



FRANCHISE ATTORNEYS SPEAK OUT ABOUT AAHOA'S 12 POINTS

Point 1: Early Termination and Liquidated Damages.

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Of all points of contention in hotel franchising, the issue of liquidated damages (LDs) creates the most problems for franchisees, who often face the unhappy prospect of paying LDs as the price of exiting an unsatisfactory relationship. It is no accident, therefore, that AAHOA put LDs as the first of the 12 Points of Fair Franchising.

AAHOA argues that, in the interests of fairness, a "franchisee should only have to pay six months of royalty fees," to be calculated by determining the average royalty paid over the last twelve months (or such shorter time that the franchisee has flown the flag), multiplied by six — and that, even here, the 6 months of royalties would only be due when it truly reflected a "liquidated damage" and not a penalty. Surely, all AAHOA members will celebrate on the day that this "First Point" becomes the prevailing standard in hotel franchising. But until that day, and even afterwards, LDs will remain a critical, contentious issue.

It is therefore appropriate to review the legal and business issues that surround LD clauses in hotel franchising. These issues come into the clearest focus in litigation after there has been a franchise termination, but lessons learned from the court cases are educational for the crucial stages of negotiating your entry into a brand as well as negotiating an exit agreement, if needed, hopefully without litigation.

The first question, of course, is "why should there be any LDs in hotel franchising?" To answer that question, we must consider the franchisor standpoint, as the

franchisor drafts the contracts containing LD clauses. A hotel franchisee (unlike his brethren in restaurant franchising, for example) typically enjoys the mobility to switch brands or even to go independent, without fear of being enjoined for violating a post-termination non-compete clause. However, when the flag comes down, the franchisor not only loses the revenue stream for that particular site, it also suffers some degree of injury to its brand value (as now there is one less flag flying, and also, there will always be some people who remember that "this property used to be a [insert name of hotel brand here]." To discourage franchisees from leaving, and to gain compensation for their actual damages (or their perceived damages, which may be different than actual ones), hotel franchisors almost inevitably seek to impose LD clauses, whereby a specific damage formula is stipulated by the parties at the start of the contractual relationship. Those clauses have historically been weighted heavily in favor of the franchisor (as AAHOA discusses on its Web page in promoting this First Point of Fair Franchising).

The second question is "how do courts react to LD clauses?" Traditionally, courts have been quick to accept the above-stated franchisor rationales for their LD clauses and have upheld most of them. Knowing that courts are often inclined to enforce the agreement as it was written, most hotel franchisors have historically been reluctant to negotiate lower LDs, secure in their belief that they



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would prevail in a court action — and further believing that most franchisees will not have the means or the willpower to mount a successful challenge to their LD clause.

However, there have been some significant exceptions, when franchisees have succeeded in blocking enforcement of an LD clause, either by court decision, or by achieving a very favorable settlement. Franchisees have prevailed on their challenges to LD clauses by proving one of the following arguments: (1) that the LD sum grossly exceeds the probable damages on breach, such that the LD was an improper "penalty," and not a true measure of damages; or (2) that the franchisor was the first party to breach the franchise agreement, thus precluding it from enforcing the LD clause or any other term of the agreement. The enforceability of LD clauses varies from state to state but most states will accept these arguments when they are properly presented.

Too often, however, we find that franchisees capitulate on LD issues without doing the necessary homework to develop one of these winning arguments. (There is a

third legal argument that can be made, that the franchise agreement is subject to rescission because it was induced by a fraudulent misrepresentation or for other reasons, but this argument is less frequently successful because the traditional offering circular (now the “Franchise Disclosure Document”) affords most franchisors significant protection from fraud claims).

Before writing a large check to pay a LD claim, every franchisee should carefully analyze the “penalty” and “prior breach” arguments to determine whether they have a winning court case, or at least a strong negotiating position. Proving that an LD clause is a penalty raises numerous fact questions: How does the particular clause compare in the industry as to similar market niche brands or published industry standards (now including AAHOA’s First Point)? Is the same sum made payable for

any variety of different breaches (some major, some minor) or does the agreement provide that a mere delay of payment has been listed among the events of default? If the franchisor is claiming brand value damage, what is the actual value of the brand to begin with, in the specific market at issue? As to claims of lost royalty revenue, has the franchisor secured “replacement revenue” (or replacement of brand value) by opening new properties nearby in the same market — and indeed, has the franchisor cannibalized the franchisee’s revenue at a particular site? Considering these types of issues may very well yield a convincing argument that the LD clause is an unenforceable economic penalty.

Likewise, to analyze whether the franchisor has committed the first breach of contract, or committed fraud, we want to know every single reason the franchisee wishes, or

is being forced, to exit the franchise relationship. Obviously, something has gone wrong, as the initial expectations of success, from the time that franchise agreement was signed, have been dashed. Learning how and why the franchise relationship has failed, and then going back to the terms of the franchise agreement and the required disclosures to assess whether the franchisor can be held accountable, often yields powerful arguments in favor of the franchisee. And this, in turn, leads to success in court or in negotiations.

We fully understand that no franchisee wishes to be embroiled in a costly lawsuit, and that is why it is even more important to negotiate good business and legal terms in your franchise agreements at the start of the business relationship — or at the exit stage, to carefully assess the arguments that you can make and win, and to negotiate



from strength.

In closing, every AAHOA member must ask himself or herself a very simple question: "Will I insist that my next franchise agreement conform to the 12 Points of Fair Franchising?" Or will I sign anyway and complain later? Keep in mind, hotel franchisors are intelligent businesspeople who understand the basic economic law of supply and demand. As an AAHOA member, you can greatly influence the "supply" of fair franchise agreements that conform to the Twelve Points, but only by "demanding" them — and by being prepared to invest your hard earned money elsewhere if your reasonable demands are not met.

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The information presented in this article is general in nature. Nothing in this article is intended to provide specific legal advice. Please contact your franchise counsel or other counsel if you have any particular issues that require attention.

To review
AAHOA's 12 Points of Fair Franchising
and AAHOA's commentary on each point,
please visit:

<http://www.aahoa.com/Content/NavigationMenu/AboutUs/12Points/default.htm>.