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PICKING A POISON PILL: SELECTING, ENFORCING, AND DEFENDING AGAINST LIQUIDATED DAMAGES, LOST PROFIT DAMAGES, AND DAMAGES WAIVERS

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PICKING A POISON PILL: SELECTING, ENFORCING, AND DEFENDING AGAINST LIQUIDATED DAMAGES, LOST PROFIT DAMAGES, AND DAMAGES WAIVERS[1]

I. INTRODUCTION AND SCOPE

Both franchisee and franchisor enter into the franchise relationship with the expectation that the franchisee will continue operating its franchised business throughout the full term of its franchise agreement. In reality, some franchisees cease operating their franchises before the contractual term is completed, and sometimes franchisors terminate early for cause. Franchisors often seek to recover damages resulting from early closure and may have different options available to them under the franchise agreement or applicable law.

When disputes arise, the parties first turn to the terms of the contract to determine what damages are available, whether the parties have pre-selected a measure of damages and whether there are any defenses as to applicability of the contractual damages provisions or whether the provisions are void by law.

This paper will explore the differences in, and pros and cons of liquidated damages provisions, express or implied rights to lost profits as damages, general damages waivers, and other post-termination provisions of the franchise agreement that have financial ramifications for the parties at the end of the franchise relationship. In doing so, this paper will examine liquidated damages provisions in detail, including franchisor best practices for drafting these provisions to increase the chances of success. From the vantage point of the franchisee, this paper will examine some common short-comings with liquidated damages provisions which might provide some hope in defending against such claims. After all, in the instance in which a franchisee is terminated due to defaults which are monetary in nature, the likelihood that a franchisee will be able to satisfy a large liquidated damages amount is low. Of course, terminations are not always due to monetary defaults, and in those non-monetary default situations, a liquidated damages provision might be extremely helpful to a franchisor to fast track a damages calculation.

In instances in which a liquidated damages provision is not present or is subject to challenges to enforceability, an alternate option is to seek lost profits. Each party at the outset of the contract makes some projections and has some expectations about the net benefits of a contract. When that contract is cut short due to early termination, regardless of which party is at fault, the parties do not realize the benefit of the bargain. Some contracts will include a provision providing for lost profits. Sometimes, the contract might be silent; and in this instance the party seeking lost profits must rely on damages available at law. As with liquidated damages, franchisees may challenge the enforceability of provisions providing for lost profit for a host of reasons; and some of the recurring challenges will be discussed in this paper.

This paper will also discuss common issues related to lease takeover provisions and inventory repurchase provisions, as well as attorney's fees provisions. Finally, this paper will provide practical guidance for enforcing and defending against liquidated damages, lost profits damages and damages waivers.

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[1] The views expressed are those of the authors and not necessarily of Clark Hill PLC and/or of Bryan Cave Leighton Paisner, LLP.

II. LIQUIDATED DAMAGES PROVISIONS

A. Overview

Liquidated damages provisions are commonplace in many franchise agreements and certainly most prominent in hotel franchise agreements. Outside the franchise context, parties may heavily negotiate liquidated damages provisions in contracts. This is not the case in the franchise context, with the limited exception of perhaps settlement agreements. The franchisor drafts the liquidated damages provision in the standard franchise agreement; and the franchisee is in most instances in a position of take-it or leave-it. From the franchisor's vantage point, holding the pen on the drafting is not without consequence: a poorly drafted provision could result in an unenforceable liquidated damages provision where a well-drafted provision could yield dividends in cost savings in the event litigation is necessary.

Liquidated damages have gained general acceptance in the United States despite some early opposition and are generally enforceable in most states.[2] However, not all states take a favorable view of liquidated damages provisions in franchise agreements. Some states still treat liquidated damages as presumptively invalid, and the burden is on the party pursuing enforcement to establish validity.[3] This is the minority view. Minnesota, in particular, prohibits the use of liquidated damages provisions in franchise agreements. "It shall be unfair and inequitable for any person to . . . (J) require a franchisee to waive his or her rights to a jury trial or to waive rights to any procedure, forum, or remedies provided for by the laws of the jurisdiction, or to **consent to liquidated damages**, termination penalties, or judgment notes; provided that this part shall not bar an exclusive arbitration clause."[4] If Minnesota law governs, a better option is to consider lost profits damages which are discussed later in this paper.

A well-drafted provision can serve to minimize complications but also minimize litigation costs associated with expert costs for extensive damages calculations. The ability to enforce the provision will vary from state to state and turns on some nuances related to how courts interpret what are generally similar factors.[5] Most courts will consider a variation of three factors when

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[2] For example, California had a law essentially standing for the proposition that liquidated damages were presumptively invalid unless certain conditions were present; however, the law is now the opposite. Cal. Civ. Code § 1671(b) ("[A] provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.").

[3] Minnesota, for example, explicitly invalidates liquidated damages provisions in franchise agreements. MINN. R. 2860.4400 (J); MINN. STAT. § 80C.01-22; Nolan v. HairColorXpress Int'l, LLC, No. 04-3037, Bus. Franchise Guide (CCH) ¶ 13,049 (D. Minn. Mar. 8, 2005); Holiday Hospitality Franchising, Inc. v. H-5, Inc., 165 F.Supp.2d 937 (D. Minn. 2001). Note also that liquidated damages provisions are disfavored in North Dakota. Securities Commissioner Policy Regarding Conduct That Is Unfair, Unjust, or Inequitable to North Dakota Franchisees, Bus. Franchise Guide (CCH) ¶ 5,340.05; N.D. CENT. CODE § 51-19-09.

[4] MINN. R. 2860.4400 (J). Minnesota does permit recovery of lost profits. Holiday Hosp. Franchising, Inc., 165 F. Supp. 2d 937.

[5] An expansive survey of state laws relating to liquidated damages is contained in a 2010 edition of the Franchise Law Journal. Deborah S. Coldwell, Altresha Q. Burchett-Williams & Melissa L. Celeste, *Liquidated Damages*, 29 FRANCHISE L. J. 211 (2010) ("Coldwell, Burchett-Williams & Celeste"). The Franchise Law Journal also published another classic article on liquidated damages and focused on the argument for routine enforcement of liquidated damages in Dennis R. LaFiura & David S. Sager, *Liquidated Damages Provisions and the Case for Routine Enforcement*, 20 FRANCHISE L. J. 175 (2001).

assessing the enforceability of liquidated damages provisions: (1) intent; [6] (2) reasonableness; [7] and (3) ascertainability.[8] These factors must be weighed against whether the provision operates as an unenforceable penalty.[9] These factors will be discussed in detail in this paper.

B. Negotiating and Drafting Liquidated Damages Provisions

If there is an option for a franchisee to participate in negotiating a liquidated damages provision, the most important elements from the franchisee's standpoint are to understand what the triggers are and the formula for calculating the damages.

From the franchisor's standpoint, one must consider whether the parties plan to make the liquidated damages provision the exclusive remedy. If the franchisor intends to preserve all other remedies, the contract should clearly state this intention. As will be discussed later in the paper, franchisors should avoid optional liquidated damages provisions to promote enforceability.

Most liquidated damages provisions are in the nature of a formula consisting of a rate of $X over a set period of time. The duration of the liquidated damages can be an important factor in the fight over enforceability of the provision and, specifically, the determination of whether it operates as a penalty. For example, a span of 35 months for damages calculation has been held reasonable considering the agreement was contracted to last 20 years.[10] A consideration of the types of damages suffered in instances similar to the potential damages the parties are trying to pre-estimate will assist with ensuring the liquidated damages provision is not too expansive as to amount to a penalty.[11]

The provision should be clear and concise to minimize challenges. It should state that the parties intend for it to govern in the event of a breach and that it is intended to compensate the nonbreaching party for conceivable losses resulting from such a breach. It should state that it is not intended as a penalty. Courts will rely heavily upon what is stated in the parties' contract to determine the intent of the parties. In a recent case discussed in further detail below, a franchisee unsuccessfully argued that the parties did not intend for a liquidated damages provision to govern. The Georgia court in *Crown Series, LLC. v. Holiday Hospitality Franchising, LLC,* eloquently explained as follows:

> "[T]he cardinal rule of construction is to ascertain the intention of the parties. If that intention is clear and it contravenes no rule of law and sufficient words are used to arrive at the intention, it shall be enforced irrespective of all technical or arbitrary rules of construction. . . Moreover, no construction is required or even permitted when the language employed

[6] Hospitality Int'l v. Mahtani, No. 2:97CV87, 1998 WL 35296447, at *17-18 (M.D.N.C. Aug. 3, 1998).

[7] Shree Ganesh, Inc. v. Days Inns Worldwide, Inc., 192 F. Supp. 2d 774 (N.D. Ohio 2002).

[8] Choice Hotels Intern., Inc. v. Chewl's Hospitality, Inc., 91 Fed. Appx. 810, 817 (4th Cir. 2003).

[9] Truck Rent-A-Center, Inc. v. Puritan Farms 2nd Inc., 361 N.E. 2d 1015, 1018 (N.Y. 1977).

[10] Crown Series, LLC. v. Holiday Hospitality Franchising, LLC, 851 S.E.2d 150, 155 (Ga. App. 2020).

[11] *Id.*

> by the parties in the contract is plain, unambiguous, and capable of only one reasonable interpretation.[12]

The provision should clearly set forth the triggering event(s). Most are triggered upon breach and subsequent termination. The provision should spell out specifically what breaches will trigger the provision. The more thought that is given to the possible losses resulting from the breaches, the better the drafter can develop a provision which is directly and compellingly tied to the anticipated damages resulting from a breach. In the case of a breach, the franchisor must ensure that all contractual opportunities to cure the breach have been afforded the franchise so as to avoid an argument that the termination was premature.

The provision should state when the payment is due. Sometimes the provision states that it is immediately due upon termination while other times the provision might set the time for payment at some date after the termination such as thirty days.

C. Requirements for Enforcing Liquidated Damages Provisions

Liquidated damages provisions are designed to provide a cost effective and efficient way to determine damages upon the termination of a franchise agreement. Drafting the provision with an eye towards enforcement will help minimize issues if there is a breach. If these provisions are litigated, courts primarily focus on three factors: (1) intent; (2) reasonableness and (3) ascertainability.

1. Intent

Liquidated damages provisions essentially lock the parties into an agreement as to how damages will be measured at some time in the future if there is a breach of the contract. Given the nature of this commitment, courts want to ascertain that there is evidence the parties intended to be bound by the provision.[13] "The intent of the parties can be determined from the language of the contract construed as a whole, in addition to the language in the liquidated damages clause and the special circumstances of the case."[14] The language should clearly state that the provision is a liquidated damages provision and that the parties understand it will govern in the event of a breach or termination.[15]

In *Hospitality Intern. v. Mahtani*, the clause at issue provided as follows:

> In addition, the parties recognize the difficulty of calculating damages caused by lost future monthly franchise fees, but nevertheless recognize and agree that such damages will arise, and hereby agree to the following formula as a compromise between them on the calculation of such damages. Upon termination by Franchisor for any default by Franchisee, Franchisor shall be entitled, *as liquidated damages and not as a penalty* and solely to compensate Franchisor for lost future monthly royalty fees, advertising fees, and reservation sales fees for the period after the termination of this Agreement, to

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[12] *Id.* at 154.

[13] Hospitality Int'l v. Mahtani, No. 2:97CV87, 1998 WL 35296447, at *17-18 (M.D.N.C. Aug. 3, 1998).

[14] *Id.*

[15] *Id.*

> a *sum equal to the product of the number of years remaining in the term*, including any Renewal Term for which Franchisee has exercised its Renewal Option, of this Agreement (prorated for any period of less than a year) *multiplied by an amount equal to fifty percent (50%) of the monthly average of the monthly royalty fees, advertising fees, and reservation* sales fees earned (even if not paid) pursuant to paragraph 6(b) hereof *over the twelve (12) month* period ending with the last day of the month preceding the termination date....[16] (emphasis added)

The significance of the use of "liquidated damages" in the provision is important.[17] While specific words alone are not dispositive to enforceability, the court emphasized that the use of the words "liquidated damages" provided evidence that the parties intended the provision to compensate for damages rather than serve as a penalty.[18] Further, the provision expressly stated it was not meant as a penalty.[19] The plain language of the agreement is the first level of analysis to discern the parties' intent.

If the contact is clear on the intent (and all other factors are satisfied), it is unlikely that a challenge to enforceability will be successful. In *Ravenstar LLC v. One Ski Hill Place LLC*, the defendant raised the issue of intent with regards to a liquidated damages provision whereby the contract permitted the seller to either seek actual damages or pursue liquidated damages in the event of a breach.[20] The defendant's argument was that by the mere fact that the seller could elect either actual damages or liquidated damages that this option invalidated the liquidated damages provision. The court was not persuaded by this argument.

The court in *Ravenstar LLC* did recognize that there is a split of authority on whether optional liquidated damages provisions are enforceable. One rationale for holding the optional liquidated damages provision unenforceable is that the parties' intent is not certain as it permits the non-breaching party to "have his cake and eat it too."[21] Likewise, the breaching party would not know on the front end which damages calculation will govern.[22] Nevertheless, the court was not convinced that optional liquidated damages provisions operated as a penalty and explained that the non-breaching party might select the liquidated damages clause merely because actual damages are difficult to ascertain or prove.[23] The court held that the parties did intend to be bound by the liquidated damages provision.[24]

The parties should attempt to make the liquidated damages provision as clear as possible to ensure the intent inquiry is satisfied. To the extent the parties include an optional liquidated

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16 *Id.* at *2.

17 *Id.* at *17.

18 *Id.*

19 *Id.*

20 405 P.3d 298, 301 (Colo. App. 2016).

21 *Id.* at 303.

22 *Id.*

23 *Id.*

24 *Id.* at 304.

damages provision, such provision will likely be subjected to increased scrutiny regarding intent; and in some instances, a state might outright invalidated the provision.

2. <u>Reasonableness</u>

A pivotal hurdle in enforcing liquidated damages provisions is the standard of reasonableness. The amount of the liquidated damages calculation must be a reasonable estimate of presumed damages resulting from the breach at the time of contract formation.[25] Most states have adopted a standard of reasonableness modeled from the Restatement (Second) of Contracts. According to the Restatement,

> [d]amages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on the grounds of public policy as a penalty.[26]

Regarding the timing for when the damages must be reasonable, the general rule is that the damages must be a reasonable forecast of probable damages at the time the parties enter into the contract.[27] Courts recognize that there might be factors at work at the time that the contract was entered into which create a situation of unequal bargaining power. The courts will often consider whether the parties were represented by counsel and the relative sophistication of the parties.[28]

State law can be critical in the reasonableness analysis. California law treats liquidated damages as presumptively enforceable, and the party opposing enforcement of the provision must establish that it is unreasonable.[29] According to the California statute, "a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."[30] A number of other states have similar statutes which impose a reasonableness standard.[31] As noted above, Minnesota, for example has explicitly rejected liquidated damages provisions in franchise agreements concluding they are presumptively unfair and inequitable.[32]

A good case study on reasonableness is *Shree Ganesh, Inc. v. Days Inns Worldwide, Inc.* in which the court considered a reasonableness challenge to a liquidated damages provision and

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[25] Shree Ganesh, Inc. v. Days Inns Worldwide, Inc., 192 F. Supp. 2d 774 (N.D. Ohio 2002).

[26] RESTATEMENT (SECOND) OF CONTRACTS § 356.

[27] Red Lion Hotels Franchising, Inc. v. First Capital Real Estate Inv., LLC, No. 2:17-CV-145-RMP, Bus. Franchise Guide (CCH) ¶16,276 (E.D. Wash. Sept. 6, 2018).

[28] *Id.*

[29] CAL. CIVIL CODE 1671(b).

[30] CAL. CIVIL CODE 1671(b).

[31] GA. CODE ANN. §13-6-7 (liquidated damages provision valid unless it violates some principle of law).

[32] MINN. R. § 2860-4400.

held the provision unenforceable.[33] The provision at issue provided for liquidated damages based on a calculation of recurring royalties during the 24 month period preceding the termination or a minimum of $2,000 per guest room.[34] The court took issue with the minimum liquidated damages of $2000 per guest room finding that, "[T]he amount of damages as calculated based on the number of rooms is approximately five times the amount that would have resulted if the calculation were based on Recurring Fees. This is clearly excessive."[35] The court then struck the entire liquidated damages provision.

In contrast to *Shree Genesh, Inc.*, the reasonableness challenge in *Red Lion Hotels Franchising, Inc. v. First Capital Real Estate Inv., LLC* was met with the opposite result.[36] Unlike the clause in *Shree Genesh, Inc.,* the clause in *Red Lion Hotels Franchising, Inc.* was based on gross room revenue. In pertinent part, the provision provided as follows:

> If the Hotel has been open for less than twenty four (24) months, then in calculating the Termination Fee we will multiply thirty-six (36) by the Average Monthly Fees at the rate of eight and one half percent (8.5%) of Gross Room Revenue, from the Opening Date through the month immediately preceding the month of termination.[37]

The challenge raised by the franchisee was that the provision bore no reasonable relationship to the actual harm suffered by franchisor and thus resulted in an unlawful penalty. The franchisee urged the court to consider the clause in light of the steep drop in clientele due to the shale oil market crash. The franchisee urged the court to blue pencil the provision based on the franchise agreement's "Severability and Interpretation" clause which permitted amendment of any provision in the franchise agreement held to be unenforceable to the minimum extent necessary to make it enforceable.

The franchisor urged the court to disregard the arguments of the franchisee because the challenges raised were based on events which happened after the contract was entered. Washington law requires the consideration of both whether the provision is a reasonable estimate of the losses and the sophistication of the parties.[38] The court agreed with franchisor that the relevant period for determining reasonableness was at the time the parties entered into the contract. "The central inquiry is whether the specified liquidated damages were reasonable at the time of contract formation."[39] The court also emphasized that the franchisee was a sophisticated business person who took on the development of the hotel knowing that there were risks associated with turning around the performance of the hotel.[40] The fact that another calculation

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[33] 192 F. Supp. 2d 774 (N.D. Ohio 2002).

[34] *Id.* at 785-786.

[35] *Id.*

[36] Red Lion Hotels Franchising, Inc. v. First Capital Real Estate Inv., LLC, No. 2:17-CV-145-RMP, Bus. Franchise Guide (CCH) ¶16,276 (E.D. Wash. Sept. 6, 2018).

[37] *Id.*

[38] *Id.* (citing Wallace Real Estate Inv., Inc. v. Groves, 881 P.2d 1010, 1018-1019 (Wash. 1994)).

[39] *Id.* (quoting Watson v. Ingram, 881 P.2d 247, 251 (Wash. 1994)).

[40] *Id.*

may be better does not negate an otherwise reasonable calculation, and the nonbreaching party need only establish that the provision is reasonable.[41]

Crown Series, LLC demonstrates how one court deemed a well drafted liquidated damages provision should be formulated.[42] The liquidated damages clause provided as follows:

> In the event Licensor terminates this License due to Licensee's breach of any of its obligations under the License prior to the time that Licensee is authorized to use the System at the Hotel, Licensee shall pay to Licensor, as **liquidated damages**, a lump sum equal to the monthly average of all amounts that would have been payable to Licensor under paragraphs 3.B (1), (3) and (4) of this License assuming the Hotel had collected Gross Rooms Revenue based on the average daily revenue per available room for all hotels in the System for the previous twelve (12) months, as determined by Licensor, multiplied by the greater of (a) six (6) or (b) the number of full and partial months from the Term Commencement Date to the termination date of the License.
>
> Licensor and Licensee acknowledge and agree that it would be difficult to determine the injury caused to Licensor by termination of this License. Licensor and Licensee therefore intend and agree the above **liquidated damages calculations** to be a reasonable pre-estimate of Licensor's probable loss and not a penalty or in lieu of any other payment.[43] (emphasis added)

The franchisee first argued that the clause was buried in the agreement. The court quickly dispensed with the challenge to the intent of the parties because the clause clearly stated liquidated damages twice.[44] The court complemented Holiday Hospitality on offering extensive support for its development of the liquidated damages formula. Of significance, Holiday Hospitality had considered the following data: (1) prior lost net system fees in similar situations; (2) average gross room revenue in the Hotel Indigo System; and (3) the assumption that the hotel would generate gross room revenue at the average rate systemwide for the twelve-month period prior to termination.

Franchisors should be able to articulate what empirical data was used to develop their liquidated damages formula. Franchisors need not show they have developed the best formula – only that the formula is reasonable.

3. <u>Ascertainability</u>

The party enforcing the provision should be prepared to demonstrate that actual damages were difficult to determine at the time the contract was formed.[45] Montana, for instance, will recognize as valid a liquidated damages provision only ". . .when, from the nature of the case, it

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[41] *Id.*

[42] 851 S.E.2d 150, 152 (Ga. App. 2020).

[43] *Id.*

[44] *Id.* at 154.

[45] Choice Hotels Int'l., Inc. v. Chewl's Hospitality, Inc., 91 Fed. Appx. 810,817 (4th Cir. 2003).

would be impracticable or extremely difficult to fix the actual damage."[46] This factor goes hand in hand with reasonableness. While the potential damages must be difficult to determine and thus, unascertainable; they must not be so outrageous as to amount to a penalty. In the franchise context, the liquidated damages are usually tied to a formula based on some historical period for royalties and other franchise fees over a set period of time.

a. <u>Liquidated damages do not have to match actual damages</u>

In *Choice Hotels Intern., Inc. v. Chewl's Hospitality, Inc.,* the court dealt with the question of whether a liquidated damages provision was invalid merely because actual damages were less than those damages stipulated in the agreement.[47] The agreement had a 20 year term, but either party could terminate the agreement without cause after five years.[48] The court was satisfied that the precise damages could not be determined at the time the parties entered the contract and the liquidated damages provision provided a reasonable method to calculate the damages. The calculation was based on profits earned prior to the termination, and the duration was based on the time remaining before the franchisee could terminate the contract without cause.[49] The clause at issue provided as follows:

> If we terminate this Agreement due to your default after the Opening Date, you will pay us, within 30 days after termination, as liquidated damages and not as penalty for premature termination, the product of (i) the average monthly Gross Room Revenues during the prior 12 full calendar months ... multiplied by (ii) the Royalty fee payable in the Remaining months (as defined below), multiplied by (iii) the number of months until the next date that you could have terminated this Agreement without penalty ('Remaining Months'), not to exceed 36 months. However, the product of (i) multiplied by (ii) will not be less than the product of $40.00 multiplied by the Rentable Rooms.[50]

The court was not convinced that the calculation of liquidated damages was so out of the range of actual damages that the clause amounted to an unenforceable penalty. The court explained that ". . . the liquidated damages provision does not 'characterize or stamp the stipulation as a penalty unless it was so exorbitant as to clearly show that such amount was not arrived at in a bona fide effort . . . to estimate the damages that might have been reasonably expected to result from a breach" of the contract."[51] The court was satisfied that the provision took into account profits earned in the months prior to termination and the amount of time remaining before the franchisee could terminate the agreement.[52]

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[46] MONT. CODE ANN. § 28-2-721.

[47] Choice Hotels Int'l., 2003 WL 22961190, at *2.

[48] *Id.* at *1.

[49] *Id.*

[50] *Id.* at *5.

[51] *Id.* (internal citation omitted).

[52] *Id.* at *6.

b. Award of liquidated damages in default judgment

The mere fact that a liquidated damages provision calculation results in a large award does not invalidate the liquidated damages provision. In *Red Lion Hotels Franchising, Inc. v. Dumon*, the court took up the issue of liquidated damages upon a motion for default judgment.[53] The franchisor filed suit against three named defendants for breach of contract. The record indicates that one of the three defendants was served while the remaining defendants were dismissed. The single remaining defendant was a guarantor under the franchise agreement. While she was duly served, she failed to respond. The franchisor petitioned the court to enter a default judgment and award it $676,777.76 pursuant to the terms of the franchise agreement. The past due franchise fees represented $196,706.24, and the balance of $480,071.52 represented liquidated damages as calculated under the formula provided in the franchise agreement.

In its assessment of the factors for entry of a default judgment, the court considered the amount of money at stake. Specifically, "the amount of money requested in relation to the seriousness of the defendant's conduct, whether large sums of money are involved, and whether 'the recovery sought is proportional to the harm caused by defendant's conduct'".[54] Given that the liquidated damages were meant to be a measure of the loss of future royalties and other franchise fees which would result from early termination, the court was convinced that the damages directly related to and flowed from franchisee's breach of the franchise agreement. While the court did acknowledge the large amount of damages at issue, it nevertheless held that a default judgment was appropriate and awarded the liquidated damages sought.

In *Super 8 Worldwide, Inc. v. Godavari Lodging, LLC*, a court took up a claim for liquidated damages in a default judgment posture.[55] After the franchisee improperly sold the property without the franchisor's consent, the franchisor demanded liquidated damages as the transfer was in effect a termination of the franchise agreement. The franchise agreement provided for liquidated damages of $2,000 per guest room the franchisee was permitted to operate at the time of the termination. Franchisee was duly served but failed to appear. The court entered judgment for the entire amount of liquidated damages sought of $80,000. If the franchisee had appeared, the franchisee might have been able to challenge the formula used to calculate the liquidated damages.

Based on these cases, it appears that a court will readily enforce liquidated damages provisions where franchisees who are duly served with a lawsuit fail to appear.

c. Enforcement of liquidated damages (plus interest) against guarantor

In *Wyndham Hotels & Resorts, LLC v. Welcome Hotel Group LLC*, the franchisor filed suit after the franchisees and guarantors who fell behind on royalty fees of $240,449.[56] Prior to filing

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[53] No. 2:20-CV-0183-TOR, 2021 WL 1269120 (E.D. Wash. Apr. 6, 2021).

[54] *Id*. (quoting Curtis v. Illumination Arts, Inc., 33 F. Supp. 3d 1200, 1212 (W.D. Wash. 2014) (quoting Landstar Ranger, Inc. v. Parth Enters., Inc., 725 F. Supp. 2d 916, 921 (C.D. Cal. 2010)).

[55] No. 2:19-cv-17930 (ES) (MAH), 2021 WL 912816 (D.N.J. Mar. 10, 2021).

[56] Wyndham Hotels & Resorts, No. 17-4065 (ES) (JAD), 2021 WL 1100610 (D. N.J. Mar. 23, 2021).

suit, the franchisor issued numerous default notices to the franchisees.[57] The franchisor asserted several claims against franchisee parties, including a claim for liquidated damages for breach of contract and breach of guaranty, among others.[58] The franchisor named an entity it claimed to be an alter ego of the franchisee and thus, as the franchisor argued, was bound by the contract as a result of its alter ego status.[59] While the franchisor was unsuccessful on reaching the purported alter ego, the franchisor was able to successfully enforce the liquidated damages provision against the franchisee signatories who remained parties to the lawsuit.[60]

The franchisor sought liquidated damages of $394,000 under the royalty formula in the franchise agreement plus 1.5% interest provided under the franchise agreement commencing thirty days after the termination through the anticipated date of the ruling on franchisor's motion, bringing the total liquidated damages sought to nearly $600,000.[61] The court relied on prior precedent holding that the court may apply the interest provision to liquidated damages even though the liquidated damages provision itself did not contain an interest provision.[62] "[U]nder New Jersey law, 'the award of prejudgment interest for claims arising in contract is subject to the discretion of the trial court.'"[63] Under New Jersey law, a personal guaranty "must be interpreted according to its clear terms so as to affect the objective expectations of the parties.[64] The guaranty at issue specifically stated that the guarantor was liable for each and every payment obligation of the franchisee.[65] Thus, upon the court satisfying itself that the liquidated damages clause was valid and enforceable, the court issued judgment against both the franchisee and guarantor for the total amount of the liquidated damages sought.[66]

D. <u>Defending Liquidated Damages Provisions</u>

1. <u>Penalty</u>

One of the most commonly asserted defenses is that the provision operates as a penalty. The factors discussed above must be balanced against whether the imposition of liquidated damages would result in a penalty,[67] as the party opposing the enforcement will often argue that the provision operates as an unenforceable penalty. In assessing whether a penalty exists, courts will consider whether the provision as a whole operates as a windfall. "A clause which provides for an amount plainly disproportionate to real damage is not intended to provide fair compensation

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[57] *Id.* at *1.

[58] *Id.* at *2.

[59] *Id.* at *5.

[60] *Id.* at *7-8.

[61] *Id.* at *8.

[62] *Id*. (citing Super 8 Motels, Inc. v. Kumar, No. 06-5231, 2008 WL 878426, at *5 (D.N.J. Apr. 1, 2008) (quoting Cooper Distrib. Co. v. Amana Refrigeration, Inc., 63 F.3d 262, 284 (3d Cir. 1995)).

[63] *Id.*

[64] *Id.* (internal citations omitted).

[65] *Id.*

[66] *Id.*

[67] Truck Rent-A-Center, Inc. v. Puritan Farms 2nd Inc., 361 N.E. 2d 1015, 1018 ((N.Y. 1977).

but to secure performance by the compulsion of the very disproportion. A promisor would be compelled, out of fear of economic devastation, to continue performance and his promise, in the event of default, would reap a windfall well above actual harm sustained."[68]

Most states have adopted the Restatement (Second) of Contracts which states that, "[a]] term fixing unreasonably large liquidated damages is unenforceable on the ground of public policy as a penalty."[69] A party opposing the provision may argue that the calculation of damages under the provision is so disproportionate to the actual harm that it should not be enforced.[70]

a. <u>The fact that liquidated damages results in a large damage number is not a dispositive showing of penalty</u>

As noted above, the mere fact that the calculation of the liquidated damages results in a large damage number does not mean it is an unenforceable penalty. In a recent case, *Little Caesar Enterprises, Inc. v. Little Caesars ASF Corporation*, the franchisor terminated the franchise agreement after the franchisee fell behind on royalty payments.[71] The outstanding fees ballooned to over $200,000. Franchisor sued the franchisee for damages for breach of contract and later sought summary judgment. The agreement provided for termination if the franchisee received more than three default notices in a twelve-month period. The franchise agreement provided for up to three years of royalties as liquidated damages upon termination of the agreement.

The franchisee argued that franchisor waived its right to seek liquidated damages because it supplied the franchisee with products during the pendency of the suit. The trial court rejected this waiver argument outright because franchisee provided no legal support for this position. The court further added that the franchisee had the burden to show clear and convincing evidence that Little Caesars waived enforcement of the post-termination rights.[72] The franchisor was awarded $2.6 million in liquidated damages.

On appeal, the franchisee attempted to argue that the liquidated damages provision was an unenforceable penalty and that the franchisor failed to mitigate damages. Given the large amount of the liquidated damages, one could expect the court might give pause to enforcing the formula which would result in the imposition of $2.6 million in liquidated damages. The franchisee also attempted to argue that the franchisor's agreement to a payment plan waived Little Caesars' right to terminate the franchise agreement. All of these arguments were rejected as untimely by the Sixth Circuit because they were not properly raised at the trial level. The case demonstrates the importance of preserving arguments for appeal. The liquidated damages provision was not grossly disproportionate to the foreseeable damages, despite yielding an extremely high number.

Contrast the above facts with another case in which the liquidated damages provision was held to be grossly disproportionate to foreseeable damages and unenforceable. In *Circuitronix,*

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[68] *Id.*

[69] RESTATEMENT (SECOND) OF CONTRACTS §356 (1981).

[70] Camelot Music, Inc. v. Marx Realty & Improvement Co., Inc., 514 So. 2d 987, 990 (Ala. 1987).

[71] 842 F.App'x 955 (6th Cir. Jan. 5, 2021).

[72] *Id.* (citing Quality Prods. & Concepts Co. v. Nagel Precision, Inc., 666 N.W.2d 252, 258 (2003)). *See also* Little Caesar Enters., Inc. v. Miramar Quick Serv. Rest. Corp., No. 19-1860, 2020 WL 4516289, at *3 (6th Cir. June 25, 2020)).

LLC v. Kinwong Electronic (Hong Kong) Co., Ltd., the manufacturer began selling circuit boards directly to distributor's customers in violation of the exclusivity provision.[73] The distributor filed suit and was awarded more than $1,000,000 in compensatory damages to compensate the distributor for out-of-pocket expenses. The contract contained a liquidated damages provision which noted that certain key relationships identified in a schedule to a previously entered settlement agreement warranted liquidated damages if the manufacturer breached the exclusivity provision by selling directly to these identified customers. The settlement agreement provided that liquidated damages would be set at $2,000,000 for each breach caused. It should be noted that the settlement agreement in question was entered into in 2010 as a result of allegations that the manufacturer previously violated the exclusivity provision.

As a result, the distributor sought to recover liquidated damages under the contract. The trial court held that the manufacturer did in fact breach the contract by selling directly to distributor's customers; however, the court held that an award of liquidated damages under the contract was excessive given the damages foreseeable at the time the parties entered the contract. The lower court also held that the distributor was not entitled to an award of lost-profits damages because the distributor failed to clearly delineate how it calculated lost profits.

The appellate court first concluded that the manufacture did violate the exclusivity provision. The court then went on to consider whether the lower court's ruling on the unenforceability of the liquidated damages provision was appropriate. Florida law permits *liquidated* damages (1) only when actual damages following a breach are not readily ascertainable and (2) where the liquidated damages are not "so grossly disproportionate to any damages that might [have] reasonably [been] expected to follow from a breach as to show that the parties could have intended only to induce full performance, rather than to liquidate their damages.[74] Florida law errs on the side of unenforceability of liquidated damages provisions when it is unclear whether the stipulated damages are a penalty or genuine liquidated damages.[75] The court concluded that the provision was clearly meant as a penalty for noncompliance. The manufacturer and distributor had only done about $3,000,000 in business at the time the liquidated damages clause was added. This fact was enough for the court to conclude that a provision setting damages at $2,000,000 per violation was grossly disproportionate to foreseeable actual damages and, therefore, a penalty.

The distributor attempted to salvage the liquidated damages provision by arguing that not every breach would trigger the $2,000,000 million liquidated damages provision as the breach provision should be read to apply only once to any given customer. The court found that this reading of the provision is not consistent with the plain meaning of the contract.

Finally, the distributor argued that the court should blue-pencil the liquidated damages provision to sever only the impermissible application of the clause. The court rejected this argument because the test is what was foreseeable at the time the parties entered the contract. Thus, a post hoc consideration of proportionality would be impermissible. The court affirmed the lower court's ruling on the unenforceability of the liquidated damages provision.

[73] No. 19-12547, Bus. Franchise Guide ¶16,852 (11th Cir. Apr. 8, 2021).

[74] *Id.* (citing Lefemine v. Baron, 573 So. 2d 326, 328-29 (Fla. 1991)).

[75] *Id.* (citing T.A.S. Heavy Equip. v. Delint, Inc., 532 So. 2d 23, 25 (Fla. Dist. Ct. App. 1988)).

With all this in mind, to best position the provision, the franchisor should always give some thought to how the formula for calculating the liquidated damages measures up to historical damages suffered in similar situations, to the extent the data is available. While there may be factual issues relating to liquidated damages, the issue of enforceability of the provisions are left to the court as a question of law.[76]

b. Void Against Public Policy

A party opposing the damages will likely argue that the provision is void as it violates public policy. This is a difficult argument and is likely only successful in a jurisdiction which either invalidates liquidated damages outright or holds a presumption of unenforceability unless certain conditions are satisfied. Minnesota has invalidated liquidated damages provisions by statute in all franchise agreements, so this issue should be raised by any franchisee who is a party to a franchise agreement governed by Minnesota law.[77]

"Liquidated damage provision will not be enforced if it is against public policy to do so and public policy is firmly set against the imposition of penalties or forfeitures for which there is no statutory authority."[78] If the liquidated damages clause results in compensation which is grossly disproportionate to the amount of actual damages foreseeable at the time the contract is entered, the clause is an unenforceable penalty.[79]

E. Burden of Proof

The prevailing rule is that the party opposing the enforcement of the liquidated damages provision will bear the burden of proof. In *Honey Dew Associates*, for example, the First Circuit heard a challenge raised by a franchisee under Massachusetts law that the liquidated damages provision amounted to an unenforceable penalty.[80] The franchisee claimed it was the franchisor's burden to prove that the liquidated damages provision did not impose a penalty.[81] The franchisee relied on a Maine case to support its position that the burden of proof lies with the party seeking to enforce the liquidated damages provision.[82] The franchisor relied on support from New Jersey and Connecticut to bolster its position that the party opposing the liquidated damages provision bears the burden of proof.[83] The First Circuit acknowledged that there was no definitive Massachusetts authority on this issue but sided with the franchisor. The court held that the party opposing the enforcement of the liquidated damages provision held the burden of proof to

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[76] Wassenaar v. Panos, 331 N.W.2d 357, 360-61 (Wis. 1983). *See also* Wyndham Hotels and Resorts, LLC, No. 17-4065 (ES) (IAD), 2021 WL 1100610 (D. N.J. Mar. 23, 2021).

[77] MINN. R. § 2860.4400 (J).

[78] Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc., 361 N.E.2d 420 (N.Y. 1977).

[79] *Id.*

[80] 241 F.3d 23, 27 (1st Cir. 2001).

[81] *Id.*

[82] *Id.* (citing Pacheco v. Scoblionko, 532 A.2d 1036 (Me.1987)).

[83] *Id.* (citing Naporano Associates, L.P. v. B & P Builders, 309 N.J.Super. 166, 706 A.2d 1123 (1998); Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 153 Conn. 681, 220 A.2d 263 (1966)).

establish it is an unlawful penalty.[84] The court explained that this ruling is consistent with what appears to be the prevailing rule based on its review of treatises and academic literature.[85]

The party opposing enforcement should be prepared to carry the burden of establishing that the provision is unenforceable. The determination of whether a liquidated damages provision is enforceable is a question of law for the court after a resolution of questions of fact.[86]

III. LOST PROFIT DAMAGES

A. Recovering Lost Profits Following Termination of a Franchise Agreement

After a franchise has been terminated, the franchisor often asserts a claim seeking the recovery of lost profits that would have been realized over the remainder of the term of the franchise agreement. As a historical general rule, if the franchisee ceased operating the business, regardless of the cause, then the franchisor could recover from the franchisee the present value of the revenue stream (e.g., ongoing royalties) the franchisor would not receive due to the premature end of the relationship.[87]

In 1996, a decision from the California Court of Appeal, discussed below, found that the franchisor's termination of the franchise agreement had caused its own damages and precluded the franchisor from recovering future lost profits. Soon other courts adopted this proximate cause analysis, which placed fairly significant restrictions on the franchisor's ability to recover lost profits. More recent decisions, however, have begun to reject this analysis and have awarded lost profits under traditional contract principles, observing that but for the franchisee's default, the franchisor would have received royalties for the remainder of the term of the franchise agreement. Under these more recent decisions, the franchisor has been able to recover "reasonably certain" lost profits' damages caused by the franchisee's breach of the franchise agreement. The law is still very unpredictable in this area and the case law, discussed below, outlines selected issues facing litigants under the current law and illustrates how various courts have evaluated a franchisor's ability to recover lost profits.

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[84] *Id.* at 27.

[85] *Id.* ("Our search of the treatises and academic literature leads us to the conclusion that the prevailing rule is that the party challenging the enforceability of a liquidated damages clause has the burden of proving that it is a penalty. "[T]he trend toward increased enforcement of stipulated damages is also encouraged by a shifting of the burden of proof to the party who asserts the existence of an unlawful penalty. The shifted burden of proof, enacted by statute in some states, has probably now become the majority rule, replacing the earlier rule requiring the enforcer of a contract to prove the absence of an unlawful penalty.") ((citing Joseph F. Brodley & Ching-to Albert Ma, *Contract Penalties, Monopolizing Strategies, and Antitrust Policy*, 45 STAN. L. REV. 1161, 1179 (1993) (citing 25A C.J.S. DAMAGES § 144(f) (1966)). *See also* Melvin Aron Eisenberg, T*he Limits of Cognition and the Limits of Contract,* 47 STAN. L. REV. 211, 236 (1995) ("[A] liquidated damages provision should relieve the plaintiff of the burden of proving damages, by shifting to the defendant the burden of establishing that the liquidated damages provision is unenforceable."); 22 Am.Jur.2d DAMAGES § 905 (1999) ("[W]here the contract contains a liquidated damages clause, the party seeking to repudiate that clause must show that agreed damage is so exorbitant as to be in [the] nature of a penalty.")).

[86] Crown Series, LLC. v. Holiday Hospitality Franchising, LLC, 851 S.E.2d 150, 153 (Ga. App. 2020).

[87] *See*, *e.g*., Rupert M. Barkoff, *Damage Award in Franchise Agreement Disputes: Burger King Corp. v. Hinton, Inc. — A "PIP" of a Decision*, N.Y.L.J. Nov. 20, 2002, at 1.

1. **Seminal Case – The *Sealy* Decision**

The 1996 case, *Postal Instant Press, Inc. v. Sealy,*[88] proclaimed at the time by the California Court of Appeals as one "of first impression not only in California but [also] the entire nation," is generally viewed as the genesis of jurisprudence on the franchisor's ability to recover lost profits.

In *Sealy*, Postal Instant Press, Inc. ("PIP"), a franchisor of printing businesses, terminated the Sealys' franchise agreement because they failed to pay royalty and advertising fees. In its complaint, PIP sought lost future royalties and advertising fees for the remaining term of the franchise agreement. The trial court awarded PIP future royalties and advertising fees based on the Sealys' sales history, with sales figures from 1990 and 1991 being averaged, and without applying any adjustment for inflation or growth. PIP then deducted its incremental costs of performance and discounted the resulting amount to present value.[89]

The Court of Appeals reversed the lost future profits award based primarily on a finding that the nonbreaching party was entitled to recover only those damages, including lost profits, that are "proximately caused" by the specific breach.[90] The court found that PIP's lost profits were not caused by the Sealys' breach, but rather by PIP's election to terminate the agreement:

> We conclude the Sealys' breach in failing to timely pay *past* royalties and advertising fees was not a 'proximate' or 'natural and direct' cause of PIP's loss of *future* royalties and advertising fees. Failing to make those payments did not prevent PIP from receiving royalties on future revenues the Sealys' produced under the Franchise Agreement. It was only when PIP elected to terminate that agreement that it ended the Sealys' ability to produce revenues as a PIP franchisee and also ended its own right to collect royalties on those revenues. Accordingly, these future profits are not a form of damages to which PIP is entitled for this particular breach of the Franchise Agreement.[91]

The Court of Appeals added that it did not intend to suggest a franchisor "can never collect lost future royalties for franchisees' breaches of the franchise agreement," noting "[t]hat entitlement ***depends on the nature of the breach and whether the breach itself prevents the franchisor from earning those future royalties***."[92] The court, however, did not elaborate further on the types of specific franchisee breaches that might qualify.

[88] 43 Cal. App. 4th 1704, 1706, 51 Cal. Rptr. 2d 365, 367 (Mar. 28, 1996).

[89] *Id.* at 1708, 51 Cal. Rptr. 2d at 368.

[90] *Id.* at *1709*., 51 Cal. Rptr. 2d at 368-369 (citing Metzenbaum v. R.O.S. Assocs., 188 Cal. App. 3d 202, 211, 232 Cal. Rptr. 741, 746 (1986); Brandon & Tibbs v. George Kevorkian Accountancy Corp., 226 Cal. App. 3d 442, 457, 277 Cal. Rptr. 40, 49 (1990) ("lost profits must be the natural and direct consequences of the breach"); 1 Bernard E. Witkin, SUMMARY OF CAL. LAW (9th ed. 1987), Contracts § 815 ("it [is] essential to establish a causal connection between the breach and the damages sought.")).

[91] 43 Cal. App. 4th at 1713, 51 Cal. Rptr. 2d at 371 (emphasis in original). Consider breaking up the block quote.

[92] *Id.*

The court further held that an award of lost profits would violate the statutory and common law prohibition of damages that are "unreasonable, unconscionable or grossly oppressive."[93] PIP's recovery of past fees, along with attorneys' fees and costs and its ability to install a new franchisee in the Sealys' former exclusive territory, provided it with "reasonable" damages. In dicta, the court suggested that PIP could have recovered royalties through the full term of the franchise agreement by bringing periodic suits against the Sealys to collect past due payments. The court reasoned such a suit would give a "strong lesson" to the Sealys, given the requirement that they pay PIP interest and costs, and surmised that the Sealys would be unlikely to be late again in making royalty payments.[94]

To summarize, under *Sealy*, a court may only award future lost royalties: (1) if the franchisee's conduct proximately caused the damages, and (2) the award is neither excessive, oppressive, nor disproportionate.[95]

a. <u>Recovery of Future Lost Profits Post-*Sealy*</u>

Before *Sealy*, some courts appeared to be far more receptive to a franchisor's claim of lost future royalties after the premature termination of a franchise agreement for any reason.[96] As the cases discussed below demonstrate, after the *Sealy* decision, there has been a general lack of consensus amongst courts nationwide as to the circumstances under which a franchisor is entitled to recover post-termination lost future profits as breach of contract damages from a franchisee.

b. <u>Cases Permitting Future Lost Profits</u>

In *Burger King Corp. v. Barnes*,[97] a case decided shortly after *Sealy*, a district court in Florida granted summary judgment in favor of a franchisor and awarded it lost future royalties for the remainder of the twenty year franchise term, after the franchisee had abandoned its franchise prior to the expiration of the term. Burger King sought royalties for the entire 210 months remaining in the franchise term and estimated lost future royalties based on an average of the sales for the twenty-nine months that the franchise was in operation. The court accepted Burger King's calculation and rejected the franchisee's arguments that the amount was too speculative and that Burger King had a duty to mitigate.[98] Although the case did not cite the *Sealy* decision, its opinion is in line with the *Sealy* analysis because the franchisee's abandonment was the proximate cause of the damage.

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[93] *Id.*, 51 Cal. Rptr. 2d at 372 (citing CAL. CIV. CODE § 3359, which provides that "[d]amages must, in all cases, be reasonable, and where an obligation of any kind appears to create a right to unconscionable and grossly oppressive damages, contrary to substantial justice, no more than reasonable damages can be recovered").

[94] 43 Cal. App. 4th at 1711, 51 Cal. Rptr. 2d at 370.

[95] *Id.*, 51 Cal.Rptr.2d at 370.

[96] *See, e.g.*, McAlpine v. AAMCO Automatic Transmission, Inc., 461 F. Supp. 1232 (E.D. Mich. 1978) (granting a franchisor's request for lost future profits for a portion of the remaining franchise term).

[97] 1 F. Supp. 2d 1367 (S.D. Fla. 1998).

[98] *Id.* at 1372.

In 2000, *Maaco Enterprises, Inc. v. Cintron*,[99] a federal district court in Pennsylvania awarded a franchisor of auto painting and body repair centers its lost future royalties even though the franchisor had terminated the franchise relationship based on the franchisees' failure to perform.[100] Rather than engaging in a proximate cause analysis, the *Cintron* court relied on a traditional contract analysis under Pennsylvania law, which governed the franchise agreement, to support the award of lost future royalties.[101] The *Cintron* court reasoned that Maaco, as the nonbreaching party, was entitled to be placed in nearly the same position that it would have occupied had there been no breach.[102] And because Pennsylvania law allowed for the recovery of lost profits, Maaco was, therefore, entitled to receive the lost future royalties that it would have received had the franchisee not breached the franchise agreement, namely "the difference between what the plaintiff[s] actually earned and what they would have earned had the defendant not committed the breach."[103]

In 2006, *Lady of America Franchise Corp. v. Arcese*, another federal district court in Florida granted summary judgment for the franchisor and awarded it lost future royalties for the 111 months remaining on the parties' franchise agreement after the franchisee had voluntarily notified the franchisor of her desire to cease operation of her franchise.[104] The court, following *Barnes*, held the franchisee's decision to cease operation of the franchise was the proximate cause of the termination of the parties' agreement and of the franchisor's lost future royalties. In so holding, it rejected the franchisee's claim that the franchisor's letter confirming the franchisee's termination meant the franchisor was responsible for the termination. The court reasoned that the franchisor's notification merely confirmed the automatic termination, but that "it was not the vehicle for termination."[105] Instead, the franchisee's decision to close the franchise was the cause of the termination based on the language contained in the parties' franchise agreement, which specifically provided for automatic termination if the franchisee "voluntarily suspends normal business operations."[106]

In *American Speedy Printing Centers., Inc. v. AM Marketing., Inc.*,[107] the Court of Appeals for the Sixth Circuit, applying Michigan law, affirmed a district court's ruling awarding lost future royalties to a franchisor of print shops. With nine years remaining on the term of a twenty year agreement, the franchisor terminated the franchise agreement based on the franchisee's failure to pay royalties.[108] The trial court granted summary judgment in favor of the franchisor and awarded the franchisor past-due and future royalties.[109] In affirming the trial court's award, the

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[99] No. 99-CV-5935, 2000 WL 669640 (E.D. Pa. May 17, 2000).

[100] *Id*. at *1.

[101] *Id*. at *4.

[102] *Id*.

[103] *Id*.

[104] No. 05-61306-CIV, 2006 WL 8431025, at *5 (S.D. Fla. May 26, 2006).

[105] *Id*.

[106] *Id*.

[107] 69 F. App'x 692, 699 (6th Cir. 2003).

[108] *Id*. at 693.

[109] *Id*. at 694-95.

appellate court held that the franchisor was entitled to all damages necessary to put itself in a position equivalent to that in which it would have found itself if the franchise agreement had continued in effect for the full twenty-year term.[110]

In 2007, a federal district court in California criticized and distinguished *Sealy,* in *Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc.*[111] The Radisson franchise agreement contained a liquidated damages clause outlining damages that the franchisee would incur if the franchisor terminated the agreement due to a breach by the franchisee.[112] The court analyzed the *Sealy* decision and distinguished the hotel franchise agreement from the agreement at issue in *Sealy*.[113] In contrast to the agreement in *Sealy*, the Radisson franchise agreement specifically contemplated liquidated damages based on the franchisor's termination of the agreement due to the franchisee's failure to pay royalties.[114] In addition, the appellate court noted in a footnote:

> Alternatively, this Court believes that the *Sealy* decision is mistaken.... The *Sealy* court based its proximate cause analysis on a single case involving a licensor-licensee relationship decided by another intermediate California appellate court in 1931. In this Court's view, the *Sealy* Court's holding that a franchisor has no remedy but to sue the franchisee over and over again as lost royalties accrue is simply untenable....the Court believes that where a franchisee breaches a contract and demonstrates that it is unable and unwilling to meet its obligations, lost future profits are a proximate result of the breach because the franchisee's actions are a "substantial factor in bringing about that loss or damage." Thus, this Court does not find *Sealy* to be persuasive.[115]

In a 2008 case, *Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc.*,[116] a Texas appellate court, applying Georgia law, held that the franchisor was entitled to future royalties that it would have received "but for" the franchisee's breach of the franchise agreement.[117] The franchisee had stopped making royalty payments for two child-care facilities, claiming that the franchisor, Kids 'R' Kids, was providing poor organizational support, and began operating its facilities under a new name. Kids 'R' Kids sued the franchisee for breach of contract. A jury returned a verdict in favor of the franchisor, found that it had complied with the terms of the franchise agreements, and awarded lost future royalties.[118] On appeal, the franchisee, relying on *Sealy*, contended that "there was legally and factually insufficient evidence that it proximately caused the amount of damages awarded for past-due and future royalty payments."[119] The

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[110] *Id*. at 699.

[111] 488 F. Supp. 2d 953, 963 (C.D. Cal. 2007).

[112] *Id*. at 956.

[113] *Id*. at 962-63.

[114] *Id*.

[115] *Id*. at 963, n. 10.

[116] No. 2-07-127-CV, 2008 WL 4831339 (Tex. App. Nov. 6, 2008).

[117] *Id*. at *4.

[118] *Id*.

[119] *Id*. at *2.

appellate court, relying on *American Speedy Printing* and *Cintron*, determined that traditional contract principles dictated that the injured party be put in as a near to the situation it would have occupied absent the breach. The court noted that "[u]nder Georgia law, damages growing out of a breach of contract must be such as could be traced solely to breach, must have arisen according to the usual course of things, and be such as the parties contemplated as a probable result of such breach."[120] The court found that lost profits were recoverable because they could be shown with reasonable certainty and were in the contemplation of the parties at the time they entered into the franchise agreements.[121]

In a 2013 case, *Leisure Systems, Inc. v. Roundup*, a district court in Ohio, denied the defendant franchisees' motion in limine to exclude the franchisor's damages calculations for lost future royalties, finding that "[d]efendants' breaches of the Franchise Agreements proximately caused those future damages of Plaintiff that are proven with reasonable certainty." [122] In so holding, the court extensively analyzed *Sealy*, and the cases following it, as well as the cases that had rejected the reasoning of *Sealy*.[123] The court also observed that "[a]ll of the Franchise Agreements are void of any language that indicates Defendants would not be liable for lost future royalties or future fees upon Plaintiff's termination of the Franchise Agreements due to a material breach by Defendants" and that "Defendants do not argue that such future damages were not reasonably foreseeable."[124]

In 2014, in *Legacy Academy, Inc. v. JLK, Inc.*, the Georgia Court of Appeals held that Legacy Academy, a franchisor of childcare centers, was entitled to recover lost future royalties when it terminated the franchise agreement upon default by franchisee JLK.[125] The trial court had found "that because the royalty fee was defined by the contract as consideration for JLK's use of Legacy's name and trademarks, and that there was no requirement in the contract that JLK actually exercise its right to use the Legacy Academy System and its licensed marks, then the consideration was eliminated when Legacy terminated the contract."[126] The appellate court disagreed, finding that the contract required JLK "to operate as a Legacy Academy with concomitant use of Legacy's trademarks."[127] The court expressly rejected *Sealy's* proximate cause rationale, explaining that "[t]he *Sealy* decision has been roundly criticized for its abandonment of traditional contract principles, for potentially offering franchisees a way to enjoy the benefits of a franchise agreement without fully paying for those benefits, and for positing that a franchisor may eventually collect its lost 'future' royalties-once they become past-due, that is-by repeatedly suing the franchisee."[128] The court also pointed out "that even *Sealy* does not foreclose future royalties even in the event of the franchisor's termination so long as the

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120 *Id*. at *4.

121 *Id*.

122 No. 1:11-cv-384, 2013 WL 12178132, at *5-6 (S.D. Ohio Jan. 23, 2013).

123 *Id*. at *3-6.

124 *Id*. at *5.

125 765 S.E.2d 472, 476 (Ga. Ct. App. 2014).

126 *Id*. at 474.

127 *Id*. at 476.

128 *Id.* at 475 n.3.

franchisee's conduct proximately caused the damages."[129] The court instead elected to utilize traditional contract principles in *Progressive Child Care*, noting that "Georgia law provides a mechanism for quantifying future profits under general contract principles, and this is how we will proceed."[130] Applying Georgia law, the appellate court determined that traditional contract principles dictated that the injured party be put in as a near to the situation it would have occupied absent the breach. Thus, the court concluded, "Legacy was entitled to seek recovery of lost future royalties that it would have received if JLK's breach had not prompted its termination of the franchise agreement prior to the completion of its original 20-year term."[131] (Ultimately, however, the court went on to find that the franchisor failed to prove its lost future royalties with reasonable certainty.)[132]

Last year, in *Janai v. Sanford Rose Associates International, Inc.*,[133] a Texas appellate court affirmed an award of damages for lost future royalties. The franchisee had failed to pay franchise fees and sought to terminate the franchise agreement prior to opening a franchised executive search business, and the franchisor sued for breach and anticipatory breach of the franchise agreement and the personal guaranty. The franchisor was awarded partial summary judgment on its claims and on the franchisee's counterclaims. On appeal, the court affirmed the award of damages for lost future royalties because the franchise agreement obligated the franchisee to ***pay a minimum royalty*** during the term of the agreement and the franchisor was entitled to recover the net present value of those future minimum royalty payments as a result of the franchisee's repudiation of the agreement.[134] Further, the court noted that under Texas law, "When a party who is obligated to make future payments of money to another absolutely repudiates the obligation without just excuse, the obligee is entitled to maintain his action for damages at once for the entire breach, and is entitled in one suit to receive in damages the present value of the future payments payable to him by virtue of the contract."[135]

Also last year, in *Carstar Franchise Systems, Inc. v. Underwood*,[136] a district court in Tennessee granted the franchisor's motion for summary judgment seeking lost future profits and other damages where the franchisee had abandoned its franchised locations. Relying on historical sales data and the contract's payment terms, the court found that the franchisor had established with reasonable certainty its right to $258,400 in lost future profits, which were calculated as the fees the franchisee would have paid over the three-year period that the franchisor asserted would be necessary to replace the abandoned businesses.

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[129] *Id*.

[130] *Id*. at 475.

[131] *Id*. at 476.

[132] *Id*. at 478; *see also* Legacy Academy v. Doles-Smith Enterprises, 789 S.E.2d 194 (Ga. App. 2016) (finding evidence was sufficient to support jury verdict in favor of franchisor on its claim for lost royalties); Legacy Academy, Inc. v. Pacu Enterprises, Inc., 825 S.E.2d 905 (Ga. App. 2019) (awarding Legacy Academy lost royalties, advertising and marketing fees when franchisee abandoned location and stopped making required payments).

[133] No. 05-18-01079-CV, 2020 WL 728428 (Tex. App. Feb. 13, 2020), *review denied* (July 31, 2020).

[134] *Id*. at *13.

[135] *Id*. (quoting Taylor Pub. Co. v. Sys. Mktg., Inc., 686 S.W.2d 213, 217 (Tex. App. 1984)).

[136] No. 2:18-cv-02149-JTF-cgc, 2020 WL 1881085 (W.D. Tenn. Feb. 21, 2020).

Just this year, in *Maaco Franchisor SPV, LLC v. Cruce*, a federal district court in North Carolina determined on a motion for default judgment, that Maaco was entitled to recover it future lost-profit damages after its franchisees had ceased operations with no intention of reopening.[137] Under the franchise agreements, the franchisees were required to continue the operation of the centers and pay certain royalties and advertising contributions for the term of the agreements.[138] The franchisor sued, alleging breach of the franchise agreements, and sought damages, including lost future royalties and lost future advertising contributions.[139] Applying North Carolina law, the court found that the franchisor had demonstrated that the closure of the centers before the end of the term of the franchise agreements proximately caused it to suffer damages because the closure stopped the potential for generating any revenue.[140] Further, the franchisor had also provided sufficient evidence, in the form of historical data concerning the franchisees' centers before closure to establish the amount of its lost profits with reasonable certainty.[141] The court also found that "it is undeniable that Plaintiff is entitled to future damages" because it was reasonable for the parties to contemplate lost profits, based on the duration of the agreements with rights to renew and exclusive territories.[142] Finally, given the duty to mitigate damages, the court found that limiting damages to three years was a reasonable period because that is the average time that it takes to replace a franchisee's operations.[143]

In *H.H. Franchising Systems, Inc. v. Robo*,[144] another opinion from this year involving a default judgment, a district court in Ohio awarded H.H. Franchising Systems, the franchisor of Home Helpers in-home care franchises, lost future royalties for the remaining franchise term. Noting that "[o]ther federal courts have concluded that *Sealy* does not preclude an award of lost future royalties where the franchisee has abandoned the franchise," the court found that the franchisee's abandonment of the franchise justified an award of lost future royalties.[145] To support its claim for future fees, the franchisor submitted an affidavit that added all potential future Royalty, National Branding, and Technology Fees that Defendant would have paid before the expiration of the Franchisee Agreement.[146] Notably, the court also found, without explanation, "there is no evidence that future profits or royalties could be mitigated by replacing Defendants with another franchisee."[147]

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[137] No. 3:18CV361, 2021 WL 706424, at *5 (W.D.N.C. Feb. 23, 2021).

[138] *Id*. at *2.

[139] *Id*. at *3.

[140] *Id*. at *5.

[141] *Id*.

[142] *Id*. at *5-6.

[143] *Id*. at *6.

[144] No. 1:19CV961, 2021 WL 388764, at *3 (S.D. Ohio Feb. 4, 2021).

[145] *Id*. at *2.

[146] *Id*. at *1.

[147] *Id*. at *2.

c. Cases Not Permitting Recovery of Future Lost Profits

In *I Can't Believe It's Yogurt v. Gunn*,[148] a franchisor of businesses that sold frozen yogurt terminated a franchise agreement because of the franchisee's failure to pay royalty fees. A district court in Colorado followed *Sealy* and concluded that franchisor ICBIY was not entitled to lost future profits because "any loss of future royalties was proximately cause by ICBIY's election to terminate the franchise agreements."[149] The court further found an award of damages based upon loss of future royalties would have been speculative and could not be determined with any degree of certainty.

In *Burger King Corp. v. Hinton, Inc.*,[150] the franchisor had terminated because of the franchisee's failure to pay royalties. While the franchisee argued that *Sealy* should be applied, the court declined to apply *Sealy* because the franchise agreement contained a Florida choice of law provision.[151] Nonetheless, the court held, as did *Sealy*, that the franchisee's failure to pay royalty fees and other payments did not proximately cause the franchisor's loss of future royalty payments. The judge, who was the same judge that had decided the *Barnes* case discussed above, distinguished *Barnes* by pointing out that the franchisee in *Barnes* abandoned its franchise and, accordingly, the franchisee's actions in *Barnes* did proximately cause the franchisor's loss of future profits. Burger King also argued that it was entitled to future revenue because the franchisee "anticipatorily breached" the franchise agreement. The court dismissed this argument, finding that Burger King's claim was outside of the pleadings in the case.[152]

In *Kissinger, Inc. v. Jaspal Singh*,[153] a federal court in Michigan considered whether a franchisor is entitled to recover future royalties under a franchise agreement after terminating the franchise agreement based upon the franchisee's failure to timely pay royalties. At the outset, the court mistakenly announced that it was considering a case of first impression in Michigan (missing the decision in *American Speedy* and the possible application of *McAlpine*). Citing *Sealy*, *Hinton*, and *Gunn*, the court held that the franchisor was not entitled to recover future royalty payments as damages because the proximate cause of the loss of future royalties was the franchisor's decision to terminate the franchise agreement.[154] The franchisor sought to terminate the franchise on three grounds: (1) failure to make royalty payments; (2) sales or use of unapproved products and/or supplies; and (3) involvement with another franchise that competes with the franchisor's system. The court found that the franchisee's failure to make royalty payments was the "only sustainable ground for termination" and held that "where a franchisor terminates a franchise agreement based upon the franchisee's failure to make royalty payments, the franchisor's decision to terminate the franchise agreement is the proximate cause of the

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[148] No. Civ. A. 94–OK–2109–TL, 1997 WL 599391 (D. Colo. 1997).

[149] *Id*. at *24.

[150] 203 F. Supp. 2d 1357 (S.D. Fla. 2002).

[151] *Id*. at 1366.

[152] *Id*. at 1367.

[153] 304 F. Supp. 2d 944, 951 (W.D. Mich. 2003).

[154] *Id*. at 950. The court, however, also noted that it had "not found any case that has reached the opposite result." *Id*.

franchisor's lost future royalty payments." For this reason, the court concluded that the franchisor was not entitled to recover future royalty payments.[155]

In *ATC Healthcare Services, Inc. v. Personnel Solutions, Inc.*,[156] a federal court applying New York law to a terminated franchise agreement declined to award lost future royalties where the plaintiff elected to terminate the contract rather than sue for an ongoing breach based on missed royalty payments. The court determined that the plaintiff's own actions, i.e., the termination, and not the defendant's breach directly deprived it of future royalties that would have been generated.

In *Dunkin' Donuts, Inc. v. Arkay Donuts, LLC*,[157] a federal court in New Jersey found "that a legal error was committed in awarding future lost profits" to a franchisor in connection with a default judgment. The court observed that "the award of future lost profits to a franchisor from a franchisee is not based on any settled precedent in New Jersey."[158] Then, relying on *Kissinger*, *Sealy*, *Hinton*, and *Gunn*, the court observed that "these cases found that the franchisees' breaches were not proximately connected to the lost future royalty payments, but rather, it was the franchisors' terminations that proximately caused the future losses."[159]

In *Meineke Car Care Centers, Inc. v. L.A.C. 1603 LLC*, a district court in North Carolina concluded that the franchisor's act of terminating the agreement prevented the franchisee from generating the revenues necessary to create an obligation to pay royalties: "When Plaintiff terminated the franchise agreement, Plaintiff terminated the Defendants' ability to generate any revenues from the sale of Meineke products which would, in turn, generate any liability for 'royalty fees' . . . or Advertising Fund fees. . . . Any percentage of zero is zero."[160]

In *Mister Softee, Inc. v. Amanollahi*,[161] a New Jersey district court, applying New York law, analyzed the case law denying franchisors future lost profits after terminating the franchise agreements under the doctrine of election of remedies, observing that "[w]hen one party commits a material breach of contract, the other party has a choice between two inconsistent rights—it can either elect to allege a total breach, terminate the contract and bring an action or, instead, elect to keep the contract in force, declare the default only a partial breach, and recover those damages caused by that partial breach—but the nonbreaching party, by electing to continue receiving benefits under the agreement, cannot then refuse to perform its part of the bargain."[162] Thus, the court concluded, "Mister Softee faced a choice: terminate the Agreements, or remain within the Agreements and sue for the ongoing unpaid royalties. It chose the former."[163]

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155 *Id*.

156 No. 01 CV 762 CBA, 2006 WL 3758618, at *11-12 (E.D.N.Y. Dec. 19, 2006).

157 No. CIV. 05-387 (WHW), 2006 WL 2417241, at *5 (D.N.J. Aug. 21, 2006).

158 *Id*.

159 *Id*.

160 No. 3:08CV73, 2008 WL 1840779, at *1 (W.D.N.C. Apr. 23, 2008).

161 No. 214CV01687KMJBC, 2016 WL 5745105, at *12 (D.N.J. Sept. 30, 2016).

162 *Id*.

163 *Id*. at *13.

d. Practical Pointers and Trends

As the cases discussed above demonstrate, post-*Sealy*, there is not uniformity regarding whether or when a franchisor may recover post-termination lost future profits as breach of contract damages from a franchisee.

Most courts agree that future lost profits damages are generally appropriate when ***the franchisee*** terminates, repudiates, or abandons its franchise.[164] However, when the ***franchisor terminates***—especially when it terminates solely on the basis of unpaid fees—many courts have denied future lost profits damages, reasoning that the franchisor proximately caused its own future losses through its decision to terminate the franchise relationship. Some courts have ignored *Sealy* and its progeny and have awarded franchisors future lost profits damages, even when the franchisor terminates and the franchisee has not repudiated, terminated, or abandoned.

The approach of the court in *Radisson* is the approach that some commentators believe follows the basic principles of contract law most closely. Those commentators explain in the 2007 law review on the subject, *Radisson and the Potential Demise of the Sealy-Barnes-Hinton Rule*, that:

> [W]hat we call the *Sealy/Barnes/Hinton* rule does not make sense. That rule, which basically allows future damages if the franchisee, but not the franchisor, terminates (even if the franchisee has committed continuing uncured breaches), elevates form over substance by failing to properly analyze proximate causation and, in many cases, properly apply principles of mitigation to avoid excessive damages. Lost profit damages should be available if, at the time of contracting, the parties might reasonably have foreseen that such losses would be the probable result of the franchisee's breach. However, . . ., a franchisor should not recover lost profits that the franchisee proves could have been avoided by installing a replacement franchisee or otherwise mitigated.[165]

It is important for both the franchisor and franchisee to carefully review the terms of the franchise agreement and to know the law in their jurisdiction before making the decision to terminate a franchise agreement or abandon a franchise. Generally speaking, a franchisor will be less likely to recover lost future profits if it affirmatively terminates a franchisee due to unpaid royalties. If the recovery of lost future profits is a primary consideration, the franchisor may be better off filing a lawsuit against the franchisee without terminating the franchise agreement. Similarly, a franchisee is more likely to owe lost future profits if it abandons the location. Prior to abandoning a franchise, the franchisee should consider approaching the franchisor to discuss other possible resolutions such as agreeing on an early exit or allowing the franchisee time to sell the franchise.

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[164] *See, e.g.*, Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 F. Appx'. 274, 282-83 (4th Cir. 2011); Morgan Indus., Inc. v. Mr. Transmission of Chattanooga, Inc., 725 F. Supp. 2d 712, 719 (E.D. Tenn. 2010) ("It is clear from a review of case law that even the *Sealy* decision does not preclude future lost royalty damages where a franchisee has clearly abandoned the franchise"); Hardee's Food Sys., Inc. v. Hallbeck, No. 4:09CV00664 AGF, 2011 WL 4407435, at *3 (E.D. Mo. Sept. 21, 2011).

[165] Robert L. Ebe, David L. Steinberg, & Brett R. Waxdeck, *Raddison and the Potential Demise of the Sealy-Barnes-Hinton Rule*, 27 FRANCHISE L.J. 3, 4-5 (2007).

B. Proving and Calculating Lost Profits

Lost profits are often an extremely important item of damages in franchise litigation. Because of the lengthy term of many franchise agreements, lost profit awards can be substantial.

Both franchisors and franchisees must pay attention to the methodology used in calculating the award. Based on the cases discussed above, the franchisor needs to take a realistic approach in its initial calculation by focusing on the particular franchisee's actual historic performance, rather than attempting to augment the amount by resorting to future sales projections untethered to the franchisee's actual performance. It is also essential for the franchisor to account for its expenses and saved costs of performance in its calculation, as well as its duty to mitigate damages. From the franchisee's perspective, if there is a realistic chance the franchisor will establish its entitlement to a lost future royalties award, the franchisee must pay attention to the franchisor's calculation and be prepared to present specific evidence of defects if it disagrees with that calculation.

1. Estimating Franchisor Damages

a. Demonstrating Reasonable Certainty

"The goal in awarding damages for breach of contract is to give the innocent party the benefit of his bargain – to place him in a position equivalent to that which he would have attained had the contract been performed."[166] Recovering lost profits generally requires a plaintiff to establish three elements: (1) causation, (2) foreseeability and (3) reasonable certainty. The third element creates a challenge for damages experts—while the plaintiff must prove that lost profit damages are reasonably certain and "not speculative,"[167] by definition, establishing lost profits involves proving something that, as a result of the defendant's misconduct, did not occur.

Almost every jurisdiction has adopted "reasonable certainty" as the standard of proof for lost profits.[168] Courts generally agree, however, that proving reasonable certainty does not require mathematical precision. Usually, damages are sufficiently certain if the evidence enables the court to make a fair and reasonable approximation of damages.[169]

For instance, in *Belleville Toyota, Inc. v. Toyota Motor Sales, U.S.A., Inc.*,[170] the Supreme Court of Illinois held that because lost profits, by their very nature, are always uncertain to some extent and incapable of calculation with mathematical precision, "the law does not require that lost profits be proven with absolute certainty." Rather, the court reasoned that "evidence need

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[166] *See* Tel-Ex Plaza, Inc. v. Hardees Rests., Inc., 225 N.W.2d 794, 796 (Mich. Ct. App. 1977).

[167] Rubin Res., Inc. v. Morris, 237 W. Va. 370, 379 787 S.E.2d 641, 650 (2016); Stern Oil Co. v. Brown, 908 N.W.2d 144, 151 (S.D. 2018); Restatement (Second) of Contracts § 352 (Am. Law. Inst. 1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.").

[168] Robert L. Dunn, Recovery of Damages for Lost Profits § 1.6 (6th ed. 2005).

[169] Precision Pine & Timber, Inc. v. United States, 63 Fed. Cl. 122, 131 (2004).

[170] 770 N.E.2d 177 (Ill. 2002).

only afford a reasonable basis for the computation of damages which, with a reasonable degree of certainty, can be traced to defendant's wrongful conduct.[171]

Whether lost profits are "reasonably certain" is a fact-intensive determination.[172] The basis of lost profits should be "objective facts, figures, or data from which the amount of lost profits can be ascertained."[173] It is generally easier to prove lost profits for an established business with an earnings track record. At one time, the "new business rule" prevented unestablished businesses from recovering lost profits on the ground that such damages were unduly speculative. That rule stated that a new or unestablished business could not recover lost profits. Today, however, most courts have rejected the new business rule and apply a new standard: the modern new business rule. This rule allows unestablished businesses to recover lost profits, as long as those profits can be proven with reasonable certainty. "The development of the law has been to find damages for lost profits of an unestablished business recoverable when they can be adequately proved with reasonable certainty.… What was once a rule of law has been converted into a rule of evidence."[174]

To avoid the harsh consequences that may result from an overly rigid application of the "reasonable certainty" requirement, courts frequently invoke a number of modifying principles, most notably, "[w]here the defendant's wrong has caused the difficulty of proof of damages, he cannot complain of the resulting uncertainty" and "[i]f the best evidence of the damage of which the situation admits is furnished, this is sufficient."[175] Experts estimating lost profits under the modern new business rule know that lost profit estimates in these cases are held to a higher reasonable certainty standard than calculations for lost profits in cases with established businesses. Failing to meet this higher standard may cause an expert's calculations to be ruled as speculative. Part of the rationale for the modern rule is that it would be unfair to penalize a plaintiff for lacking a sufficient track record when it was the defendant's actions that prevented the plaintiff from establishing a track record.

b. <u>But-For Analysis</u>

Generally speaking, evaluating damages suffered by a business as the result of an alleged wrongful act of another party is a process of identifying revenues or profits that could have been earned "but for" the alleged bad act.[176] The purpose of such an analysis is to determine what amount of compensation is necessary to make the claimant economically whole -- to determine the magnitude of the harm suffered as a result of the alleged bad act. There are any number of methodologies that can be used to estimate what sales or profits could have been and then compare those estimates with actual sales or profits to determine the extent of economic harm suffered by the business.

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[171] *Id.* at 199-200; *see also* DXS, Inc. v. Siemens Med. Sys., Inc., 100 F.3d 462, 473 (6th Cir. 1996) ("Any uncertainty about lost profits damages should be resolved against the defendant, who, as the wrongdoer, bears the risk of uncertainty").

[172] Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992).

[173] *Id.*

[174] Robert L. Dunn, RECOVERY OF DAMAGES FOR LOST PROFITS § 4.2 at 280 (6th ed. 2005) (collecting cases).

[175] Charles T. McCormick, MCCORMICK HANDBOOK ON DAMAGES § 27 at 101.

[176] *Calculating Lost Profits,* AICPA Practice Aid 06-4, at 3.

The process for determining damages for non-payment requires the expert to determine (1) the appropriate level of franchise fees "but-for" the breach of the franchise agreement,[177] and (2) the appropriate interest rate for historical fees and discount rate for future fees. After determining these variables, the present value of the franchise fees "but for" the breach is calculated. These "but for" or "would-have-been" franchise fees are then compared to the present value of the actual fees received, and the difference is an estimate of the damage suffered by the franchisor.

The but-for approach calculates the expected performance of the alleged wronged party during the period but-for the alleged action.[178] The main objective of this approach to calculating damages is to put the harmed party in the same position they would have been in but-for the alleged action. In performing this analysis, the damages expert would create an impaired model, which is a representation of what actually occurred. He would then compare that model with the unimpaired model, which is the expectation of what would have occurred but-for the alleged impairment. These models are achieved by making business projections or forecasts utilizing available information and informed assumptions.[179]

Courts generally recognize two models for proving lost profits: the so-called "before and after" comparison and the "yardstick" approach. Under either framework, courts examine whether the evidence of lost profits is supported by verifiable and relevant data.[180]

The "before and after" approach compares the profitability of the plaintiff before the breach to the post-breach profitability, or lack thereof.[181] For example, in *UST Corp. v. General Road Trucking Corp.*, the court found that "one of the best ways of establishing reasonably certain future lost profits . . . is to use the operational history of the enterprise for which future lost profits are being sought, or a representative portion thereof, as a basis for predicting lost profits" (the "before and after" test).[182] The court ultimately determined that lost profit damages were not proven with reasonable certainty where the business had only been operating for approximately three months at the time of the breach and the plaintiff's damage expert's projections of future lost profits were

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[177] Since franchise fees tend to be a percentage of sales, the expert must also determine the appropriate base of sales for the franchise location in order to arrive at an estimate of the "but for" franchise fees owed to the franchisor as a result of the franchisee's breach of the franchise agreement.

[178] Roman L. Weil et at, LITIGATION SERVICES HANDBOOK: THE ROLE OF THE ACCOUNTANT AS EXPERT 30.2 (2d ed., 1995).

[179] *See e.g.,* Michaels v. Greenberg Traurig, 62 Cal. App. 5th 512, 525 (2021) (discussing the expert's use of the "Before and After Method" which divided the contract into two periods and considered the effect of prevented marketing activities on profitability to calculate the profits that would have been received but for the actions of the defendant).

[180] Investigation and analysis of possible historical under-reporting of sales or revenues may also be necessary and can take many forms. Since different franchisors may have their own metrics used to anticipate approximate levels of franchise fees, these metrics may be one way to estimate alleged historical under-reporting. Evaluation of "comparable" stores or franchises can also be used to evaluate under-reporting. Additionally, evaluation of bank records, computerized cash register records, store franchisee financial statements and other accounting measures can be employed as warranted to determine under-reporting.

[181] Lehrman v. Gulf Oil Corp., 500 F.2d 659, 667 (5th Cir. 1974).

[182] UST Corp. v. Gen. Rd. Trucking Corp., 783 A.2d 931, 942 (R.I. 2001).

based on only one week of available operating data.[183] The court also found that the damage expert relied on unsupported and speculative assumptions.[184]

The yardstick approach is used when the "before and after" method is not available and uses some other entity or benchmark (such as an industry standard) to set profitability.[185] In franchise cases, reasonable certainty can sometimes be established even when the franchised business does not have a substantial operational history.

For example, in *Pauline's Chicken Villa, Inc. v. KFC Corp*.,[186] the court noted that certain characteristics of franchise outlets eliminate significant amounts of uncertainty that might exist in other contexts. The court held that when the franchisor is a national or regional franchisor with uniform advertising and quality control, and when there is available data on earnings and expenses and on failure and success ratios from similar locations, the franchisee can usually show lost profits with "reasonable certainty."[187] The court further noted that if, in addition, the franchisee is experienced in the particular business or has a past record of success in that industry (the yardstick approach), the case for awarding lost profits becomes even stronger.[188]

One important consideration in applying the but-for approach is that it is essential to establish that but for the breach, the business would have enjoyed continued success. Thus, where a franchisee testified at trial that it had consistently had operating losses, and there had been other stores closed, there was uncertainty as to whether any losses would actually be incurred by the franchisor.[189]

Determination of "but for" franchise fees related to future periods may require trend analysis and factoring in corrected historical sales or revenue amounts. Other influences should also be considered as warranted, such as increases or decreases in competition in the immediate vicinity, demographic shifts, changes in traffic patterns, influx of commercial/residential development, etc.[190]

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183 *Id*.

184 *Id*.

185 *Id*.

186 701 S.W.2d 399, 401 (Ky. 1985).

187 *Id.*

188 *Id*. at 401-02.

189 Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc., case number 2009 WL 579516 (D. Colo. Full date 2009); *see also* Meineke Car Care Centers, Inc. v. L.A.C. 1603 LLC, No. 3:08CV73, 2008 WL 1840779, at *3 (W.D.N.C. Apr. 23, 2008) (denying future lost profits where franchisee had been operating at a loss because "Meineke has failed to prove that such profits would have been realized"); Meineke Car Care Centers, Inc. v. Duvall, No. 3:06cv180W, 2007 WL 1100841 (W.D.N.C. Apr. 12, 2007) (no prospective profits for franchisor on breach of franchise agreement claim where franchise had been operating at a net loss).

190 *E.g.,* Days Inns Worldwide, Inc. v. Inv. Props. Of Brooklyn Ctr., LLC, No. 10-609, 2011 WL 4538076, at *11-13 (D. Minn. Aug. 26, 2011) (noting that many factors may influence profitability, including changes in the location or formation of highways, traffic patterns, and the ability of the public to use the facilities and highlighting plaintiff's failure to provide the court proof of competitive market conditions, proof of its expansion or contraction, proof of its historical accuracy in forecasting future revenue streams from franchised hotels, and proof of its ability to forecast economic trends).

c. Determining Recoverable Profits

A franchisor's recoverable profits must be determined on a net rather than a gross basis. Thus, the franchisor must deduct expenses from expected future royalties in order to prove lost profits.[191] Where a franchisor failed to introduce evidence of its operating expenses attributable to doing business with the defendants so as to reduce its royalties to net, rather than gross royalties, it failed to carry its burden at trial to submit substantial evidence from which future damages could be calculated with reasonable certainty.[192]

It may be possible to argue that incremental expenses of maintaining a single franchisee in the system are minimal once the business is operational. For example, in *Legacy Acad., Inc. v. Doles-Smith Enterprises, Inc*., the court accepted testimony by Legacy's owners that:

> The majority of its expenses were fixed and front loaded and therefore should not be deducted from the lost profit damages being requested.[193]

Alternatively, courts have accepted methodologies whereby the franchisor's fixed costs were calculated on a per store basis and then deducted to reach net lost royalties.[194]

Parties claiming damages also typically have a general duty to mitigate their losses. Thus, courts will typically limit the recoverable period to the average time that it takes to replace a franchisee's operations.[195] Courts, however, have held that a franchisor's duty to mitigate losses due to cessation of franchise operations by franchisees does not apply in cases that involve non-exclusive franchise agreements.[196]

d. Witnesses for Lost Profits

Both expert and lay witnesses can be used to establish lost profits. It is important to carefully analyze the unique benefits and potential pitfalls of each when deciding how to present a case for lost profits.

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[191] Legacy Acad., Inc. v. JLK, Inc., 330 Ga. App. 397, 403, 765 S.E.2d 472, 477 (2014) ("[T]o recover lost profits one must show the probable gain with great specificity as well as expenses incurred in realizing such profits. In short, the gross amount minus expenses equals the amount of recovery.").

[192] *Id*. at 402-405, 330 Ga. App. At 476-78.

[193] Legacy Acad., Inc. v. Doles-Smith Enterprises, Inc., 337 Ga. App. 575, 585, 789 S.E.2d 194, 203 (2016).

[194] *See* Burger King Corp. v. Barnes, 1 F. Supp. 2d at 1367, 1369 (S.D. Fla. 1998).

[195] *See, e.g.*, Maaco Franchisor SPV, LLC v. Cruce, No. 3:18-cv-361, 2021 WL 706424, at *6 (W.D.N.C. Feb. 23, 2021) (limiting damages to three years was a reasonable period because that is the average time that it takes to replace a franchisee's operations); Carstar Franchise Systems, Inc. v. Underwood, No. 2:18-cv-02149-JTF-cgc, 2020 WL 1881085, at *2 (W.D. Tenn. Feb. 21, 2020) (awarding fees the franchisee would have paid over the three-year period that the franchisor asserted would be necessary to replace the abandoned businesses); but see Meineke Car Care Centers, Inc. v. L.A.C. 1603 LLC, No. 3:08-cv-73, 2008 WL 1840779, at *2 (W.D.N.C. Apr. 23, 2008) (denying future lost profits after finding "Meineke's claim that it usually takes it three years to re-franchise a business is speculative").

[196] *Barnes*, 1 F. Supp. 2d at 1372 (where a non-exclusive contract would allow a franchisor to enter into other similar contracts, an exception to the requirement of avoiding foreseeable consequences is created and there is no duty to mitigate or minimize losses).

e. Rule 702 and *Daubert* Considerations

In federal court, the admissibility of expert testimony on any subject is governed by Rule 702 of the Federal Rules of Evidence and *Daubert v. Merrell DowPharmaceuticals, Inc*.[197] and its progeny. When using a damages expert to establish lost profits, one must be particularly mindful of the hurdles posed by these authorities.

Rule 702 requires that an expert's testimony: (1) help the trier of fact understand the evidence or determine a fact in issue; (2) be based on sufficient facts or data, (3) be the product of reliable principles and methods, and (4) reliably apply the principles and methods to the facts of the case.[198]

In *Daubert*, the U.S. Supreme Court clarified that Rule 702 requires a court faced with a proffer of scientific expert testimony to determine whether the testimony is both relevant and reliable by considering: (1) whether the method or technique presented by the expert can be and has been tested, (2) whether the technique or method has been peer reviewed, (3) whether the method or technique has been evaluated in terms of a known error rate, and (4) whether the method or technique is generally accepted in the relevant scientific discipline[199] These determinations impose upon the trial court a "gatekeeping" function by requiring the court to admit only those theories, methods, or techniques meeting the Rule 702 requirements, as clarified by *Daubert*.[200] The Supreme Court subsequently made clear that this “gatekeeping” requirement and the relevance and reliability standards of Rule 702 likewise apply to proffers of non-scientific expert testimony.[201]

Under *Daubert* and its progeny, the trial judge must make a threshold determination as to the admissibility of proffered expert opinion testimony, whether or not the expert is challenged by the other side.[202] A trial or appellate court can also strike expert evidence that fails to meet the requirements of Rule 702 at any stage in the proceedings. Thus, it behooves the practitioner to lay the foundation required by *Daubert*, even if the evidence has not been challenged.[203]

It is vital to choose an expert with the right experience and credentials. In most situations, the expert should be credentialed as a Certified Public Accountant, and the expert should have experience not only in franchise disputes but also in franchise auditing and valuation. This background should allow the expert to evaluate potential damages from a number of perspectives: actual damages in terms of lost revenues, sales, or profits; damages as indicated by bank records

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197 509 U.S. 579 (1993).

198 Fed. R. of Evid. 702. Rules of evidence applicable in state court proceedings usually impose similar standards on expert testimony.

199 *Daubert*, 509 U.S. at 594-95.

200 Michael H. King & Steven M. Evans, *Selecting An Appropriate Damages Expert In A Patent Case; An Examination of the Current Status of Daubert*, 38 AKRON L. REV., 357, 367 (2005).

201 Kumho Tire Co. v. Carmichael, 526 U.S. 137, 147 (1999).

202 *Daubert*, 509 U.S. at 593.

203 *See* Weisgram v. Marley Co., 120 S. Ct. 2011 (2000), for a cautionary tale about a trial court accepting expert opinion evidence and the Eighth Circuit and Supreme Court striking it after the fact.

or sales records (e.g., register records); and damages as indicated from operational metrics such as evaluating orders of supplies against production records.

f. <u>Expert vs. Non-Expert Witness</u>

It is not uncommon for litigants to seek to introduce evidence regarding damages through their own employees and executives, who may or may not qualify as "experts" under the applicable rules of evidence, rather than offering this evidence through retained experts. The first question presented by such internal witnesses is whether they are offering expert testimony governed by Rule 702 of the Federal Rules of Evidence, or if they qualify as lay witnesses under Rule 701.

Where a witness is going to offer expert testimony based on "scientific, technical or other specialized knowledge," the admissibility of that testimony is governed by Rule 702, irrespective of whether the witness is specially retained or employed.[204] Where, however, the witness is not testifying as an expert but still intends to offer opinions or inferences, Rule 701 governs. Rule 701 provides:

> If the witness is not testifying as an expert, the witness' testimony in the form of an opinion is limited to one that is: (a) rationally based upon the witness's perception, (b) helpful to clearly understanding the witness's testimony or to determining a fact in issue, and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702.[205]

Prior to its 2000 Amendment, Rule 701 contained no prohibition on offering lay witness testimony based on scientific, technical, or other specialized knowledge.[206] The amendment of Rule 701 was designed to "eliminate the risk that the reliability requirements set forth in Rule 702 will be evaded through the simple expedient of proffering an expert in lay witness clothing."[207]

This does not mean that lay opinion testimony can never be appropriate. Under Rule 701(a), lay opinion testimony should be "based on the witness' firsthand knowledge or observations" to be admissible.[208] The requirement of a rational basis for the witness' perception means that the witness must "'have perceived with his senses the matters on which his opinion

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[204] Rule 26(a)(2) of the Federal Rules of Civil Procedure sets out different disclosure obligations for retained and non-retained experts. For the latter, the party must disclose the identity of the witness, as well as the individual's contact information and the subjects on which the non-retained expert will testify. *See* Fed. R. Civ. P. 26(a)(2)(A). For retained or specially employed experts and employees whose duties regularly involving giving expert testimony, the party must also provide a written report meeting the requirements set out in Rule 26(a)(2)(B).

[205] Fed. R. of Evid. 702.

[206] *Id*. at Advisory Committee Notes, 2000 Amendment.

[207] *Id.; see also* Cook v. Rockwell Int'l Corp., 233 F.R.D. 598, 601 (D. Colo, 2005) (noting that Rule 701's restriction on testimony based on scientific, technical, or other specialized knowledge is in rule in order to prevent evasion of requirements for expert witness by calling expert under guise of lay witness).

[208] DIJO, Inc. v. Hilton Hotels Corp., 351 F.3d 679, 685 (5th Cir. 2003); *see also* LifeWise Master Funding v. Telebank, 374 F.3d 917 (10th Cir. 2004) (holding witness must have personal knowledge of all items factored into opinion for lay opinion testimony to be admissible); Bank of China v. NBM LLC, 359 F.3d 171, 181 (2d Cir. 2004) (holding that lay opinion testimony only admissible to extent based on witness' perceptions).

is based' and satisfy the court that there is some 'rational connection between the witness' opinion and his perceptions."[209]

In *Servicios Comerciales Lamosa, S.A. de C.V. v. De la Rosa*,[210] the plaintiffs moved to exclude the defendant's opinion testimony regarding lost profits and related damages. The court, however, found that Mr. De la Rosa's educational and business background, as well as day-to-day responsibilities at Mundo Tile, qualified him to offer lay testimony under Rule 701.

IV. OTHER DAMAGES PROVISIONS

A. Damage Waivers

Due to the potential size and difficulty of calculating lost-profits damages, many parties, including franchisors, seek to limit them prospectively in their contracts with damage waivers. Such damages waivers can serve as an important tool to allocate risk and contracts that attempt to limit damages for fear of the uncertain, are often drafted in in conjunction with liquidated damages provisions.

As long as the provisions "are set forth clearly in the agreement between the parties and the agreement was 'knowingly, voluntarily and intentionally' entered into, contractual damages disclaimers are generally enforceable."[211] Courts, however, are generally wary of damage limitation provisions and tend to construe them narrowly.[212] They are considered on a case-by-case basis, and the results can be unpredictable.[213]

Lost profits can be considered as either direct or consequential damages. Direct or general damages are those that are "the necessary and usual result of the defendant's wrongful act; they flow naturally and necessarily from the wrong."[214] Consequential or special damages, on the other hand, are those losses that "do not arise directly and inevitably from any similar breach of any similar agreement," but instead, "are secondary or derivative losses arising from circumstances that are particular to the contract or to the parties," e.g., when the non-breaching party suffers loss of profits on collateral business arrangements.[215] Based on the language of the

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209 KW Plastics v. U.S. Can Co., 131 F. Supp. 2d 1265, 1272 (M.D. Ala. 2001) (quoting Charles Alan Wright and Victor James Gold, FEDERAL PRACTICE & PROCEDURE § 6254 (1997)).

210 328 F. Supp. 3d 598 (N.D. Tex. 2018).

211 Airport Mart Inc. v. Dunkin' Donuts Franchising LLC, No. 18-CV-170 (KMK), 2019 WL 4413052, at *8 (S.D.N.Y. Sept. 16, 2019); *see also, e.g.*, Quicksilver Res., Inc. v. Eagle Drilling, LLC, 2009 WL 1312598, at *7 (S.D. Tex. May 9, 2009); Fish Net, Inc. v. ProfitCenter Software, Inc., 2013 WL 5635992, at *10−11 (E.D. Pa. Oct. 15, 2013).

212 Capital Equip., Inc. v. CNH Am., LLC, 471 F. Supp. 2d 951, 958 (E.D. Ark. 2006) ("Contractual provisions limiting damages are strictly construed against the party invoking their protection."); Best Western Int'l, Inc. v. Patel, No. CV-04-02307-PHX-JAT, 2008 WL 205286 (D. Ariz. Jan. 23, 2008) (damages limitation held to apply only to contract and not tort claims).

213 Edward W. Dunham, *Enforcing Contract Terms Designed to Manage Franchise Risk*, 19 FRANCHISE L.J. 91, 97 (2000).

214 Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 816 (Tex. 1997); *see also* Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).

215 Lewis Jorge Constr. Mgmt., Inc. v. Pomona Unified Sch. Dist., 34 Cal. 4th 960, 968, 102 P.3d 257, 261 (2004); *see also* Hartford Acc. & Indem. Co. v. Case Found. Co., 10 Ill. App. 3d 115, 124 (1973); Unilever United States, Inc. v. Johnson Controls, Inc., 2017 WL 622209, at *4 (N.D. Ill. Feb. 15, 2017) (applying New York law).

contractual disclaimer, whether lost profits are characterized as direct or consequential damages could be dispositive.

Typically, lost profits in the context of a franchise termination are considered direct damages, because a profitable relationship is contemplated by the franchise agreement. Thus, consequential damages waiver provisions are not very effective in franchise termination cases, as courts usually find they do not waive recovery of lost profits. For example, in *Westlake Financial Group, Inc. v. CDH-Delnor Health System*[216], the court considered the following disclaimer:

> Limitation of Liability. Except with respect to the indemnification and confidentiality obligations contained in this Agreement or any Exhibit hereunder, without limitation to the foregoing, under no circumstances shall either party be liable to the other party for any indirect, incidental, consequential, special, punitive or exemplary damages, even if either party has been advised of the possibility of such damages, arising from this Agreement, such as, but not limited to, loss of revenue or anticipated profits or lost business.

This case considered whether the disclaimer prevented an award of any lost profits, or just incidental or consequential lost profits.[217] The court ultimately agreed with the plaintiff and found that the plain reading of the clause disclaimed only indirect, consequential damages from lost profits, but not direct lost profits.[218]

Similarly, in *Penncro Associates, Inc. v. Sprint Spectrum*, *LP*, the court found that a provision excluding consequential damages "includ[ing], but . . . not limited to, lost profits" only limited *consequential* lost-profit damages.[219] Lost profits as a whole were not singled out as a distinct type of damage and, therefore, not precluded from recovery in their entirety.[220]

However, in *Quicksilver Resources, Inc. v. Eagle Drilling, LLC*, the provision stated that the "parties [have] agreed that special, indirect or **consequential damages shall be deemed to include, without limitation, . . . loss of profit or revenue**; . . . [and] cost of loss of use of property, equipment, materials and services, including without limitation those provided by contractors and subcontractors of every tier or by third parties."[221] The court held that this provision manifested a clear intent by the parties to modify the legal meaning and breadth of the

[216] Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).

[217] *Id*. at 1175.

[218] *Id*. at 1177.

[219] Penncro Assocs., Inc. v. Sprint Spectrum, LP, 499 F.3d 1151, 1155 (10th Cir. 2007).

[220] *Id*. at 1157-58; *see also* Ingraham v. Planet Beach Franchising Corp., No. CIV.A. 07-3555, 2009 WL 1076713, at *1 (E.D. La. Apr. 17, 2009) (finding that a provision waiving claims "for any punitive, exemplary, incidental, indirect, special or consequential damages (including, without limitation, lost profits)" did not preclude claims for lost profits "which can be proved to have resulted directly from the opening of the new franchise," but only "lost profits that indirectly came about"); Biotronik A.G. v. Conor Medsystems Ireland, Ltd., 22 N.Y.3d 799, 808 (2014) (provision excluding consequential damages precluded only consequential lost profits).

[221] Quicksilver Res., Inc. v. Eagle Drilling, LLC, No. H-08-868, 2009 WL 1312598, at *5. (S.D. Tex. May 8, 2009).

term consequential damages.[222] The court found that the wording in *Penncro* implied that other unlisted damages could also be considered consequential damages and, as a result, where the provision at issue stated that the listed damages were to be considered special, indirect, or consequential, "without limitation," only those specifically enumerated damages categories were barred from recovery.[223]

Since consequential damage waivers do not typically apply to lost profits damages because they are usually considered to be direct damages, it is a better practice for franchisees to insist upon an explicit waiver of lost profits. For example, in *Airport Mart Inc. v. Dunkin' Donuts Franchising LLC*, the franchise agreement provided: "Waiver of Rights: Both we and you waive and agree not to include in any pleading ... [a] demand for trial by jury; claims for lost profits; or claims for punitive, multiple, or exemplary damages," which the court found effective to waive a franchisee's claim for lost profits.[224]

Due to the arguable power imbalance inherent in many agreements, franchisees will sometimes argue that a damage waiver is unconscionable. Other doctrines exist to challenge the validity of contracts—such as duress, fraud, and mistake; however, these are ordinarily not applicable where only a specific provision is being challenged. Unconscionability is therefore the principal ground for attacking a damages limitation clause.[225]

When assessing unconscionability, courts generally evaluate two aspects—procedural unconscionability and substantive unconscionability. Some courts do not explicitly make such a distinction, while others will require both before making a finding of unconscionability.[226] Procedural unconscionability concerns allegedly sharp or unfair tactics by the franchisor. This includes using excessively legalistic language or fine print in agreements,[227] seeking out unsophisticated or impoverished clients, swapping contractual terms at the last minute, or pressuring and rushing the execution of a contract, or fraud.[228] The absence of meaningful choice is the key here. Substantive unconscionability relates to the terms of the agreement itself. Gross

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[222] *Id.* at *7.

[223] *Id.*

[224] No. 18-CV-170 (KMK), 2019 WL 4413052, at *2 (S.D.N.Y. Sept. 16, 2019).

[225] *See* RESTATEMENT (SECOND) OF CONTRACTS §208 ("If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.").

[226] *See, e.g.*, A & M Produce Co. v. FMC Corp., 186 Cal. Rptr. 114, 121-22 (Cal. Ct. App. 1982).

[227] *See, e.g.,* Carter v. Exxon Co., 177 F.3d 197, 207-08 (3d Cir. 1999). In that case, the Third Circuit refused to enforce a contractual provision disclaiming damages in part because the provision was not sufficiently conspicuous. "The court was persuaded by the fact that the provision was not capitalized or highlighted, and therefore there was no indication that the disclaimer might be of greater importance than other provisions in the agreement.

[228] *See, e.g.*, Best Western Int'l, Inc. v. Patel, No. CV 04-02307-PHX JAT, 2008 WL 205286 at *3 (D. Ariz. Jan. 23, 2008).

disparities between price and value, overly harsh or one-sided effects, commercial reasonableness, and public policy are all factors.[229]

Challenging a waiver on the basis of unconscionability is generally an uphill battle for any franchisee, since unconscionability requires the showing of oppressive terms and unsophisticated parties, which can be exceedingly difficult to prove in the context of an ordinary franchise agreement. Claims of unconscionability in this context can often be defeated by pointing to the franchisee's sophistication if they have substantial business experience, particularly in the same industry as their franchise system, as well as their representation by counsel in the negotiation process.[230] Moreover, the conspicuousness of the clause, the plaintiff's business experience, and the fact that they were represented by counsel, who reviewed the agreement before the signing, can also be used to establish that the waiver was "knowing, voluntary, and intentional."[231]

The potential for very large awards and the unpredictability of enforcement mechanisms has also caused some franchisors to incorporate punitive damages waivers into their franchise agreements. Like any other contract provision, punitive damages waivers are generally enforceable,[232] unless the enforcement of the waiver would fall under the doctrine of unconscionability, discussed above. Punitive damages waivers can have broad applicability. They can be phrased to cover not only issues within the contract, but also those arising out of or connected to the contract, and even other contracts. For example, in the case *Dunkin' Donuts Franchised Restaurants, LLC v. Manassas Donut Inc.*, the court, in granting the plaintiff's motion to strike the defendant's demand for punitive damages, found that "the language of [the Agreement's waiver provision] is broad enough to encompass all disputes between the parties, including those not arising out of their contractual relationship."[233]

Recently, *in Airport Mart, Inc. v. Dunkin' Donuts Franchising, LLC*, the court held that a Dunkin' Donuts franchisee had knowingly and intentionally waived its rights to lost profits and punitive damages, noting that: (1) the waiver clause was conspicuously printed in bold and upper-case text; and (2) despite being a relatively small entity, the franchisee did not lack bargaining power because its owner had extensive experience in negotiating commercial contracts and its counsel had reviewed the draft franchise agreement.[234]

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229 Manufacturer Direct LLC v. DirectBuy, Inc., No. 2:05-CV-451, 2006 WL 2095247 (N.D. Ind. Jul. 26, 2006); NEC Techs., Inc. v. Nelson, 478 S.E.2d 769, 771-72 (Ga. 1996); Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965).

230 *See* Dollar Rent A Car Sys., Inc. v. P.R.P. Enter., Inc., 242 F. App'x 584 (10th Cir. 2007); Original Great Am, Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992); COC Servs., Ltd. v. CompUSA, Inc., 150 S.W.3d 654 (Tex. App. 2004).

231 Coraud LLC v. Kidville Franchise Co., LLC, 109 F. Supp. 3d 615, 624–25 (S.D.N.Y. 2015); *see also* Airport Mart Inc. v. Dunkin' Donuts Franchising LLC, No. 18-CV-170 (KMK), 2019 WL 4413052, at *8 (S.D.N.Y. Sept. 16, 2019).

232 *COC Servs.*, 150 S.W.3d at 676-79.

233 No. 1:07CV446 (JCC), 2008 WL 110474, at *4 (E.D. Va. Jan. 8, 2008); *see also* Keating v. Baskin-Robbins USA Co., 2001 WL 407017, at *15 (E.D.N.C. Mar.27, 2001) (finding that an explicit waiver of punitive damages in the franchise agreement rendered inappropriate an award of such damages).

234 *Airport Mart*, 2019 WL 4413052, at *8.

B. Lease Takeover/Inventory Repurchase Provisions

1. Inventory Repurchase Provisions

Many franchise agreements include language regarding the repurchase of inventory upon the termination of a contract. Before drafting a statutory provision, it is important to know that some states have enacted statutes which govern franchisor's buyback. The purpose of these state statutes is to promote the public policy of protecting franchisees from the risk of making a large investment in goods or equipment required by the franchise system and, indirectly, from the risk of arbitrary termination.[235] The statutory requirements from state to state may differ on: (1) whether the repurchase is triggered by any termination or only a termination by the franchisor without good cause, (2) whether repurchase is required in nonrenewal situations, (3) the items to be purchased, and (4) the consideration to be paid by the franchisor.[236]

In states without statutory buyback requirements, the franchisor still might want the option to repurchase unsold inventory from a franchisee upon the termination of the relationship. For the franchisor, the repurchase provision should secure the return of confidential information and trademarked items at the franchised site in such a way to prevent the former franchisee from using any trade secrets. The franchisor should also determine how it will fairly compensate the franchisee for the present value of the inventory and equipment for a smooth transition. In determining the price for inventory buyback, franchisors should also consider putting a provision in their franchise agreements that the fair market value of inventory, equipment, and supplies will not exceed the net book value, less shipping costs if the assets will be moved to another location.[237] Moreover, the agreement should address the terms regarding any repurchase, including:

- When and how such option or right must be the exercised;
- The amount to be paid or credited by the manufacturer for any repurchased goods;
- The procedures for inspecting and transporting the inventory;
- Which party will bear the associated costs, including loading and transportation costs; and
- What products will be subject to the repurchase.

In *Southern Track & Pump, Inc. v. Terex Corp.*, the Third Circuit Court of Appeals considered whether used goods were included in the statutory inventory repurchase requirement of the Delaware Dealer Statute.[238] Because of the Delaware legislature's silence on the issue, in

[235] *See* Clay A. Tillack, Mark E. Ashton, *Who Takes What: The Parties' Rights to Franchise Materials at the Relationship's End*, 28 FRANCHISE L.J. 88, 89 (2008).

[236] ARK. CODE ANN. § 4-72-209; CAL. BUS. & PROF. CODE § 20035; CONN. GEN. STAT.§ 42-133f(c); HAW. REV. STAT. § 482E-6(3); IOWA CODE § 523H.11; MD CODE COMMERCIAL LAW, § 11-1304; MICH. COMP. LAWS ANN. § 445.1527; WASH. REV. CODE § 19.100.180(j); WIS. STAT. ANN. § 135.045; R.I. GEN. LAWS §§ 6-50-5.

[237] Gary R. Batenhorst, *Breaking Up Is Hard to Do: Challenges and Opportunities in Franchisor Buyback Rights and Obligations*, 30 FRANCHISE L.J. 97, 103 (2010).

[238] S. Track & Pump, Inc. v. Terex Corp., 618 F. App'x 99, 107 (3rd Cir. 2015).

an otherwise detailed statute, the court concluded that the silence signified that used products were not included in the statutory requirement of the repurchase provisions.[239]

In *Victory Lane Quick Oil Change, Inc. v. Hoss*, the court held that a contractual provision that required the franchisee to sell back to the franchisor assets of the franchise business not uniquely identified with the franchisor was consistent with the Michigan Franchise Investment Law.[240] While the Michigan Franchise Investment Law usually prohibits this type of provision, it was dispositive that the franchisee breached the franchise agreement and failed to cure it.[241] Further, the franchisee had secretly transferred assets to a relative without allowing the franchisor a right of first refusal; and this was a clear breach of the franchise agreement.[242]

It is advisable for franchisors to consider including a repurchase provision in the agreement which will set forth the items subject to the provision, the method for calculating the amount to be paid, inspection rights and transportation costs. Settling on these basics upon the execution of the franchise agreement may prove very helpful to streamline issues upon the termination of the franchise. If franchisors are operating in states with applicable statutory provisions, those requirements should be considered in the drafting and enforcement.

a. <u>Lease Takeover</u>

Many franchise agreements contain provisions giving the franchisor the option to step into the franchisee's lease upon termination. These provisions, if drafted and executed appropriately, could provide a seamless option for the franchisor to step in and commence operation of the business with little to no disruption, at least for the customer's vantage point. In addition to the franchise agreement reciting these rights, the franchisor must ensure that the addendum lease or lease rider explicitly grants the franchisor beneficial rights. The applicable addendum or rider should state that the franchisor is a third-party beneficiary to the lease and give the franchisor an independent right to enforce the terms of the lease. It should identify the events upon which the franchisor's rights are triggered. Landlords want to ensure that all required protocol is followed before turning the premises over to the franchisor.

If the franchisor does not wish to exercise its lease takeover rights, it should make sure it does not take any actions which could be deemed an agreement to assume the lease. *Cottman Transmission Systems, LLC v. FVLR Enterprises, LLC*, is an illustrative and cautionary tale.[243] There, the landlord entered into a ten-year agreement with a franchisee. The franchisor insisted on adding a lease rider to the agreement that gave it the option to assume the lease upon either termination or expiration.[244] When the franchisee-tenant moved out of the premises before the lease term was finished, the franchisor continued to pay rent, accepted the premises after the locks had been changed, placed a manager at the premises, and secured water, electricity, and

239 *Id.*

240 Victory Lane Quick Oil Change, Inc. v. Hoss, No. 00-cv-73104 2001 WL 1219152 (E.D. Mich. Sept. 28, 2001).

241 *Id.*

242 *Id.*

243 Cottman Transmission Sys., L.L.C. v. FVLR Enters., L.L.C., 295 S.W.3d 372, 375 (Tex. App.—Dallas 2009, pet. denied.

244 *Id.*

telephone services.[245] When the franchisor refused to keep paying the rent, the landlord sued.[246] The court found that the franchisor was bound by the lease rider, and it had exercised its option to assume the lease because its actions constituted partial performance.[247]

It is important for the parties to clearly set forth which parties have what rights as well as how those rights may be exercised to avoid ambiguities. In *Franchise & High Properties, LLC v. Happy's Franchise, LLC*, the Court of Appeals of Michigan considered whether the term "tenant" only referred to the franchisee or if the franchisor was also included as a co-tenant.[248] The franchisor signed a five-year lease for the commercial space to be occupied by its franchisee, Happy's Pizza #19, Inc.[249] In the lease itself, the franchisor secured the right of first refusal to purchase the property and the right to require that the lease be assigned to the franchisor if the franchisee defaulted.[250] The court ruled that, because both the signature lines and the right of first refusal provision within the lease distinguished the "Tenant" from the "Franchisor," the lease was ambiguous and required extrinsic evidence to determine the intention of the parties.[251]

A collateral assignment assigns the franchisee's interest in the lease to the franchisor with a provision stating that the assignment will operate to transfer the franchisee's interest upon the occurrence of a subsequent event, such as the franchisee's default under the franchise agreement.[252] In *Snelling & Snelling, Inc. v. Martin*, the franchisee unilaterally terminated its three employment agency franchises but did not continue to operate the businesses for an additional 180 days as required by the franchise agreement.[253] The court enforced a provision in the franchise agreement requiring the franchisee to assign its leases to the franchisor. The court accepted the franchisor's argument that customers of the clients were familiar with the location and that the franchisor would suffer an irremediable loss if the court did not enter an injunction enforcing the assignment provision. [254]

In *Dunkin' Donuts, Inc. v. Taseki*, the franchise agreement was terminated following a number of breaches by the franchisee. The court enforced the terms of a lease option agreement, which gave the franchisor the right to lease the premises from the franchisee if it notified the franchisee of such intent within thirty days of termination. The court agreed with Dunkin' Donuts' argument that it would be irreparably harmed if it could not preserve the goodwill accumulated at this location. The court cited a case involving a Jiffy Lube franchise in which the court had held that the franchisor not only had an interest in protecting the goodwill it had developed but also

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[245] *Id.*

[246] *Id.*

[247] *Id.* at 379.

[248] Francis & High Props., LLC v. Happy's Pizza Franchise, LLC, No. 322678, 2015 Mich. App. LEXIS 2160, at *11 (Ct. App. Nov. 17, 2015).

[249] *Id*.

[250] *Id*.

[251] *Id*. at *14.

[252] *See* W. Michael Garner, FRANCHISE LAW & PRACTICE § 4.5 (2009).

[253] Snelling & Snelling, Inc. v. Martin, No. C 97-4479 FMS, 1998 WL 56995, at *4 (N.D. Cal. Jan. 28, 1998).

[254] *Id*.

had an interest in placing a new franchisee at or near the location where the goodwill had been created.

In a scenario in which a franchisee does not have sufficient assets to satisfy a judgment (i.e. the franchisee is judgment proof) or satisfy a liquidated damages provision, taking over the lease to salvage the business might be the best option and can be very cost effective.

C. Attorneys' Fees

In the United States, the general rule (called the American Rule) is that each party pays only their own attorneys' fees, regardless of whether they win or lose. This rule, however, does not apply when attorneys' fees are authorized by the parties' contract or by statute.[255]

Attorneys' fees may or may not be available depending on whether or not the franchise agreement expressly authorizes the recovery of fees by a prevailing party. Sometimes, in cases where attorneys' fees are available, the amount of such fees in a hard-fought litigation can be even greater than compensatory damages. The significance of prevailing even with nominal damages in such cases, therefore, cannot be overstated. Nominal damages of one dollar can turn into significant amounts once the attorneys' fees are calculated.

Franchise agreements sometimes provide that *only the franchisor* is entitled to recover attorneys' fees. Yet, some states, such as California, Florida and Oregon, have adopted attorneys' fees reciprocity statutes, which provide that if one party is permitted to recover attorneys' fees by contract, the other party may also avail itself of the provision.[256]

In addition to contract-based awards of attorneys' fees, many states provide for attorneys' fees by statute, for example, in their little FTC Acts.[257] At least one state, New Jersey, also provides for attorneys' fees by statute in the case of wrongful termination of a franchise, as well as for deceptive practices.[258]

V. CONCLUSION

Franchise relationships can often last for decades. In most instances, both the franchisee and franchisor enter into the relationship in good faith, with the hope that it will be prosperous for both parties and that any disputes will be resolved without litigation. As with many long-term relationships, disputes can arise, some of which will have to be decided by a judge or jury. While the franchisee and franchisor should hope for the best, planning both at the inception of the

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[255] While most states enforce contractual attorneys' fees provisions, some states only award attorneys' fees if authorized by statute, so it is important to check the law in your state before seeking attorneys' fees. "Furthermore, attorney fees are recoverable in Nebraska only where provided by statute or allowed by custom. A contractual provision that in the event of any dispute or litigation involving the contract, the prevailing party shall be entitled to recover all costs of suit, including reasonable attorney fees, is contrary to public policy and void." *See, e.g.,* GFH Financial Services Corp. v. Kirk, 231 Neb. 557, 567, 437 N.W.2d 453, 459 (Neb. 1989).

[256] *See* OR. REV. STAT. 20.096; CAL. CIV. CODE § 717; FLA. STAT. § 57.105.

[257] *See, e.g.*, WASH. REV. CODE 19.86.090; MASS. GEN. LAW. ANN. Ch. 93A, §9(4); TEX. BUS. & COM. CODE, §17.50; MD. CODE ANN., COM. LAW §13-408(b); N.Y. GEN. BUS. LAW § 349(h).

[258] N.J. STAT. ANN. § 56:1010.

relationship and in advance of any dispute can put them in a better position in the event of a lawsuit.

In drafting the franchise agreement, the franchisor should consider what type of damages it will want to seek if there is a later dispute with the franchisee. The franchisor should assess the current laws in both the states where it will be selling franchises, as well as the state listed in any choice of law provision. A well-drafted liquidated damage or lost profits provision will increase the likelihood that such damages will be permitted. A prospective franchisee should attempt to negotiate any damage provisions contained in the franchise agreement, if it has the ability to do so. This will also require an understanding of the applicable law.

Once a dispute has arisen, careful planning is also important. The franchisor should consider the impact on damages if it terminates the franchise agreement. The franchisee should conduct a similar analysis before abandoning a franchise relationship. Both parties should consider whether they have sufficient evidence to support, or defend against, a claim for liquidated damages or lost profits, including which witnesses will be needed to testify.

Careful planning, both at the outset and during the relationship, will not guarantee success in litigation, but it can increase a party's chances of getting the result the party is seeking, as well as of avoiding unpleasant surprises.

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