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# The Franchise Valuations Reporter

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Within the franchise, distribution and dealership context, we are experts in:

- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security

We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

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### Just Published

An article in the Summer 2016 issue of *Franchise Law Journal* by Carmen D. Caruso and Bruce S. Schaeffer on damages for lost future profits is available here.

## Tax Nexus: Sales and Use Tax

***Does Relax the Back Have Tax Nexus with Illinois? It Depends***

For a franchisor with franchisees in Illinois there are two potential sales and use tax nexus pitfalls: 1) Does the presence of franchisees provide sufficient nexus to obligate it to collect and pay over sales and/or use tax? and 2) Does failing to do so expose it to lawsuits?

In a recent case[1] brought by a law firm (whose main business seems to be the bringing of such claims) under the Illinois False Claims Act (a whistle blower statute) on behalf of the State of Illinois, an appellate court ruled that California-based Relax the Back (RTB), a business that sold back and neck care products, was not liable under the Illinois False Claims Act for failing to collect use tax on Internet or catalog sales to Illinois residents.

RTB's only connection to the state was the existence of five retail stores owned and operated by franchisees. The franchisor had no physical presence in the State and the trial court's finding of tax liability (approximately $5,181) and an award of attorney fees (over $110,000) to the law firm were overturned because the appellate court found that RTB made a good faith inquiry into its tax liabilities which vitiated liability under the statute. Furthermore, the Court noted that the State of Illinois had reviewed the case and found no liability and that New York, too, had audited RTB and found no liability to collect and pay over the use tax.

The company's franchise agreement expressly disclaimed any agency relationship between RTB and franchisees, the court noted, and franchisees were required to display their identification as an independent owner prominently in their stores. RTB's only physical presence consisted of trainer or inspector visits at least once a year, the required mailing of catalogs to customers, and a website from which Illinois consumers could purchase merchandise. The trial court had found the catalog distribution requirement provided the substantial nexus to the state, by inviting customers to place orders by fax or phone.

The appellate court agreed with the trial court's determination that the company's chief financial officer (CFO) "made an honest effort to determine whether or not any tax liability occurred," citing his consultations with legal and tax professionals and the company's annual audits. It also held that the company's physical presence fell far short of the "frequent, almost daily contact" that had been required under controlling Illinois law which was based on another case brought by the same lawyers under the same statute against a different enterprise.

However, it must be noted that the Court specifically refused to rule that RTB was not obligated to collect and pay over the use tax finding only that it was not liable under the whistle-blower statute which was based on the Federal False Claims Act. ***A word to the wise franchisor: if a company is going to take the position that it is not obligated to collect and pay over use tax, it should have tax counsel review all***

## We Write the Book

**Franchise Regulation and Damages**, the only treatise that covers damages in franchise disputes and valuations of franchises, is updated 3 times a year.

For more details, to see a Table of Contents or to place an order, go to the Wolters Kluwer Law & Business web page here.

## DISCLAIMER

The information provided in this newsletter is for informational purposes only and should not be construed as legal or expert advice which can only be obtained from appropriate professionals. Franchise Valuations, Ltd. and Franchise Technology Risk Management provide such expert advice on the topics addressed herein.

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***its agreements and provide an opinion to that effect.***

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[1]*People ex rel. Beeler Schad and Diamond, P.C. v. Relax the Back Corp.*, October 17, 2016, Harris, S

## Damages: Lost Future Royalties Denied

***Mr. Softee Granted Injunction but Denied Lost Future Royalties on Summary Judgment***

In a case that has been going on for years -- *Mister Softee, Inc., Mister Softee Sales and Manufacturing, LLC, and Spabo Ice Cream Corp. v. Reza Amanollahi* [1] -- the dispute included a claim for lost future royalties.[2] The decision by the U.S. District Court for New Jersey followed the *Postal Instant Press v. Sealy*[3] line of cases. In his reasoning Judge McNulty asserted that "lost future royalties are not routinely available as damages." Portions of his decision deserve to be quoted:

I must first consider the scope of Spabo's entitlement to future royalties. Under New York law, plaintiffs seeking lost future profits must show that the loss was caused by the defendant's breach of contract, that the amount lost can be proven with reasonable certainty, and that the parties contemplated this type of damages at the time the contract was made. *Kenford Co. v. Erie Cty*., 67 N.Y.2d 257, 261 (N.Y. 1986). "[T]he damages may not be merely speculative, possible or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of intervening causes." Id. In determining whether the damages sought were within the reasonable contemplation of the parties, the Court may consider "the nature, purpose and particular circumstances of the contract known by the parties." *Travellers Int'l, A.G. v. Trans World Airlines, Inc.*, 41 F.3d 1570, 1578 (2d Cir. 1994) (quoting *Kenford Co., Inc. v. County of Erie*, 73 N.Y.2d 312, 319 (N.Y. 1989)). Often these difficulties are addressed by the inclusion of a liquidated damages provision; that was not done here.

I therefore consider more fundamental principles of law. Hornbook law supplies a starting point:

When 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. 13 Williston on Contracts § 39:32 (4th ed.); *see also VFS Fin., Inc. v. Falcon Fifty LLC*, 17 F. Supp. 3d 372, 380 (S.D.N.Y. 2014) ("New York's doctrine of election of remedies provides that 'the non-breaching party must choose between two remedies-it can elect to terminate the contract and recover liquidated damages or it can continue the contract and recover damages solely for the breach.' " (quoting *ESPN, Inc. v. Office of Com'r of Baseball,* 76 F.Supp.2d 383, 387-88 (S.D.N.Y. 1999))).

The case law as to similar terminated franchise arrangements confirms that lost future royalties are not routinely available as damages. In *ATC Healthcare Services, Inc. v. Personnel Solutions, Inc.*, a federal trial 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. No. 01 CV 762 CBA, 2006 WL 3758618, at (E.D.N.Y. Dec. 19, 2006); *see also Kissinger, Inc. v. Singh*, 304 F. Supp. 2d 944, 949-51 (W.D. Mich. 2003) (applying similar proximate cause analysis). Other courts applying state laws similar to New York's have consistently reached the same result:

Defendants have cited multiple cases where future lost profits were not awarded under franchise agreements where, as in this case, the agreement was terminated by the franchisor, even when the breach was caused by the franchisee's failure to make royalty payments. *Kissinger, Inc. v. Singh*, 304 F. Supp. 2d 944 (W.D. Mich. 2003); *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (1996); *Burger King Corp. v. Hinton, Inc.*, 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002); *I Can't Believe It's Yogurt v. Gunn*, 1997 WL 599391, at (D. Colo. Apr. 15, 1997). *Dunkin' Donuts, Inc. v. Arkay Donuts, LLC*, No. CIV. 05-387 (WHW), 2006 WL 2417241, at (D.N.J. Aug. 21, 2006) (reaching the same result under New Jersey law and collecting cases from other jurisdictions).

Here, Mister Softee decided to terminate Amano's Franchise Agreements because Amano moved his trucks out of the Manida Street Depot and stopped making payments under the Truck Notes.[footnotes omitted]. Mister Softee faced a choice: terminate the Agreements, or remain within the Agreements and sue for the ongoing unpaid royalties. It chose the former. On the record currently before me, Amano is not as a matter of law entitled to future royalties under the Franchise Agreements. Amano's motion for summary judgment must be denied on this count.

***The Judge's decision makes clear that claims for lost future royalties are not slam dunks as this author has frequently written and opined as an expert witness.***

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[1] 2016 WL 5745105D. New Jersey. Civ. No. 2:14-CV-01687(KM)(JBC)

[2]The case involved two law firms well known to the Franchise Valuations Reporter: Fisher Zucker LLC, Philadelphia, PA, for Plaintiffs and Marks & Klein, LLP, Red Bank, NJ, for Defendant.

[3]43 Cal. App. 4th 1704 (1996)

## Valuations: Intangible Property

***Study Finds More Value Allocated To Identifiable Intangible Assets While Goodwill Holding Steady***

Houlihan Lokey has completed its 15th annual Purchase Price Allocation Study in which it reviewed public filings for 1,525 completed transactions in 2015. For the 2015 Study, identifiable intangible assets were classified into five categories, including:

- Developed technology (including patents);
- In-process research and development (IPR&D);
- Customer-related assets (including backlog, customer contracts, and customer relationships);
- Trademarks and trade names (including domain names); and
- Other (including non-compete agreements, licenses, contracts,

and core deposits, among others).

The study found that more value is being allocated to identifiable intangible assets, while goodwill is holding steady. The study used "purchase consideration," defined as the sum of the purchase price paid and liabilities assumed in connection with a business combination and found that the percentage of the purchase consideration allocated to intangible assets increased to 34% on average in 2015, up from 30% in 2014. The percentage of purchase consideration allocated to goodwill was 38% on average in 2015, the same percentage reported for 2014. Contingent consideration (earnouts) represented 21% of purchase consideration (up from 20% in 2014).

The categories of intangible assets acquirers most commonly identified were: customer-related intangibles, cited in 69% of deals (up from 59% in 2014); trademarks and trade names, 50% (up from 45%); developed technology, 44% (up from 40%); and in-process research and development, 10% (up from 7%). Other intangible assets typically included were noncompete agreements, licenses, permits, and other contracts or agreements.

For readers who wish to review the full study it is available here.

## Clinton's Proposed Income Tax Hikes

***Top 1/10th of 1% Are Targeted***

According to a report in the Wall Street Journal the top-earning 1% of U.S. households-and especially the top 0.1% will have a lot to lose from Hillary Clinton's tax proposals with the major impact falling on a very thin but wealthy sliver of the population. The paper reports that according to the Tax Policy Center's analysis of Mrs. Clinton's recently released tax proposals nearly 80% of the higher taxes will hit the top 1% of households and more than half of that will hit the top 0.1%.

The center, using a broader definition of income than is shown on tax returns, sets about $732,000 in annual household income as being in the top 1% and $3.8 million for the top 0.1%. The Tax Policy Center analysis doesn't include her most recent proposals, such as taxing unrealized capital gains at death and implementing a 65% tax on estates exceeding $500 million.

The top 1% now receive about 17% of the nation's income before taxes and pay 28% of federal taxes as a result of the progressive tax code, according to the Tax Policy Center. One of Mrs. Clinton's proposals would impose a minimum 30% tax rate on households with incomes over $2 million and another would apply the 3.8% tax created in the 2010 health law to active business income.

***These proposals, coupled with the recent IRS proposed changes to disallow minority discounts under IRC Section 2704 for estate tax purposes, should put people with substantial wealth and income on notice that now is the time for planning and action. Further delay is probably not wise.***