

# LEASING

## for a FRANCHISED BUSINESS



**By Steven Crea, Principal, Crea Legal**

***Many franchised businesses require premises from which to operate. These premises are often leased. The lease therefore becomes an integral part of the franchised business. The lease defines the location of the business and sets out all the terms upon which the site is occupied including details of rent and outgoings payable, term and options for the leases renewal. If you get it right, the lease will be a valuable business asset. If you get it wrong, it can become a crippling liability which at best will compromise the success of your business and at worst, lead to the business's failure.***

Further, given that most landlords require you to personally guarantee the rent payments whether your business continues to occupy the premises or not, it is obvious that getting the terms and conditions of your lease right from the outset is fundamental for your financial success and security. This article examines some of the regular issues which arise with leases in the context of a franchised

business and provides some practical tips for avoiding them.

### **WHO HOLDS THE LEASE - FRANCHISOR OR FRANCHISEE?**

Historically in Australia, particularly in the context of a retail business, the franchisor would hold the lease and then grant to the franchisee a licence to occupy the premises or a sub-lease, generally on the same or very similar terms to the lease.

By holding the lease, a franchisor is able to exert more control over the site. It allays the fear that a franchisee could abandon the franchise, either during or at the end of the term and trade from the location in its own right, as an independent. This leaves the franchisor to sue for alleged breach of the restraint of trade clauses, which are typically included in any franchise agreement for this very reason. There is also an ability to swap out one franchisee for another in the event of termination of the franchise agreement or sale of the franchised business by a franchisee, without the practical difficulties associated with assigning the lease.

Franchisors, especially those with a national presence who are prepared to hold the lease, can generally achieve more favourable lease terms than a 'mum and dad' franchisee. Landlords are more open to negotiations with a multi-site tenant as both parties have more at stake. Franchisors that establish good records of rent payment and lease compliance will tend to get access to superior new site opportunities, particularly in the case of redevelopments, which have been a constant part of the retail landscape in recent times.

The down side for a franchisor is the potential liability associated with holding leases. A landlord within this framework will have no contractual relationship with the franchisee and will look squarely at its franchisor tenant for the rent, irrespective of what recourse the franchisor may have to the franchisee. If the franchisor has done its job well but the franchisee cannot pay the rent due to insufficient financial resources, the characteristics of site are likely to be poor. At this point a franchisor requires deep pockets,



whether it cuts franchise fees, takes the site on as a corporate store, re-franchises it or seeks a surrender of lease.

There is no right or wrong model; the most appropriate structure depends on the nature of the business, the resources of the franchisor and franchisee, and their respective bargaining power. Franchisees should be aware that a franchise opportunity which requires them to hold the lease is probably structured that way to avoid a contingent liability residing with the franchisor. However, the lease liability is passed on to franchisees anyway through the licence, so whilst it may feel like a more serious commitment to sign a lease, franchisees are probably not taking on anything more onerous than they would under a premises licence arrangement.

What is vital is that each franchisee seeks professional advice from their lawyer, accountant or business adviser to determine the best model for them. As with most legal documents, in leases, the devil is in the detail.

#### **FIT OUT CONTRIBUTIONS OR LEASE INCENTIVE PAYMENTS**

Sometimes, fit out contributions or lease incentive payments are offered. This is particularly the case with redevelopments, where big investments are made by developers in getting what they see is the right tenancy mix in a shopping mall. They involve the landlord making a one off payment at the start of the tenancy to a tenant, as an inducement to take on a lease of a particular site.

Historically, landlords were quite relaxed about these and they were handed out with few restrictions and minimal supporting documentation. This opened the door for franchisors experiencing network growth to 'pocket' the lease incentive payment often unbeknown to the franchisee. The franchisor justified it as a contribution to the development of its network, arguably indirectly assisting the franchised business and to offset the risk that it carries with holding the lease.

Over time we have seen a tightening up by the landlords on the cash payments

and these days they tend to be documented in a formal deed, classified as fit out contributions and carrying conditions in the nature of the following:

- The money must actually be spent on the fit out and documentary evidence provided before payment is made;
- The landlords will have rights to claw back a percentage of the money in the event of termination, surrender or assignment of lease, i.e. when the tenant ceases being in possession of the site (other than due to a franchisee being in possession);
- The landlords also look for rights to ownership of the property in the fit out to the value of the contribution, either from the outset or at the termination or expiry of the lease.

Given these parameters, there are major difficulties associated with the practice of a franchisor retaining fit out contribution money. As the franchisee typically funds the fit out and the purpose of the payment is to ease the burden of the capital investment required in fitting out

a premises, the money should, in fairness go to the franchisee. The franchisee also usually owns the fit out and therefore a franchisor has no basis to agree to confer rights of ownership to a landlord under any circumstances. Landlords should also be acutely aware of this issue and make an enquiry as to ownership of the fit out.

Inducements also impact on the other commercial terms such as the rent, which may be higher than it otherwise would be, because the landlord looks at its return over the entire term of the lease in negotiating the amount. It may also have influenced a franchisor, particularly a cash strapped franchisor, in deciding on a location; and other factors such as geo-demographic considerations may have been overlooked or attributed insufficient weight, in favour of what the dollars could do for cash flow of the franchisor.

If a franchisor is going to accept fit out contributions, I believe they should disclose them and pass them on to the franchisee, even where the franchisor holds the lease. The franchisor should think past the short term gain because the franchisee is bound to find out about it later; and I am yet to find a franchisee who is comfortable with this where they have funded the fit out. Franchisees should ask the question and not commit to the site if they think the franchisor is receiving a payment from the landlord.

## TRANSFER/SALE OF A FRANCHISED BUSINESS

Most franchisees invest in a franchised business with the comfort of knowing that if things go as planned, there will be a valuable asset there one day to sell. There are protections in the Franchising Code of Conduct to prevent a franchisor unreasonably withholding consent to a proposed sale, and Franchise Agreements usually set out a procedure to be followed in the event that the business is sold.

What is often overlooked however, is the length of the term remaining on the lease and/or the franchise; and what is often assumed is that a new lease will be secured upon expiry of the current one on similar terms. In the absence of an option (which is very rare in retail premises), never assume a new lease term will be offered by the landlord. The landlord is under no obligation at all to renew a lease. The landlord may have plans for the centre which don't involve this business being in the current location or in the centre at all. Even if it does offer a renewal in the current location, the offer may be on very different terms to those in the current lease. It is not uncommon for landlords to request rental increases of 20% or more, especially with the benefit of your sales information or where there is other interest in your site, and an increase of this kind will eat directly into your bottom line and change the value of the

business significantly.

If you are interested in a purchasing a retail business with limited time remaining on the lease, you should either:

- value the business and offer a price taking on the fact that you may not be there after the lease expiry date; or
- go to the landlord (through the franchisor if it holds the lease) and request an early renewal.

Then you can buy the business with the assurance of the tenure of the renewed term. Most franchisors will renew the franchise term so that it is concurrent with the new lease term. There may be some negotiation of franchise fees involved to account for the new franchise term, but this is a matter which can be dealt with by the outgoing franchisee (vendor). Bear in mind that the landlord will rarely be open to negotiating a starting rent level for the new lease anywhere below the current rent at the time. The landlord is under no obligation to renew and could happily stay with the current lease until the end of the term.

## INVOLVEMENT OF THE FRANCHISEE

As a franchisee, whether you hold the lease or not, ultimately you are going to be paying the rent; and whether it is a new lease or a renewal of a lease negotiation, I suggest you have visibility into the lease negotiation process and be wary of any franchisors that have a closed door policy on this. This is not to say that you can call the shots or make a nuisance of yourself, thereby frustrating the efforts of the franchisor to secure the best deal, but you should be kept in the loop. By having a view, you can satisfy yourself that the negotiation was conducted properly and the best possible result was achieved.

There is nothing worse than later wondering whether the location of your premises could have been better or the rent could have been lower. Or finding out that a neighbouring franchise owner got a better deal on their lease with the same landlord because yours was a bit on the wild side. You need peace of mind that you have every bit of ground that



the landlord can possibly give without losing the site. A savvy franchisor will appreciate the importance of your support to the terms of the lease, and the Disclosure Document and your Franchise Agreement will likely contain assurances from you that this is the case.

#### **WHAT IS NEGOTIABLE?**

Certainly rent is the main focus as it should be, but other items which are commonly negotiable in a retail lease include:

**Promotions charges** - typically range from 3-5%;

**Rent review** - typically between 3-5%, 5% tending to be the norm with the major landlords currently. Sometimes lower percentage plus CPI;

**Term** - typically 5 years but can be as low as 3 or as high as 7;

**Percentage rent** - typically somewhere between 5-10%. This is often negotiated in tandem with the rent and moves inversely with movements in rent. i.e. a higher base rent should mean a lower percentage rent and vice versa.

**Security deposits** - typically somewhere between 2-4 months gross rent assuming a personal guarantee is also provided.

#### **CONCLUSION**

The unusual relationship of franchisee and franchisor presents some unique challenges when it comes to lease dealings. The lease is a serious undertaking for both franchisee and franchisor, and will play a major role in determining the success or otherwise of the business. Franchisees need to get it right from the outset and avoid the pitfalls such as those mentioned above. If inappropriate terms are agreed at negotiation stage, it can be difficult or impossible for any lawyer to rectify this later; an acute awareness of the legal position is vitally important at the time of lease negotiations. Franchisees should aim for a collaborative approach and avail themselves of a franchising lawyer with relevant leasing experience.

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