate equitable relief in the circumstances” of the case.

G. **Lender Rights to Lease**

The Indiana Court of Appeals’ decision in *Merrillville 2548, Inc. v. BMO Harris Bank N.A.* is a cautionary tale to a party operating a franchise without any rights under the franchisee’s lease. In *Merrillville*, a franchisee operating a Golden Coral restaurant in Merrillville, Indiana executed a lease with third-party Century Plaza, LLC. The lease prohibited the franchisee from “assigning, selling, or in any manner transferring [the] Lease or any interest therein, by operation of law or otherwise,” from subletting the premises, and from allowing anyone other than the franchisee to occupy the premises. Approximately one year after executing the lease, the franchisee executed a promissory note that was secured by a leasehold mortgage with a lender. The leasehold mortgage gave the lender “a security interest in all of [the franchisee’s] rights, titles, and interest in the [Merrillville] Lease and [the franchisee’s] leasehold estate” for the Merrillville premise. The lender ultimately assigned its rights under the promissory note and the leasehold mortgage to BMO Harris Bank, N.A.

Approximately, one year after executing the promissory note and leasehold mortgage, the franchisee transferred its franchise agreement to GC 2548, Inc. While GC 2548 operated the restaurant pursuant to the terms of the lease, made payments directly to the landlord and also paid property taxes and made improvements to the real estate, it never became a party to the lease, was never assigned the franchisee’s rights under the lease, and never made payments to BMO Harris on the promissory note.

After the franchisee failed to make payments in accordance with the promissory note, BMO Harris filed suit against the franchisee and its personal guarantors for breach of contract, foreclosure of the leasehold mortgage, and appointment of a receiver. The trial court appointed a receiver and, shortly thereafter, GC 2548 filed a motion to intervene, which the trial court granted.

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118 *Id.*


121 *Id.* at 385.

122 *Id.* at 385.

123 *Id.* at 386.

124 *Id.* at 385.

125 Of the defendants, only one personal guarantor filed an answer to the suit. BMO Harris filed for, and was granted, a default judgment as to all defendants other than the one personal guarantor that filed an answer. The personal guarantor who timely filed an answer “agreed to a judgment of foreclosure being entered against him.” *Id.* at 388.

126 *Id.* at 384.

127 *Id.* at 386.
On appeal, the Indiana Court of Appeals affirmed the trial courts finding that the lease had not been equitably assigned to GC 2548 and also rejected GC 2548’s argument that the equitable assignment of the lease extinguished BMO Harris’s security interest.\textsuperscript{128} In doing so, the appellate court explicitly disapproved of GC 2548’s attempt to rely on the doctrine of equitable estoppel to assume the franchisee’s beneficial rights without being burdened by the franchisee’s obligation of the security interest.\textsuperscript{129} The court did, however, find that BMO Harris had no right to immediate possession of the property, finding that while BMO Harris had a lien on the property, it had no right to possession of the premises.\textsuperscript{130} The court remanded the case for a sheriff’s sale pursuant to Indiana law.\textsuperscript{131}

**H. Franchisor Right to Purchase Upon Termination of Franchise Agreement**

Section III.C discusses a franchisor’s right to purchase its franchisee’s real estate upon termination of the franchise agreement. Where the franchisee owns the property where the franchise will be located, the franchisee will likely want to retain ownership of the property after the franchise relation ends. Occasionally, however, a franchisor will persuade a franchisee to agree to sell the premises to the franchisor upon termination of the franchise agreement. That was the case in *Huddle House, Inc. v. RPB Enterprises, Inc*. There, the franchise agreement and separate purchase agreement obligated the franchisee’s owner and owner of the real estate itself to sell the property to Huddle House upon termination of the franchise agreement.\textsuperscript{132} The issue before the court was how to arrive at a sales price given conflicting provisions in the franchise agreement and purchase agreement on this point.

The court held that the terms of the parties’ purchase agreement would govern. This required each side to select an appraiser and for those appraisers to work together to determine the sales price.\textsuperscript{133} If this process failed to produce a sales price that the parties could agree upon, the parties would then choose an alternative appraiser by ranking a list of appraisers. The selected appraiser would then determine the sales price. The franchisee objected to the final appraisal of $150,000. Ultimately, the court found that the “process resulting in the $150,000 appraised value for the Huddle House property . . . was both proper and the product of an agreement between the parties. One side’s displeasure with that outcome is not the basis to be excused from the contractual obligations governing the parties’ business relations.”\textsuperscript{134} The court ordered the franchisee to sell the property to Huddle House at the appraised value of $150,000.\textsuperscript{135}

\textsuperscript{128} *Id.* at 390.

\textsuperscript{129} *Id.* at 392.

\textsuperscript{130} *Id.* at 394.

\textsuperscript{131} *Id.* at 395.

\textsuperscript{132} Superior Court of Fulton County, Georgia, Case No. 2014 CV 250736, Aug. 14, 2015 (paper co-author Annie Caiola served as lead counsel for Huddle House in this case). A copy of this unpublished order is attached at Appendix 4.

\textsuperscript{133} *Id.* at 1.

\textsuperscript{134} *Id.* at 3.

\textsuperscript{135} *Id.*
V. CONFLICTING LANDLORD RIGHTS

Franchisees have financial obligations to their franchisor, their landlord and their lender. All of these creditors will want security to protect their interests by way of lien rights and possessor rights. This Section V describes how the landlord’s security remedies are enforced.

A. Landlord Lien Rights

Under the lease agreement or applicable state law, the landlord may have a lien on the tenant’s assets. “A landlord’s lien for unpaid rent long has been enforceable against personal property found on the premises in the possession of the tenant[.]” International Harvester Credit Corp. v. Goodrich, 350 U.S. 537, 546 (1956). This right began with the common law doctrine of distraint, which permits the landlord to seize the tenant’s property in order to satisfy unpaid rent. Many states have enacted statutes that replace or supplement the common law right of distraint. These statutory landlord liens permit landlords to levy upon the goods of a tenant located on the demised premises in order to satisfy unpaid rent. Each state that has a landlord lien statute has its own processes the landlord must follow before levying upon the goods of a tenant. In Callen v. Sherman’s, Inc., the New Jersey Supreme Court ruled that New Jersey’s statute was unconstitutional because distraint by a constable constituted “state action” and therefore entitled tenants to procedural due process. Similarly, in Cochran v. Gilliam, the Sixth Circuit ruled that a landlord lien on personal property “does not give a landlord carte blanche to take possession of the tenant’s property without going through the proper judicial processes.”

The landlord in Cochran was entitled to the statutory lien to remove Cochran’s personal property (which the landlord did), but he was not entitled under Kentucky law to dispossess tenant of his “worldly possessions” by using a “swat team” of deputy sheriffs without first complying with the statute’s provisions. In other states, Michigan for example, no common law or statutory landlord lien exist.

Depending on the state, Article 9 of the Uniform Commercial Code may also entitle a landlord to a lien on a tenant’s personal property. Generally, the lease must have described the collateral and provided for a security interest that was subsequently perfected by the landlord, and if necessary, extended through the filing of a continuation statement. Once a tenant defaults, the landlord could foreclose upon the personal property pursuant to the UCC and state-specific procedures. The rights under the lease or under state law often conflict with both the tenant/franchisee’s lender’s lien and sometimes with the franchisor’s lien rights granted by the franchise agreement. Given the weakness of the landlord lien and the importance of the lender’s lien, both the franchisor’s lien rights and the landlord’s lien rights are often subordinated or waived to provide the lender with first priority.

136 See, e.g., 68 PA STAT ANN. § 321; N.J. STAT. § 2A:42-1; and ARIZ REV. STAT. ANN. § 33-362.
138 Cochran v. Gilliam, 656 F.3d 300, 309 (6th Cir. 2011).
139 Id.
B. Eviction Rights

Landlords generally have the right to evict tenants who remain in the premises beyond the lease term or who fail to abide by the provisions of the lease. Depending on the circumstances, the terms of the lease, and the jurisdiction, dispossession procedures must be followed, usually involving judicial supervision. Generally, a landlord will send a notice to the tenant setting forth the default and demanding remediation of the default within a certain period of time. If the default is not cured within this period of time, the landlord may send a notice to quit, terminating the lease and demanding the tenant vacate the premises. If the tenant fails to do so, the landlord may be forced to proceed with filing for eviction and recovery of any unpaid rent.

Each state has its own procedures regarding eviction, but every state permits landlords to engage in some version of a summary proceeding in which the time period to respond to an eviction complaint is shortened. In these summary proceedings, generally, only the issue of “who is entitled to possession” is presented. These general features of a summary proceeding (an early trial and limitation on litigable issues) were approved by the Supreme Court in Lindsey v. Normet, which held that Oregon’s summary proceeding statute complied with the Due Process and Equal Protection Clauses of the Constitution. For example, in Florida, typically defendants have twenty days to respond to a complaint. However, if the complaint is for eviction, a tenant only has five days to contest the landlord’s right to possession.

C. Termination Rights

The most obvious default giving rise to a lease termination right occurs when a tenant fails to pay rent. However, most leases contain other default provisions that permit a landlord to terminate a lease prior to its expiration, including: (1) tenant’s failure to comply with applicable law; (2) tenant’s failure to perform covenants under the lease; (3) a bankruptcy filing; and (4) tenant’s abandonment of the premises.

Regardless of the justification for declaring a default, landlords must strictly abide by the lease’s termination provisions. This is especially true with regard to notice and cure provisions. If a tenant fails to pay rent, but the landlord terminates the lease prior to the expiration of a cure period, the termination may be invalid. A failure to properly terminate may have serious repercussions, especially if the tenant files for bankruptcy in the interim.

It is also extremely important that landlords abide by laws governing eviction and termination notices both when drafting the lease and when seeking to terminate the lease. New Jersey law provides an example of a typical statute. When a landlord seeks to terminate a commercial tenancy for breach of a covenant or agreement in the lease, the landlord must cause a written notice of termination to be served upon the tenant. This notice must specify the cause of the termination of the tenancy and demand that the tenant remove themselves

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142 Fla. Stat. § 83.21; Fla. Stat. § 51.011; Camena Invs. & Prop. Mgmt. Corp. v. Cross, 791 So. 2d 595, 596-97 (Fla. 3d DCA 2001) (“the summary procedure statutes to evict a tenant envision an expedited process to determine the right to possession promptly without the necessity of deciding all other issues between the parties.”).
from the premises within three days from the service of such notice.\textsuperscript{145} Importantly, the right to terminate a tenancy for breach of a covenant is not available in the first place unless a “right of re-entry” was reserved in the lease.\textsuperscript{146}

D. **Landlord Right to Property Left Behind; Fixtures v. Trade Fixtures**

A landlord may have certain rights concerning items located on the demised premises at the conclusion of the lease term, which rights may be in direct conflict with the lender’s rights or the franchisor’s rights. Generally, the terms of the lease will govern the landlord’s rights. However, if the lease is silent, real property “fixtures” will stay with the property, while “trade fixtures” may be removed by a vacating tenant.

A fixture is “personal property that is attached to land or a building and that is regarded as an irremovable part of the real property, such as a fireplace built into a home.”\textsuperscript{147} Under §9-102 of the UCC, fixtures are “goods that have become so related to particular real property that an interest in them arises under real property law.” Because such articles are irremovable and “so related” to the real property, they must not be removed by the tenant, and the landlord, as owner, has a real property interest in them.

To the contrary, an item may be considered a “trade fixture” if it meets the three-prong test adopted by many jurisdictions and developed in *Teaff v. Hewitt*: (1) actual annexation to the realty; (2) appropriation to the use or purpose of that part of the realty with which it is connected; and (3) the intention of the party annexing the property.\textsuperscript{148} New Jersey employs a similar test which provides that an article may be considered a “trade fixture” if the article is (1) annexed to the property for the purpose of aiding in the conduct of a trade or business exercised on the premises; and (2) capable of removal from the premises without material injury thereto.\textsuperscript{149}

As such, perhaps the most important distinction between fixtures and trade fixtures is whether removal will cause material injury to the premises. The logic follows that if removal of an article would cause material injury to the premises, the parties must have intended for the article to remain beyond the lease term.

Tenants characterize the property they install as trade fixtures so they may remove them from the premises at lease expiration.\textsuperscript{150} Franchisors stepping into their franchisee’s shoes will similarly seek to claim this property, as will the lender taking the position that its lien extends to such property. Landlords, in turn, characterize items as fixtures, so they remain with the property and potentially raise its value. One possible exception to this is a situation where a tenant has installed a specialized or proprietary piece of equipment in the premises. Depending on the terms of the lease, a landlord may want to characterize the specialized equipment as a trade fixture and encourage or force the tenant to remove it at the tenant’s cost. For example, if

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\textsuperscript{145} Id.

\textsuperscript{146} Id.

\textsuperscript{147} Black’s Law Dictionary (10th ed. 2014).

\textsuperscript{148} *Teaff v. Hewitt*, 1 Ohio St. 511, 530 (1853).

\textsuperscript{149} *Handler v. Horns*, 2 N.J. 18, 24-25 (1949).

\textsuperscript{150} See e.g., *In re Jackson Tanker Corp.*, 69 B.R. 850 (Bankr. S.D.N.Y. 1987) (tenant attempted to remove conditioning systems, irrigation systems, bolted down light fixtures and even circuit breaker panels by arguing these items were trade fixtures).
the tenant installed a specialized vault for storage based on franchisor’s specifications, landlord may push to have that expensive item to be removed at lease expiration so that the landlord need not incur that necessary expense since the next tenant will most likely not want it. In response, the franchisee/tenant may seek to allow the item to remain as it will have no future use for it and will be costly to remove.

Franchisors can be particularly helpful to their franchisees when negotiating the lease in pointing out whether there will be a dispute over fixtures at the time of surrender of the premises. If there are specialized fit-out items that have repeatedly been haggled over by corporate or other franchisees, they should let the franchisee know how to draft the lease to avoid that fight.

VI. CONFLICTING LENDER RIGHTS

When a franchisee fails to meet its financial obligations to its lender, a conflict may arise between a franchisor and a lender with regard to the right to payment and the validity, extent and priority of security interests and liens attached to the franchisee’s assets. Generally, as a condition of a franchisee obtaining a loan, a lender will require a security agreement, which gives the lender enforcement rights against the franchisee’s collateral upon default. For example, when a franchisee defaults under the loan, the franchisor’s rights may conflict with those of the franchisee’s lender, particularly when the lender’s security interest includes the franchise agreement or when the franchise agreement provides that the franchisor holds a security interest in the franchisee/borrower’s assets. Since security agreements are enforceable upon default by the borrower, disputes pertaining to the validity, extent and priority of liens often arise within the context of bankruptcy proceedings.

A. Competing Interests in Collateral

When a franchisee defaults under its loan obligations and under the franchise agreement, a conflict may arise between the lender and franchisor regarding the priority and extent of their respective lien rights in the franchisee’s collateral. For example, it is common for lenders to obtain an assignment of leases as security for a loan. Likewise, franchise agreements often provide that, upon expiration or termination, a franchisee shall assign the lease and FFE to the franchisor at the franchisor’s option.

In In re Flour City Bagels, LLC,151 the Bankruptcy Court for the Western District of New York addressed the competing interests in leases between Bruegger’s Bagel and the subordinate lender, Canal, when Bruegger’s largest franchisee filed for Chapter 11 protection. The franchise agreements included provisions that, upon expiration or termination of the agreements, Bruegger’s had the option to require the franchisee to assign its interest in the lease and to sell the FFE to Bruegger’s.152 In the proceedings, Bruegger’s conceded, however, that it did not have a valid perfected security interest in the leases and certain collateral of the

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152 Id. at 60.
franchisee. On the lender side, under the terms of the security agreements accompanying the franchisee’s loans from Canal and the senior lender, a blanket security interest was granted in the franchisee’s assets, including general intangibles. Both the senior lender and Canal filed UCC-1 financing statement to perfect their respective interests in collateral and asserted that their liens extended to the franchisee’s leases.

The franchisee later defaulted on the loans and Canal exercised its step-in rights and began to operate the franchises prior to filing for Chapter 11 bankruptcy. The bankruptcy was filed and designed to sell all the franchisee’s assets as a going concern through the bankruptcy proceeding. The franchisee’s bidding procedures were approved by the bankruptcy court, and an auction occurred with competing bids, including bids from the lenders and Bruegger’s. Canal offered a $5 million bid (consisting of $1.3 million in cash and $3.7 million in the form of a credit bid) and Bruegger’s $4.75 million all-cash bid.

However, in a successful attempt to block the approval of a sale to Canal, Bruegger’s asserted that neither Canal nor the senior lender had properly perfected their security interests in the franchisee’s leases. The lender’s security interest was of particular import to the sale analysis because it was assumed that the credit bid was supported by the lenders’ properly perfected interest in all of the franchisee’s assets, including the leases.

The bankruptcy court rightfully looked to state law, citing the seminal case of Butner v. U.S. for the proposition that “it is a well-settled . . . that property interests are created by and governed by state law.” Under the court’s analysis of New York law, the UCCs did not adequately identify the leases as collateral under U.C.C. § 9-108(c). Therefore, the lender’s lien did not extend to the leases and the amount of the lender’s credit bid should be evaluated accordingly. As such, Bruegger’s successfully attacked the extent to which Canal’s lien rights extended, and the bankruptcy court denied the proposed sale to Canal.

Although, here, Bruegger’s conceded that it did not have a valid perfected security interest in the leases, Bruegger’s tactic with respect to defeating the lender’s lien on the leases demonstrates the indirect and direct competing interest in collateral between franchisors and lenders. Franchisors will be well served by taking steps at the outset of the franchise

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153 Id. at 74 (explaining that “without a validly perfected security interest, Bruegger’s is left in the position of a general unsecured creditor”). Instead, Bruegger’s sought to compel the assignment of leases and the sale of certain property to it pursuant to provisions in the franchise agreements under a specific performance theory, which the court denied. Id. at 74-76 (holding, in part, that under applicable New York law, Bruegger’s failed to prove that it lacked an adequate remedy at law and would be irreparably harmed).

154 Id. at 60.
155 Id. at 63.
156 Id. at 63.
157 Id. at 66 (Canal was bidding its own secured position together with that of the senior lender).
158 Id. at 57.
159 Id. at 67.
160 Id. at 72 (explaining that property interests are created by and governed by state law, and unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding) (citations omitted).
161 Id. at 73.
relationship to obtain and perfect a security interest in collateral. In the event of a franchisee default, the franchisor should be able to take possession of a franchisee’s assets for the purpose of selling those assets (possibly to a new franchisee) to recover monies due from the franchisee or to keep those assets to operate the unit. To ensure the right to do so, the franchisor should take a security interest in the furniture, fixtures and equipment used in the franchised business. This security interest can be created in the franchise agreement and can be perfected by a recorded UCC financing statement (UCC-1). A properly perfected security interest is of particular import in the context of bankruptcy proceedings because only a valid perfected security interest entitles a franchisor (or any creditor) to a secured position. Should the franchisor find itself as a creditor in the bankruptcy proceeding, a perfected security interest permits the franchisor to exert greater control in the proceedings, including the right to credit bid in any sale under Section 363(k) of the Bankruptcy Code. The franchisor can also best protect its rights by requiring a collateral assignment of lease that is entered into simultaneously with the franchisee’s lease. This will allow the franchisor to enforce its rights upon default without requiring the cooperation of the franchisee or the consent of the landlord.

B. Competing Interests with Subordination Agreements

In In re Lantana Motel, a Knight's Inn franchisee defaulted under its note and filed a Chapter 11 bankruptcy to prevent the foreclosure of its hotel. As a Chapter 11 debtor-in-possession, the franchisee continued to operate the hotel during the bankruptcy, and, as such, sought court permission to remit royalty fees in the ordinary course. The lender objected and argued that the parties’ subordination agreement effectively subordinated the franchise agreement to the mortgage and, accordingly, the franchisor should not receive the royalty payments.

The bankruptcy court overruled the lender’s objection and permitted the ongoing remittal of royalties despite the subordination agreement. The court was less than impressed with the drafting of the subordination agreement and characterized the agreement as a subordination of property interests between the franchisor and the lender. In reaching this holding, the court explained subordination agreements generally and made the distinction between debt subordinations and property interest subordinations. The court defined a debt subordination

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162 The Bankruptcy Code provides that a debtor or trustee can avoid any unperfected interest in the debtor’s collateral. See 11 U.S.C. § 544(a).

163 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.") (emphasis added); see also Meredith Barnes et al., Protecting Real Estate Rights When the Franchise Relationship Ends, 37 Franchise L.J. 553, 557-561 (Spring 2018).


165 Id.

166 Id. at 255 (explaining that the subordination agreement was executed by the franchisee borrower, the franchisor’s parent company and the lender and was valid despite the lender’s missing signature).

167 Id. at 257.

168 Id. at 256-7 (Section 510(a) of the Bankruptcy Code recognizes and enforces subordination agreements to the extent they are enforceable under state law).

169 Id. at 255 (citing Nimmer, Commercial Asset-Based Financing § 8.38 (1990); Rude, Asset Based Financing: A Transactional Guide § 13.01 et seq. (1990)).
as an agreement that subordinates the junior creditor’s rights completely to the superior debt.\(^{170}\) As a result, with debt subordination agreements, the junior creditor would not receive any payments until the superior debt was paid in full. In contrast, a pure property interest subordination agreement affects the parties’ relative rights to certain real or personal property but not the right to receive payments.\(^{171}\) Accordingly, since the subordination agreement was held to only subordinate the franchisor’s property interest (as opposed to a debt subordination agreement), the court held that the franchisor was not limited in its rights to receive payments under the franchise agreement.\(^{172}\)

In order to limit disputes with lenders, franchisors can enter into clear and concise intercreditor agreements that specifically spell out the disposition and distribution of the franchisee’s assets in the event of a default under the franchise agreement or loan agreements or bankruptcy. The practical effect of incorporating intercreditor agreements into the franchising process results in a protracted closing of a franchise sale, which may be unappealing for both the franchisor and franchisee. Should the franchisor incorporate an intercreditor agreement into the franchise sales process, careful attention should be given to how goodwill, intellectual property rights, real property rights, books and records and customer information will be treated.

C. **Franchisor’s Right to Set-Off Against Secured Creditors**

In *InfinaQuest, LLC v. DirectBuy, Inc.*, the court addressed whether a party with a security interest in franchisee’s accounts receivable takes that interest subject to a franchisor’s right of set-off.\(^{173}\) The franchisor, DirectBuy, Inc., entered into a franchise agreement with JDB Direct, LLC for the franchisee to operate a DirectBuy club in Orlando, Florida.\(^{174}\)

The franchise agreement permitted DirectBuy to collect the receivables owed and sweep JDB’s merchandise account daily. After collecting the funds, DirectBuy would return to the franchisee any amounts it was entitled to, subject to the franchisor’s contractual set-off rights.\(^{175}\) Specifically, the set-off provision in the franchise agreement permitted DirectBuy to “apply any payments by you [JDB], or offset any amounts we or any of our Affiliates owe you, to or against any of your past due indebtedness for royalties, Marketing and Legislative Fund contributions or any other indebtedness to us or any of our Affiliates, notwithstanding any contrary designation by you.”\(^{176}\)

\(^{170}\) *Id.* (explaining that debt subordinations are “routinely utilized when a corporate or partnership borrower seeks financing from a commercial lender. The commercial lender will insist that all indebtedness of the corporation or partnership to management or other insiders be subordinated to the lender’s proposed financing. The lender demands subordination for reasons more than just security; the lender wants its loans to be used as working capital in the borrower’s business and not just to repay insider debts.”).

\(^{171}\) *Id.* (using the example of a lien subordination agreement whereby “the subordinating party agrees to demote the priority of its lien to that of another secured creditor, thereby delaying its recourse to the identified collateral until the other party’s secured claim has been satisfied”) (citing U.C.C. § 9–316).

\(^{172}\) *Id.* at 257 (explaining that debt subordinations, on the other hand, typically postpone the subordinated party’s right to payments until the senior creditor is paid in full).


\(^{174}\) *Id.* at 961.

\(^{175}\) *Id.*

\(^{176}\) *Id.* at 962.
Approximately five years into the franchise agreement, InfinaQuest Business Capital, LLC filed a financing statement with the Florida Secured Transaction Registry, perfecting a security interest granted to it in two receivables agreements between InfinaQuest and the franchisee. At the time the franchisee entered into the agreements, it owed franchisor DirectBuy $365,000 in general bills. The franchisee ultimately defaulted on the receivables agreements with InfinaQuest and its franchise agreement with DirectBuy, resulting in the termination of the franchise agreement. InfinaQuest ultimately sued the franchisor (and another party), alleging that it took money that rightfully belonged to InfinaQuest under its perfected security interest in JDB’s receivables.

In finding in favor of the franchisor—that the franchisor’s right to set-off trumped InfinaQuest’s security interest—the court looked to UCC § 9-404, which provides:

> Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to:

(a) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and

(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

The court found that the franchisor was an “account debtor” under UCC § 9-404 because the franchisor was obligated on the account, after taking out any funds owed to DirectBuy or its affiliate, to make payments to the franchisee subject to the set-off provision. The court also found InfinaQuest to be an “assignee” under UCC § 9-404 and that InfinaQuest did take an interest in an existing account receivable (the merchandising account that DirectBuy had the right to set off its debts after performing its daily sweep). Accordingly, InfinaQuest “took its interest in the existing accounts subject to this pre-existing right of set-off.” On this basis, the court granted the franchisor’s motion for summary judgment.

### D. The Lender’s Collateral Can Include the Franchise Agreement

In Section 9-106 of revised Article 9 of the Uniform Commercial Code, security interest may be obtained in fixtures and equipment, inventory, accounts receivable, cash or other

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177 Id.
178 Id.
179 Id.
180 Id.
181 Id. at 963 (quoting UCC § 9-404).
182 Id.
183 Id. at 965.
184 Id.
proceeds, and in general intangibles. General intangibles may include the rights in the franchise agreement itself.\textsuperscript{185} As a result, a conflict may arise between a franchisor, who wants to maintain control over the franchise agreement, and a secured party lender, who may take the position that the franchise agreement is an asset in which the lender has a security interest and, therefore, such lender may seek to dispose or liquidate the intangible rights provided by the franchise agreement.

In \textit{Gordon Car and Truck Rental, Inc. v. American Motors Leasing Corp. (“AMC”) (In re Gordon Car and Truck Rental, Inc.)}, a former Avis-Rent-A-Car franchisee sought a declaratory judgment as to whether AMC, lessor under a master fleet agreement, or its bank held any interest in its Avis franchise agreements and licenses.\textsuperscript{186} Applying state law (New York’s version of the Uniform Commercial Code), the bankruptcy court summarily rejected the bank’s argument that the franchise agreements and licenses would be captured under the bank’s perfected security interest in “accounts” because the franchise agreements did not amount to a “right to payment.”\textsuperscript{187} Alternatively, AMC asserted that it had a perfected security interest in the franchise agreements because the franchise agreement constituted a “general intangible.”\textsuperscript{188} The bankruptcy court agreed that a franchise agreement would fit within the UCC’s “general intangibles” definition but, ultimately, determined that the “after acquired” language in the grant of security interest did not extend to the franchisee’s pre-existing franchise agreements.\textsuperscript{189}

Although Article 9 grants lenders the right to take a security interest in franchise agreements even when the franchise agreement expressly prohibits the same,\textsuperscript{190} engaged franchisors can maintain control over a lender’s proposed disposition of collateral based on their rights to approve a successor or assignee of the franchise agreement. Moreover, franchisors typically will only approve a successor following specific diligence and review at the time of the intended transfer and not in advance. As a result, the practical effect of a lender’s security interest in the franchise agreement is that the lender may seek proceeds from the sale of the franchise rights or challenge the franchisor’s right to receive payment, as described in Subsection C herein.

\section*{VII. CHASING COLLATERAL}

Aside from guarantees, personal or otherwise, the franchisee’s main collateral to secure its promises to pay and perform are its furniture, trade fixtures and equipment (“FFE”) - the hard assets, its lease and franchise agreement - the intangible or soft assets. The lender works hardest at obtaining a security interest in these assets, but both franchisor and landlord also have an interest in the process of pledging and liening assets. Most franchisors and landlords recognize the importance of franchisee financing and will cooperate to allow this funding.

\textsuperscript{185} UCC § 9-106.
\textsuperscript{186} \textit{In re Gordon Car & Truck Rental, Inc.}, 75 B.R. 466 (Bankr. N.D.N.Y. 1987).
\textsuperscript{187} \textit{Id.} at 469.
\textsuperscript{188} \textit{Id.} at 468; \textit{See also In re Scheidmantel Olds–Cadillac, Inc.}, 144 B.R. 296 (Bankr. W.D. Pa. 1992) (holding that a franchise agreement or license falls within the UCC’s definition of “general intangibles”); \textit{In re Topsy’s Shoppes, Inc.}, 131 B.R. 886, 888 (Bankr. D. Kan. 1991) (same); \textit{In re Hengalo Enterprises, Inc.}, 51 B.R. 54 (Bankr. S.D. Fla. 1985) (same).
\textsuperscript{189} \textit{Id.} at 472.
However, each will want certain protections during the loan term and especially in the event of a default and then foreclosure.

With all of the conflicting positions among the franchisor, the franchisee, the lender and the landlord, it is challenging to resolve them without open and clear communication. With a recognition agreement, comfort letter, subordination agreement or intercreditor agreement, the players can set forth the rights and obligations of the parties. A landlord will typically not be a party to such an agreement, especially for smaller loans. The landlord may separately agree to both a leasehold mortgage in favor of the lender and to subordinate or waive its statutory landlord lien on the tenant/franchisee’s hard assets.

In an intercreditor agreement, the franchisor may or may not consent to the lender being able to enforce its lien on the franchise agreement. The franchisee may pledge its intangible rights under the franchise agreement as collateral for its financing, even if the franchise agreement prohibits the pledge of the intangible rights or requires the consent of the franchisor. Upon perfection, the lender will have a security interest in those tangible rights, but without franchisor’s consent, it will only be entitled to proceeds from the sale and not the right to use or assign the franchise agreement. If the franchisor provides its consent to the security right, it likely will provide a notice and opportunity for the lender to cure, as well as rules or parameters regarding franchisor’s consent to the assignee of the franchise agreement. In addition to consenting to the pledge of the franchise agreement to lender, an intercreditor agreement may also provide the franchisor’s consent to the franchisee’s lease assignment to lender. If the location is great and indirect control of the site is important for the franchisor, who may diligently require detailed lease riders with broad assignment rights, it may be unwilling to cede its lease assignment rights to the lender.

The FFE should also be addressed in an intercreditor agreement. The franchisor will either simply acknowledge the lender’s lien or will subordinate its interest in the FFE to the lender’s security interest. Once the lender’s lien rights are recognized, can the FFE be retained by the lender in satisfaction of the loan? Can the FFE be sold at a public auction, which sale may include proprietary equipment and cause bad press for the system? The franchisor will want the lender to communicate and cooperate to preserve the goodwill of the brand and to transition smoothly to the next, acceptable operator. Separately, the franchisee wants to maximize its loan proceeds and minimize its exposure to monetary liabilities when the value of the collateral is insufficient to repay its lender. The key is to have the forethought -- through ongoing communications and some form of intercreditor agreement -- to properly plan for the day that the lease, the franchise agreement and/or the loan agreement are materially breached and the chase begins.

VIII. CONCLUSION

As demonstrated throughout the foregoing case law, having well-drafted agreements is often the distinguishing factor between a franchisor who can maintain the brand at a particular location, and one that cannot. With location being one of the biggest indicators of success, franchisors should take time to draft their protective provisions properly on the front end in order to avoid losing a critical location on the back end. Disputes arise where there are conflicting or

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191 See UCC §9-408(a).

192 The rules and parameters will include the experience and qualifications of the successor franchisee, the time to cause the transfer, as well as the obligation to cure the franchisee’s defaults, including royalty and as fees arrearages.
inconsistent provisions among the operative documents. The parties will be best positioned for success with agreements that are both well thought-out and well-drafted.
APPENDIX 1 - Mandatory Franchisor Lease Terms

We may require that any Lease or any renewal contain certain provisions that:

(i) expressly permit or require the lessor to provide us with all revenue and other information it may have related to the operation of your franchised business as we may request at any time;

(ii) require the lessor to contemporaneously provide us with copies of any written notice of default under the Lease sent to you and which grants to us, at our option, the right (but not the obligation) to cure any default under the Lease (should you fail to do so) within 15 days after the expiration of the period in which you may cure the default;

(iii) require that in the event of your default of the Lease or this Franchise Agreement, and upon written notice from us (the “Assignment Notice”) the Lease will, at our option, be assigned to us, we will become the lessee, we will be liable for all obligations under the Lease accruing once we take possession, you will promptly cooperate in vacating the premises and the landlord will recognize us as the lessee as of the date of the Assignment Notice;

(iv) authorize your right to display the Marks in accordance with the specifications required by the operations manuals, subject only to the provisions of applicable law;

(v) limit the use of the leased premises to the operation of the Franchise;

(vi) require that any lender will not disturb your possession of the franchised premises so long as the lease term continues and you are not in default (along with such documents as are necessary to ensure that such lenders are bound);

(vii) contain a Lease term which is at least equal to the Franchise Agreement’s term, either through an initial term of that length or rights, at your option, to renew the lease for the Franchise Agreement’s term;

(viii) restrict the Lease from being modified without our prior written approval;

(ix) permit the Lease or a memorandum of the Lease to be recorded by us; and

(x) require the lessor to acknowledge that the Lease is subordinate to the terms of this Franchise Agreement and that the Lease is not subordinate, and shall not become subordinate, to any lien without our advance written consent.
APPENDIX 2 - Franchisor's Right to Purchase

(a) Exercise of Option. Upon our termination of this Agreement in accordance with its terms and conditions, or your termination of this Agreement without cause or the expiration of this Agreement, we have the option, exercisable by giving written notice to you within 60 days after the date of such termination, to purchase your [franchise] (including all or any portion of the real property related to the [franchise]) from you, including the ownership or leasehold rights to the Site. The date on which we notify you whether or not we are exercising our option is referred to in this Agreement as the “Notification Date”. We have the unrestricted right to assign this option to purchase your [franchise]. We will be entitled to all customary warranties and representations in connection with our asset purchase, including, without limitation, representations and warranties as to ownership and condition of and title to assets; liens and encumbrances on assets; validity of contracts and agreements; and liabilities affecting the assets, contingent or otherwise.

(b) Purchase Price. The purchase price for your franchise under this Section will be the fair market value (“Fair Market Value”) of the [franchise] exclusive of any goodwill, determined in a manner consistent with reasonable depreciation of the [franchise]’s equipment, signs, inventory, materials and supplies, provided that the [franchise] will be valued as an independent business and its value will not include any value for:

(i) the Franchise or any rights granted by this Agreement;
(ii) the Marks or Copyrights; or
(iii) participation in the System.

We may exclude from the assets purchased cash or its equivalent and any Operating Assets, such as equipment, signs, inventory, materials and supplies that are not reasonably necessary (in function or quality) to the franchise’s operation or that we have not approved as meeting standards for franchises, and the purchase price will reflect such exclusions.

(c) Appraisal. If we and you are unable to agree on the Fair Market Value of your franchise within ten (10) days of the Notification Date, the Fair Market Value will be determined by an independent appraiser selected by both you and us within ten (10) days of our collective inability to timely agree on the Fair Market Value. If we cannot timely agree on an independent appraiser, then such appraiser will be selected as follows. Within five (5) days of our inability to agree on an independent appraiser, we will choose a certified public accounting firm and you will choose a certified public accounting firm. Those two firms shall, within ten (10) days, select a mutually acceptable appraisal firm (the “Appraiser”) to make the independent appraisal, in accordance with this Agreement. The Appraiser shall have at least ten (10) years’ experience valuing properties similar to the [franchise] and the individual responsible for valuing real estate shall be a Member Appraisal Institute (MAI) appraiser. You and we shall each bear one-half of the costs of the Appraiser.

(d) Due Diligence. For a period of thirty (30) days following our receipt of the Appraiser’s determination of value, we have the right to conduct a due diligence investigation (the “Due Diligence Period”) of your franchise, the Operating Assets, and all of your rights, liabilities and obligations. You must give us reasonable access to your facilities, books and records during the Due Diligence Period. In addition, you must otherwise reasonably cooperate with us to make yourself and Personnel available during the Due Diligence Period. We are
under no obligation to continue with our due diligence if, the results of our due diligence are not satisfactory to us for any reason or if we are not satisfied with the Appraiser’s opinion of value, to be determined in our sole discretion. In that case, we will notify you in writing that we are withdrawing our offer to purchase your [franchise]. At any time during the Due Diligence Period, we have the unconditional right to withdraw our offer.

(e) Payment of Purchase Price. The purchase price shall be paid in cash at the time of closing, which shall take place no later than thirty (30) days following the expiration of the Due Diligence Period.

(f) Closing. At closing you agree to deliver such instruments we reasonably request, including those documents sufficient to transfer to us:

(i) good and valid title to the Operating Assets purchased, free and clear of all liens and encumbrances (other than liens and security interests acceptable to us), with all sales and other transfer taxes paid by you; and

(ii) all licenses and permits of the [franchise] which may be assigned or transferred; and

(iii) the fee or leasehold interest and improvements at the Site, free and clear of all encumbrances except those we agree to assume.
APPENDIX 3 - Franchisor’s Right of First Refusal

If you (or any of your Owners) determine to sell, assign or transfer for consideration an interest in this Agreement, the Site and/or the franchise (including all or any portion of the real property related to the franchise, whether a leasehold, fee interest or otherwise) or an ownership interest in you at any time during the Term; or if you (or any of your Owners) at any time during the five (5) year period commencing on the effective date of termination or expiration of this Agreement determine to sell, assign or transfer for consideration any interest (leasehold, fee or otherwise) in the Site or substantially all of your assets, including the former Operating Assets or more than a 50% ownership interest in you, you (or such Owner) agree to obtain a bona fide, executed written offer and earnest money deposit (in the amount of 5% or more of the offering price) from a responsible and fully disclosed offeror (including lists of the owners of record and all beneficial owners of any corporate or limited liability company offeror and all general and limited partners of any partnership offeror and, in the case of a publicly-held corporation or limited partnership, copies of the most current annual and quarterly reports and Form 10K) and within 5 days of receipt submit to us a true and complete copy of such offer, which includes details of the payment terms of the proposed sale and the sources and terms of any financing for the proposed purchase price. To be a valid, bona fide offer, the proposed purchase price must be denominated in a dollar amount. In the event the consideration offered by a third party is not specified in cash, we have the right to substitute the reasonable equivalent in cash. The offer must apply only to an interest in you, in this Agreement, the franchise, and/or the Site and may not include an offer to purchase any of your (or your Owners’) other property or rights, or of just the Operating Assets, unless the offer for the Operating Assets is post-Term. However, if the offeror proposes to buy any other property or rights from you (or your Owners) under a separate, contemporaneous offer, such separate, contemporaneous offer must be disclosed to us, and the price and terms of purchase offered to you (or your Owners) for the interest in you or in this Agreement and the franchise must reflect the bona fide price offered and not reflect any value for any other property or rights.

We have the right, exercisable by written notice delivered to you or your selling Owner(s) within 30 days from the date of the delivery to us of both an exact copy of such offer and all other information we request, to purchase such interest for the price and on the terms and conditions contained in such offer, provided that:

(a) our credit will be deemed equal to the credit of any proposed purchaser;

(b) we will have not less than 30 days after giving notice of our election to purchase to prepare for closing; and

(c) we are entitled to receive, and you and your Owners agree to make, all customary representations and warranties given by the seller of the assets of a business or the capital stock of an incorporated business, as applicable, including, without limitation, representations and warranties as to:

(i) ownership and condition of and title to stock or other forms of ownership interest and/or assets;

(ii) liens and encumbrances relating to the stock or other ownership interest and/or assets; and
(iii) validity of contracts and the liabilities, contingent or otherwise, of the Business Entity being purchased.

(d) We have the right to obtain, at our sole cost and as a condition precedent to closing the sale, a survey, title commitment, and environmental assessment. In the event such survey, title commitment or environmental assessment is unacceptable to us in our sole discretion, we may elect not to close on the purchase. In the event of any material change in the terms and conditions of the offer to purchase, or if more than 120 days shall pass without a closing on such offer, you are required to resubmit such revised offer to us for consideration.

If we do not exercise our right of first refusal, you or your Owners may complete the sale to such purchaser pursuant to and on the exact terms of such offer, subject to our approval of the transfer, provided that, if the sale to such purchaser is not completed within 120 days after delivery of such offer to us, or if there is a material change in the terms of the sale (which you agree promptly to communicate to us), we will have an additional right of first refusal during the 30 day period following either the expiration of such 120 day period or notice to us of the material change(s) in the terms of the sale, either on the terms originally offered or the modified terms, at our option.
AMENDED ORDER ENFORCING PARTIES’ AGREEMENT

All things must come to an end, including this protracted dispute over the fate of an empty Huddle House restaurant in Lincoln, Georgia. In this Court, the dispute shall end with the immediate sale of the Huddle House to Plaintiff for $150,000. The Court previously determined that Defendants were obligated, pursuant to a series of written franchise agreements with Plaintiff, to sell the property to Plaintiff. The sticking point then became how to arrive at a sales price. The Court found that the terms of the parties’ 1998 Option Agreement, requiring each side to select an appraiser and for those appraisers to work together to arrive at a sales price, would govern the proceedings. According to both parties, this approach proved (perhaps unsurprisingly) unworkable, as the two appraisers were unable to agree on much other than that the property existed. Faced with this impasse, the parties devised their own plan and somehow managed to agree on a ranked list of appraisers. After a problem arose with the parties’ first choice appraiser, they turned to the firm that employed their second choice appraiser: Driggers Commercial Group, Inc.¹

¹ In the previous iteration of this Order, the Court mistakenly identified the appraiser relied upon by the parties. This amended Order supersedes the Court’s Order issued on 13 August 2015.

² Soon after the parties retained Driggers Commercial Group, the specific appraiser at Driggers whom the parties had selected, Aaron Carone, resigned. Rather than forfeit their retainer with Driggers, the parties agreed to continue to work with Driggers.
Mr. Driggers and his firm did their work, prepared a report detailing their efforts, and arrived at an appraised value of $150,000. Defendants are unhappy with both the figure and the process by which it was obtained. Defendants complain most strongly that Driggers and his firm erred by relying on a market participant who was allegedly biased (Powell) and by mischaracterizing the views of a second market participant (Turner). The Court finds that Powell’s alleged bias has not been sufficiently proven nor have Defendants shown how her supposed bias would have impacted Driggers’ final valuation, given the sworn testimony that Powell’s input was (a) limited to confirming information and calculations that Driggers’ firm had already gathered and made and (b) not determinative of the final valuation. The Court also finds that Turner’s views were accurately reflected in Driggers’ final report and that, even if they were not, the hearsay opinions expressed in Turner’s affidavit (which appears not to have been carefully reviewed by either Turner or Defendants’ counsel) would not have changed Driggers’ appraisal.

Defendants additionally criticized some of the methodology employed by Driggers and his firm. While these points were interesting, they were not supported by competent evidence (expert or otherwise) and they were contradicted by the testimony of Driggers’ associate. Plus, the Court finds that Driggers’ methodology was sound: he focused on

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8 As it was explained to the Court, a market participant is someone -- typically a local appraiser or real estate professional familiar with local market conditions -- who offers the actual appraiser (who often is unfamiliar with the property and its vicinity) with a means of confirming that his estimates, calculations, and projections are consistent with local market realities (e.g., rents, sales prices, time to sale, etc.).

9 Indeed, the sworn testimony of Dilbeck’s associate was that he spent 50-60 hours preparing the draft appraisal, of which only twenty to thirty minutes involved discussions with the market participants. He added that the only way the market participants’ input might have affected his conclusions would have been if one or both disagreed with his figures and then offered up evidence to support the disagreement. This did not happen.

10 Upon receiving the appraisal from the agreed-upon appraiser, Defendants promptly obtained their own appraisal from someone they selected with no input from Plaintiff. Et vellic: a higher figure was obtained! While the Court, at Defendants’ insistence, reviewed that appraisal during the recent hearing on Plaintiff’s emergency motion to enforce the option agreement, the Court did not (and should not) give it any evidentiary weight. (It is worth noting, however, that all but one of the relevant market comparables in Defendants’ appraisal were operating Huddle Houses (or similar franchises).)
market comparables consisting of sales (or offerings) of commercial properties on which the former restaurant was no longer in operation — which is, of course, precisely the status of the property at issue here. Indeed, the most compelling comparable found in either of the appraisals — Driggers’ or Defendants’ (see n.3 supra) — was an empty former Huddle House on a thoroughfare with similar traffic patterns in a similarly populated area in south Georgia. And that property sold for less than the market value offered in Driggers’ appraisal.

In short, the Court finds that the process resulting in the $150,000 appraised value for the Huddle House property in Lincoln is both proper and the product of an agreement between the parties. One sides’ displeasure with that outcome is not a basis to be excused from the contractual obligations governing the parties’ business relations. Defendants are ORDERED to sell the property at issue to Plaintiff at the appraised value of $150,000 and to do so instanter.6

SO ORDERED this 14th day of August 2015.

Robert C. I. McBurney, Judge
Fulton County Superior Court
Atlanta Judicial Circuit

Copies to:
Anne P. Caiola (annie@slotkincaiola.com)
Hayden R. Pace (pace@stokeswagner.com)

6 The Court appreciates that this transaction may prove financially difficult for Defendants and is not unsympathetic to their plight, especially given what the Court has learned about the good works Defendant Brown has undertaken in his community. Such welcome benevolence, however, is not a proper consideration in this matter.
MARK SHAPIRO

Mark Shapiro is a founding partner of Hyland Levin LLP, a 16-attorney law firm in Marlton, New Jersey. Mark’s franchise practice includes counseling regional and national franchisors on franchise structuring as well as operational, relationship and regulatory issues. He also represents developers, franchisors and investors in the acquisition, lease and development of real property. Mark has participated as a program presenter on franchise law for the American Bar Association’s Forum on Franchising, the New Jersey Institute of Continuing Legal Education, the International Franchise Association and the Pennsylvania Bar Institute. He served as Chair (2009-2011) and Secretary (1997-1999) of the New Jersey State Bar Association’s Franchise Law Committee and has been a member of the American Bar Association’s Forum Committee on Franchise Law since 1996.

Mark is a graduate of Emory University (1990) and the George Washington University Law School (1993).

ANNIE CAIOLA

Annie Caiola is the managing partner of Caiola & Rose, LLC, an Atlanta-based national law firm focused on representing franchisors in regulatory compliance, litigation, real estate, trademarks and bankruptcy. In addition to serving as national trial counsel to franchisors in litigation, Annie also represents international commercial real estate holding and property management companies in leasing and real estate disputes. Annie has particular expertise at the intersection of franchise and real estate law, helping franchisors enforce their franchise rights against competing interests in real estate. Annie has also served as General Counsel to one of the fastest growing, shared-services franchise systems in the U.S., where, in addition to providing legal counsel on regulatory issues and business imperatives, she managed multi-district mass tort litigation, crisis recovery, and insurance coverage disputes.

Annie graduated Phi Beta Kappa from the University of North Carolina in Chapel Hill, where she also received her law degree with honors. Annie has been recognized as a "Rising Star" by Georgia Super Lawyers Magazine, a "Top 40 Under 40" by The Daily Report, and a "Legal Elite" by Franchise Times Magazine. In addition to practicing law and owning her law firm, Annie is the Chair of the Board of Education for the City of Decatur, an elected position she has held since 2014. Annie lives in Decatur, Georgia with her husband and two daughters.