Franchisor's Addendum Enhances Franchisee's Right to Assign Store Lease

Authors: Joel Buckberg
February 28, 2012

Many retail store leases signed during the past several years of down markets reflect favorable rents and terms, often with tenant-favorable renewal options. When a franchisee tenant wants to sell its store and assign its lease, can the landlord use the opportunity to wrestle the lease terms into current market rates and conditions? Tennessee courts say no, because the franchisor's lease addendum modifies the assignment clause in the original lease.

A physician and his wife formed a limited liability company to lease and operate a Quiznos sandwich shop, which was to be staffed by their son. The LLC leased a store in Jackson, Tennessee, for a five-year term, with two options to renew for additional five-year terms exercisable on 180 days' notice. If the first renewal option was not exercised, the tenant would be obligated to repay half of the tenant improvement costs borne by the landlord. The lease and renewal documents prohibited assignments of the lease and the renewal options by the tenant. The landlord also signed the franchisor's lease addendum, which provided for transition arrangements if the franchise was sold or taken over by the franchisor or an affiliate. The tenant had the absolute right to assign the lease or sublet the premises to the franchisor and its affiliates. The addendum allowed either the franchisor or the original tenant the right to assign the lease and any related options to renew or extend to a duly authorized franchisee with the consent of the landlord, which was not to be unreasonably withheld or delayed.

After several years of operation, the franchisee wanted to sell the business. A purchaser was identified and approved by Quiznos' franchisor to become the authorized franchisee for the store. Since a short time remained on the initial lease term, the landlord refused to honor the addendum and instead offered to allow the successor to sublease the space (but only for the balance of the original term) and assign the lease for the balance of the original term and one renewal term but not the full two renewal terms. However, the landlord wanted the original tenant improvement cost to be escrowed for payment to him if the lease was not renewed.

The prospective successor balked at these terms and negotiated a lower purchase price to the seller franchisee, with an escrow of the tenant improvement cost put up by the seller and only one renewal option. The buyer walked away after the original lease term expired, leaving the seller to forfeit its escrow. The seller filed an action against the landlord for its damages. After discovery, a denied motion for summary judgment by the landlord and a bench trial, the court found for the seller and awarded the purchase price differential and the escrow amount.

The Tennessee Court of Appeals affirmed the trial court's decision. The court looked at prior Tennessee precedent in articulating a narrow standard for reasonably withholding consent. The language “not unreasonably withhold or delay” is read to mean that the landlord must act in a commercially reasonable manner. Consent may not be withheld on the basis of personal whim or taste, or for other arbitrary reasons. The landlord must act in good faith in a commercially reasonable manner and can only withhold consent purely on the basis of whether the landlord reasonably perceives the prospective assignee to present financial or other risks that are different from the risks accepted with the assignor. The landlord's desire to extract an economic concession or its aversion to working with an assignee who is a tough negotiator or perceived to be personally difficult were found not to be permissible reasons for withholding consent.

In this case, the franchisee benefitted from the franchisor's lease addendum, which changed the lease's assignment provision. The landlord had no obligation not to withhold consent unreasonably in the original lease language. The effort to obtain the landlord's signature on this frequently forgotten document was well rewarded. The overriding assignment provision designed to allow for easier transfers of the franchise would have worked well, had the landlord cooperated, to preserve value for the selling franchisee.

This court also erased any distinction under Tennessee law between “not unreasonably withhold” and “commercially reasonable” standards of conduct for parties with the right to consent. Indeed, the court limits the consent right to the consideration of the financial qualification of the proposed assignee and its ability to perform the contract to be assigned. The court foreclosed the landlord's notion that a request to consent to assign was an opportunity to renegotiate the terms of the contract or back out of a deal that may no longer make economic sense under changed market conditions. Tennessee contract drafters will need to be more specific if such rights are to be reserved and exercised at the time of assignment under this formulation of the Court of Appeals, if this precedent applies outside the lease context. Franchises should retain a higher level of discretion, because the economic interest of the franchisor is more complex and nuanced than that of a landlord. The court leaves open the possibility that withholding of consent is reasonable when the franchised unit is likely to fail at the proposed purchase price because of some intrinsic issue, such as a size too small to be sustainable given its level of investment. Withholding consent will likely need some articulated commercially tenable reason relating to the risk of future performance in future situations in Tennessee when a covenant not to unreasonably withhold consent is part of the bargain between the parties.