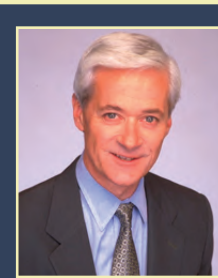
Dunn on Damages

The Economic Damages Report for Litigators and Experts



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Please enjoy the following article, reprinted from *Dunn on Damages*, with my compliments!

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Current Damages Issues in Franchise Disputes:

Lost Future Royalties and the Value of a Terminated Franchise

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BACKGROUND: FRANCHISING IN THE ECONOMY

Franchise businesses are everywhere and generate a substantial number of disputes where damages are claimed. Practitioners in the area should have a general understanding of the nature of the beast.

Franchising encompasses a variety of business arrangements that generally fall within two categories: product and trade name franchises and business format franchises. Product and trade name franchises include arrangements in which franchisees are granted the right to distribute manufacturers' products within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark. Business format franchises generally have three elements: a trademark, a fee and a business plan.

Although the explosive growth of franchising is a relatively recent development, it has existed in various forms since 1851. One of the first was when Isaac Singer accepted fees from independent salesmen to acquire territorial rights to sell his sewing machines. The franchising concept gained broader recognition with its incorporation in the marketing techniques of General Motors after 1898 and its eventual use throughout the automobile and gasoline industries by the 1930s. Business format franchising has dominated the field since the 1960s with McDonald's being the most recognizable franchisor of that type.

According to the International Franchise Association, the 788,285 franchise businesses operating in 2007 employed an estimated 7.7 million workers; i.e., about the same number of people as all manufacturers of durable goods, such as computers, cars, trucks, planes, communications equipment, primary metals, wood products, and instruments combined.[1] It is estimated that franchising accounts for more than 40 percent of all retail sales in the U.S. with one out of every 12 retail establishments being part of a franchise network.[2]

And franchising has expanded throughout the world with India and China the new frontiers for franchise expansion since 2000. Approximately 260 U.S. companies operated 17,000 franchise outlets outside the United States in the late 1970s. By the 1980s the number of foreign units had doubled to more than 34,000 and by 2004, the number of U.S.-based franchisors having operations outside the United States doubled to about 500.[3]

A CONTENTIOUS FRANCHISOR CLAIM: LOST FUTURE ROYALTIES

The *Sealy* Case

Courts regularly award lost past royalties to franchisors for any period that a franchisee operates under a franchisor's marks.[4] This is deemed necessary to deter other franchisees from unauthorized use of the franchisor's marks after termination and the continued use of marks, after notice, is considered willful and deliberate which generally justifies the award of lost profits.

However, whether or not a franchisor is entitled to damages for future royalties is another matter. In *Postal Instant Press, Inc. v. Sealy,*[5] a 1996 decision, the California Court of Appeal was confronted with "a case of first impression not only in California but the entire nation … whether a franchisee's failure to timely pay some past royalty fees entitles a franchisor to both terminate the franchise agreement and receive an award of … 'future lost royalties'."

The court held that lost future royalties were not a proper element of contract damages in the particular case, offering three separate theories for its decision: (1) the franchisor's termination of the franchise agreement, and not the franchisee's non-payment of past due royalties, was the "proximate cause" of the franchisor's lost future royalties – as a matter of law; (2) regardless of the proximate cause "it is inappropriate to award lost future profits where it would result in damages which are unreasonable, unconscionable and oppressive"; and (3) the calculation of future royalties was too "speculative" to be allowed as contract damages.

Subsequent Cases

Many other courts have reached the same conclusion as *Sealy.* In *Burger King v. Hinton*,[6] a federal court, applying Florida law, concluded that a franchisee's failure to pay past due royalty and rent payments did not proximately cause the franchisor's loss of future profits. As in *Sealy*, the court found it was the franchisor's act of terminating the franchise agreements that was the cause.

A Colorado court also found *Sealy* "persuasive"[7] and it was followed and quoted extensively with approval in *Kissinger, Inc. v. Singh*,[8] where the court said it had not found any case that reached a contrary result. Also, it has been held that a franchisor cannot collect future royalties and other fees from a franchisee that closed because the operation was unprofitable.[9]

In still another case, a franchisor's claims for lost future royalties were denied because the franchisor failed to submit any evidence as to its op-

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erating expenses. Under the law of several states, future royalties, like all future damages, are subject to the evidentiary rule of reasonable certainty, and courts have ruled that a claim for lost future royalties was akin to a claim for lost profits.[10]

Similarly, a federal district court found that a franchisor of child learning centers failed to provide sufficient evidence to enable the court to make a fair and reasonable estimate of the amount of lost future royalties it was entitled to from a franchisee's *abandonment*[11] (see below). In denying summary judgment, the court noted that the franchisor calculated its lost future royalties by simply averaging the gross revenues for the franchise collected over the three years before its closure, without providing any of the underlying data, such as annual or quarterly revenue figures, past royalties collected, or other supporting documentation. The franchisor also failed to provide an estimate of the costs of other losses that it avoided by not having to perform the terminated agreement.

Another court seemed to leave open the possibility of a mitigation defense against a claim for lost profits based upon the lack of profitability, noting that the very viability of the franchisee was questionable because of its persistent operating losses.[12]

In a Connecticut case, a claim for lost future franchise royalties equal to 7 1/2 percent of gross sales was rejected with the court finding, "The plaintiff failed to prove damages other than speculative amounts. No expert testimony was offered to prove the damages. Expert testimony is needed where the issue sought to be proven is beyond the ken of the average juror."[13]

But not all the case law in the area is the same in either result or reasoning. For example, the disparity is glaringly shown by two decisions involving the same franchisor, Medicine Shoppe. In *Medicine Shoppe International v. Turner Investments,*[14] the Court of Appeals for the 8th Circuit upheld an arbitrator's award of future continuing license fees for the remainder of the agreement's 20-year term (and attorneys' fees and costs); while in *Medicine Shoppe International v. TLC Pharmacy Inc.*,[15] a federal district court held *sua sponte* (in the case of a *pro se* franchisee) that lost future royalties were not recoverable.

The most recent decision on this issue came in April 2011, when the Fourth Circuit, in *Meineke Car Care vs. RLB Holdings*,[16] overturned a district court's grant of summary judgment, dismissing a franchisor's damages claim for lost future royalties. The district court had held that because lost future royalties were not expressly addressed, they could not have been part of the contract. But the appellate court did not specifically rule that lost future royalties were allowed—it merely said that they are not automatically precluded as a matter of North Carolina law when the issue is not specifically addressed in the franchise agreement. Thus, the court held that there was an outstanding fact issue and the case was not appropriate for summary judgment. Yet, the opinion conceded that to become a provision of the contract it would have to have been within the contemplation of both sides.

In that light, one must ask whether such a contract provision (i.e., whether or not damages claims should lie for lost future royalties) can be "within the contemplation of the agreement" if the agreement is silent on the matter. Will any franchisee say it was within its contemplation?

Termination vs. Abandonment

But there is another wrinkle: several cases have made the distinction between "termination" and "abandonment" in deciding whether a franchisor is entitled to future royalties—with an abandoning franchisee being liable while a terminated franchisee is not.[17] This distinction was applied in two Florida cases.

In *Burger King Corp. v. Barnes*[18] it was held that the franchisor was entitled to $247,870 in future royalties for the remaining 210 months of the franchise agreement and that the franchisor was under no obligation to mitigate the damages by re-franchising. A similar result was obtained in *Lady of America v. Arcese,*[19] an unreported case, in which the court awarded 10 years' future royalties to the franchisor when a franchisee abandoned its franchise; and found that the franchisor spent considerable sums on advertising and, therefore, met its obligation to mitigate damages, even though it did not find another franchisee for the abandoned territory.

Liquidated Damages vs. Lost Future Royalties

And a final aspect to confuse the situation: in *Radisson Hotels v. Majestic Towers,*[20] a hotel franchisee was terminated for failure to pay royalties. The franchisor brought suit seeking the recovery of (1) past due fees, (2) liquidated damages, and (3) attorneys' fees. The court granted "summary adjudication on the issue of past due fees and liquidated damages." There was no claim for lost future royalties, and the issue was not adjudicated by the court.

But the franchise agreement's liquidated damages clause calculated the franchisor's right of recovery as two times the royalties paid during the prior year. And in court the franchisor alleged that it took them, on average, two years to find a replacement franchisee. Because of that reference, it has been argued by many in the franchise bar that, since one segment of the decision strongly disagreed with *Sealy*, claims for future lost royalties will now be more readily entertained.[21]

Those making the argument rely on the language in *Radisson* that, "this Court believes that the *Sealy* decision is mistaken . . . 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."[22] *Radisson* was decided by a federal district court that noted that it was only bound by decisions of California's highest court—and that the *Sealy* court was merely an intermediate appellate court.

However, this author believes the criticism of *Sealy* in *Radisson* is clearly dicta, and, in fact, it is merely footnote dicta, because, as noted, there was not even a claim in the case for lost future royalties. Accordingly, in this writer's opinion, the essence of the decision simply upheld a specifically negotiated liquidated damages clause that happened to base its calculation on prior royalties.

The recent case of *Days Inn Worldwide vs. Investment Properties of Brooklyn*[23] again raised the issue of hotel franchisors' rights to lost future royalties
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– in that case in the context of a default judgment. In *Days Inn* the franchisee defaulted three years into a 15-year term (by selling the property) after failing quality inspections and not paying royalties for the last several months of operation.

The franchisor sued, won a default (when the defendant failed to appear) and then claimed the remaining twelve years of royalties, discounted to present value, as damages. The judge disagreed, specifically referencing other case law holding that hotel franchisors were only allowed to collect an amount equal to the royalties forsaken during the period it would take them to re-franchise the area and that those cases generally provided franchisors with damages equal to only two years of royalties.

A CONTENTIOUS FRANCHISEE ISSUE: WHAT IS THE VALUE OF A WRONGFULLY TERMINATED FRANCHISE?

"Wrongful termination" claims are a term of art in franchise law.[24] They refer to causes of action alleging the breach of specific relationship/termination laws which may apply to franchises, dealerships and distributorships. In many states there are also special industry laws and other statutes that give protection against termination to specific types of dealers. To succeed in a claim for wrongful termination a plaintiff must allege and prove that: (1) the requisite relationship was terminated (2) without good cause (3) in violation of statute (4) causing damages. In this context "good cause" is also a term of art and generally has nothing to do with the concept of "good faith" from the franchisor's point of view.

Relationship/termination statutes generally provide protections against wrongful termination which override the terms of the franchise or distributorship agreement. For example, regardless of the language in the agreement, in South Dakota franchisors cannot terminate or fail to renew dealers in motor vehicles, motorcycles or snowmobiles unless the franchisor can prove there will be a replacement franchisee established in the community.[25] In some states "substantial changes in the competitive circumstances" can be cause for a constructive (and wrongful) termination. Leading examples of such statutes can be found in New Jersey and Wisconsin.

When a perceived wrongful termination situation arises, the franchisee may seek an injunction to prevent the termination or bring suit for damages. There are several measures of damages which may be employed in these circumstances, some determined by statute and others by court decisions. One substantial issue is how to value a wrongfully terminated franchise.

The two general damages theories usually claimed in these cases are for lost profits and/or loss of business value. Although in theory the value of a business may be considered the same as the present discounted value of its future lost profits, it does not always work out that way in court.

In one relevant case, *Baur Truck*,[26] a manufacturer licensed a second distributor in the plaintiff's territory and the "change in competitive circumstances" in the nature of encroachment was deemed a wrongful termination under Wisconsin law. In another, *Cooper v. Amana*[27] ("Cooper I"), the manufacturer decided to sell directly to retailers in the existing distributor's territory and then refused to renew the distributorship. This was held to be a wrongful termination under New Jersey law.

In *Baur* the court found the proper method for measuring the damages was the discounted cash flow ("DCF") method, with projections of lost profits and terminal value based on the two years of operation before the wrongful termination. On the other hand, in *Cooper* the court found that the years before the termination could not be used to measure damages for lost profits. In both cases the distributor's sales and profits were going up before the wrongful acts began and dropped precipitously afterwards.

In *Cooper I* the Third Circuit stated that a franchise may be valued as either the present value of lost future earnings or the present market value of the lost business. But on the second appeal, in *Cooper II*,[28] the court changed direction and expressed a strong preference, if not an outright requirement, for the use of market value (i.e., value based on the hypothetical willing buyer/willing seller). The *Cooper II* court rejected the franchisee's arguments that the value should be based upon the present value of the lost future earnings expected if: (1) the franchise remained in the hands of the present franchisee; or (2) the franchise was taken over by the franchisor (as actually occurred).

Rather, according to the *Cooper II* court (which seemingly ignored the "wrongful" aspect of the termination), the expropriation of the franchise by the franchisor as part of national consolidation was a termination "in good faith and for a *bona fide* reason" and thus required use of the hypothetical willing buyer/willing seller formula. The result at the second damages trial was a finding that a willing buyer would not be willing to pay anything for a terminated franchise and no damages were awarded while almost $10 million was awarded at the first trial.

DAMAGES COMPUTATIONS

Generally, in calculating lost future royalties or lost business value for franchise disputes the methodology is not unique. DCF is the most frequently used method because "comparable" data is generally hard to obtain and book value rarely takes account of self-created intangibles which often make up 70-80 percent of the value of franchise companies.[29]

However, there are many damages and valuation aspects unique to franchises, distributorships and dealerships. For example, (1) the asset is a mere contract right, not outright ownership; (2) a management analysis must take into account two levels of management – both at the franchisor and franchisee level; and (3) regulation. There is a Federal Trade Commission Rule and 14 states that require the registration of franchise offerings. Second only to the securities industry, franchising is subject to incredible regulation at state, federal, and international levels – most requiring documentation in the form of a prospectus providing specific information, and many requiring registration complete with merit reviews of the offerings.

For these reasons, damages practitioners must carefully review the

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Franchise Disclosure Document (FDD) (generally mandated under the Federal Trade Commission rule) to analyze *inter alia*: (1) the risk of termination and/or non-renewal (which will surely affect the assumed term and terminal value aspects of the DCF method); (2) Covenants Not To Compete which are generally present from the purchase of the business in franchising (as opposed to commencing with the sale of a business as is common outside of franchising); and (3) Rights of First Refusal and/or Approval of subsequent operators which are almost always present in franchise agreements and generally result in some discount (though a difficult one to quantify).[30]

Moreover, in determining the appropriate discount rate to use in a franchise-related DCF computation, there are several layers of interested parties and the weighted cost of capital of the franchisor is rarely the same as that of a franchisee. Therefore, damages opinions in the franchise context are generally required to give substantial explanations and support for a chosen rate.

CONCLUSION

Franchise businesses are ubiquitous and professionals should be aware of their unique issues and the elements that set them apart from a normal business damages report or valuation.

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1 International Franchise Association Educational Foundation, *Franchise Business Economic Outlook: 2011,* prepared by PricewaterhouseCoopers, (January 3, 2011), at 3.

2 David J. Kaufmann, "The Big Bang: How Franchising Became an Economic Powerhouse the World Over," *Entrepreneur,* January 2004, p. 86.

3 Id.

4 *In re Dynamic Enterprises v. Fitness World of Jackson, CCH Business Franchise Guide* ¶8054 (M.D. Tenn. 1983). See also *Precision Tune Auto Care, Inc. v. Pinole Auto Care Inc., CCH Business Franchise Guide* ¶12,238 (E.D. Va. 2002).

5 43 Cal.App.4th 1704, 51 Cal.Rptr.2d 365 (1996).

6 203 F.Supp.2d 1357, 1366 (S.D. Fla. 2002).

7 *I Can't Believe It's Yogurt v. Gunn,* 1997 WL 599391 (D.Colo. Apr. 15, 1997).

8 304 F. Supp.2d 944, *CCH Business Franchise Guide* ¶12,747 (W.D. Mich. 2003).

9 *Healy v. Carlson,* 2002 U.S. Dist. LEXIS 19800 (D. Minn. October 16, 2002) *CCH Business Franchise Guide* ¶12,443.

10 *Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc.* (D. Colo. March 4, 2009) *CCH Business Franchise Guide* ¶14,093.

11 *Kiddie Academy Domestic Franchising LLC v. Faith Enterprises DC, LLC* (D. Md. February 2, 2010) *CCH Business Franchise Guide* ¶14,326.

12 *Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc.* Op. Cit.

13 *Cottman Transmissions Systems, Inc. v. HOCAP Corp* 2004 WL 503801 (2004) (Unpublished opinion).

14 (8th Cir. 2010), *CCH Business Franchise Guide* ¶14,443.

15 (E.D. Mo. 2010) CCH *Business Franchise Guide* ¶14,416.

16 U.S. Court of Appeals, Fourth Circuit, Case No. 09-2030 (Decided April 14, 2011, Appeal from W.D. N.C.). (designated Not For Publication).

17 See e.g., *It's Just Lunch Franchise, LLC v. BLFA Enterprises, LLC and Angela Stephens,* (S.D. Cal. July 21, 2003) *CCH Business Franchise Guide* ¶12,620, where the court held "that under *Sealy,* a franchisor who has terminated the franchise agreement cannot recover for future profits. This observation is correct" but found the case before it to be outside *Sealy* finding "The *Sealy* court expressly refused to consider whether damages for future profits would be available where, as alleged in *It's Just Lunch's* complaint, the franchisee terminated the agreement".

18 *CCH Business Franchise Guide* ¶11,413 (S.D. Fla. 1998).

19 *CCH Business Franchise Guide* ¶13,680 (S.D. Fla. September 19, 2006).

20 *CCH Business Franchise Guide* ¶13,581 (C.D. Cal. filed Jan. 25, 2007).

21 See e.g., Klaus, Cynthia M. and Winkelman, Sejal Desai, "California Court Awards Franchisor Damages for Lost Future Fees," *LJN's Franchising Business & Law Alert* (June 2007); and Cohen, Fredric A. and Schnell, Brian B. "Judicial Update," IFA 40th Annual Legal Symposium, (May 2007). For an excellent and exhaustive study of the entire issue, arguing that there is a distinction between the "hotel" cases (which this author feels are liquidated damages cases), and future royalty cases see, Ebe, Robert L., Steinberg, David L., and Waxdeck, Brett R., "Radisson and the Potential Demise of the *Sealy-Barnes-Hinton* Rule," *Franchise Law Journal,* Volume 27, Number 1, Summer 2007.

22 *Radisson* Op.Cit. footnote 10.

23 (DC MN) August 26, 2011, *CCH Business Franchise Guide* ¶14,756.

24 Other generic causes of action that allege wrongful termination (not for breach of a statute) are basically breach of contract claims.

25 South Dakota Codified Laws, Title 32, Chapter 32-6B, Sections 32-6B-45 through 32-6B-60, as added by Laws of 1986, Chapter 250, approved March 11, 1986, effective July 1, 1986. *See also* Connecticut General Statutes, Title 42, Chapter 739, Sections 42-133j through 42-133n; and Puerto Rico Dealer's Contracts Law Sec. 278a.

26 *Baur Truck & Equipment, Inc. v. Svedala Industries, Inc.* (Wis. Ct. App. 1993) *CCH Business Franchise Guide* ¶10,193.

27 63 F.3d 262 (3d Cir. 1995) *CCH Business Franchise Guide* ¶10,743. This case went on appeal to the Third Circuit twice.

28 180 F.3d 542 (3d Cir. 1999) *CCH Business Franchise Guide* ¶11,650.

29 See e.g., Susan J. Robins and Bruce S. Schaeffer, "Valuation of Intangible Assets in Franchise Companies and Multinational Groups," Volume 27 *Franchise Law Journal* Number 3 (Winter 2008). For an extensive review of the subject, see also Michael J. Mard, Steven D. Hyden, and Edward W. Trott, "Valuation of Intangible Assets in a Business Combination," *The Value Examiner* (September/October 2009).

30 See e.g., *Estate of Heck v. CIR,* T.C. Memo 2002-34; 2002 Tax Ct. Memo LEXIS 38; 83 T.C.M. (CCH) 1181; T.C.M. (RIA) 54639 (2002).