

# Liquidated Damages Provisions: Strategic Drafting and Enforcement Issues

*Benjamin B. Reed*

## I. Introduction

The Spring 2010 issue of the *Franchise Law Journal* featured an excellent and thorough article authored by Deb Coldwell, Altresha Burchett-Williams, and Melissa Celeste that surveyed the laws of each state regarding the enforceability of liquidated damages provisions.<sup>1</sup> The legal standards have not changed significantly in the intervening years, and many franchise litigators (author included) refer to that article in preparing to brief the enforceability of these provisions. However, as any litigator will tell you, there is more to enforcing a contract term than simply stating the legal standard. There are many other factors to consider when litigating the enforceability of a liquidated damages provision in a franchise agreement.<sup>2</sup> After briefly summarizing the applicable legal standards, this article examines the considerations for drafting an enforceable liquidated damages provision, the arguments and evidence that have satisfied the applicable standard, the arguments and evidence that courts have considered in refusing to enforce liquidated damages provisions, and certain procedural issues that can arise in enforcement efforts.



Mr. Reed

## II. The Legal Standard, Generally Speaking

The 2010 *Franchise Law Journal* article on liquidated damages included a chart that summarized the standard each state applies when determining whether or not a liquidated damages provision is enforceable.<sup>3</sup> We will

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1. Deborah S. Coldwell, Altresha Q. Burchett-Williams & Melissa L. Celeste, *Liquidated Damages*, 29 *FRANCHISE L. J.* 211 (2010).

2. Dennis R. LaFiura & David S. Sager, *Liquidated Damages Provisions and the Case for Routine Enforcement*, 20 *FRANCHISE L. J.* 175 (2001).

3. Coldwell et al., *supra* note 1, at 218–30.

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*Benjamin B. Reed (breed@plavekoch.com) is a partner at Plave Koch PLC in Reston, Virginia and the current Director of the Forum's Litigation and Dispute Resolution Division. Mr. Reed expresses his appreciation to Setareh Deljo-Roland, an associate with Plave Koch PLC, for her assistance in preparing this article.*

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not endeavor to reinvent that wheel here. However, in general terms, the standard is relatively similar from state to state.<sup>4</sup> In examining whether a liquidated damages provision is enforceable, courts will generally look at whether: (1) the parties intended to liquidate damages; (2) when the contract was made, the amount of liquidated damages specified was a reasonable estimate of the presumed actual damages that a breach would cause; and (3) when the contract was made, the amount of actual damages that would result from a breach was difficult to determine.<sup>5</sup> Liquidated damages provisions are more likely to be considered reasonable if damages would be more difficult to ascertain.<sup>6</sup> However, the amount of the liquidated damages must be reasonably proportional to the amount of probable damage that will result from a breach.<sup>7</sup> Liquidated damages that are deemed penalties—because they are not a reasonable estimate of the probable damage arising from a breach—are not enforceable as a matter of public policy.<sup>8</sup>

The differences in how courts evaluate liquidated damages provisions turn on how the generally applicable standard is applied. As discussed in more detail below, state law varies based on several considerations, including: (1) whether liquidated damages provisions are presumptively enforceable or unenforceable;<sup>9</sup> (2) whether the reasonableness of the estimate of damages is judged based on reasonableness at the time of contracting or at the time the provision is to be enforced;<sup>10</sup> (3) the role actual damages play

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4. *Id.* at 212 (“Although there exist commonalities among the tests used by various states to evaluate and enforce liquidated damages provisions, there are also some differences and distinctions.”). One notable exception is Utah. In a 2012 decision, the Utah Supreme Court held that liquidated damages provisions should be evaluated in the same manner as other contractual provisions and not subject to heightened judicial scrutiny as to whether they are reasonable or constitute a penalty. *Commercial Real Estate Inv., L.C. v. Comcast of Utah II, Inc.*, 285 P.3d 1193 (Utah 2012). As a result, under Utah law, liquidated damages provisions are subject to attack only on grounds generally applicable to other contractual provisions, such as mistake, duress, fraud, or unconscionability.

5. Coldwell et al., *supra* note 1, at 211; LaFiura & Sager, *supra* note 2, at 175 (citing RESTATEMENT (SECOND) OF CONTRACTS § 356(1)); *see also* Circle B Enters., Inc. v. Steinke, 584 N.W.2d 97, 101 (N.D. 1998); O’Hara Grp. Denver, Ltd. v. Marcor Hous. Sys., Inc., 595 P.2d 679, 683 (Colo. 1979).

6. LaFiura & Sager, *supra* note 2, at 176; *see also* Fox Chicago Realty Corp., Ltd. v. Zukor’s Dresses, Inc., 122 P.2d 705, 708 (Cal. Ct. App. 1942).

7. Meyer Ventures, Inc. v. Barnak, No. Civ A. No. 11502, 1990 WL 172648, at \*5 (Del. Ch. Nov. 2, 1990) (“An amount which is not reasonably proportional to the amount of probable damages, but which is fixed instead as a punishment to deter the breach, will be held unenforceable as a penalty.”).

8. *See, e.g., id.*; Kalenka v. Taylor, 896 P.2d 222, 229 (Alaska 1995).

9. *See, e.g.*, Wingate Inns Int’l, Inc. v. P.G.S., LLC, No. 09-CV-6198 WHW, 2012 WL 3550764, at \*6 (D.N.J. Aug. 16, 2012); Radisson Hotels Int’l, Inc. v. Majestic Towers, Inc., 488 F. Supp. 2d 953, 958 (C.D. Cal. 2007); Travelodge Hotels, Inc. v. Kim Shin Hosp., Inc., 27 F. Supp. 2d 1377, 1382–83 (M.D. Fla. 1998); Wasserman’s Inc. v. Twp. of Middletown, 645 A.2d 100, 108 (N.J. 1994).

10. *See* LaFiura & Sager, *supra* note 2, at 176–77. *Compare* Ramada Franchise Sys., Inc. v. Cusack Dev., Inc., No. 96 CIV. 8085 (MGC), 1999 WL 165702, at \*6 (S.D.N.Y. Mar. 24, 1999) (“Courts must measure the reasonableness of the liquidated amount as of the time the parties entered into the agreement at issue, and not as of the time of the breach.”) *with* Caudill v. Keller Williams Realty, Inc., 828 F.3d 575, 577 (7th Cir. 2016) (applying Texas law) (“And though the

in determining the reasonableness of the estimate;<sup>11</sup> and (4) what factors courts will consider in deciding whether or not the provision constitutes an unenforceable penalty.<sup>12</sup>

Because of these differences, a provision that is enforceable under one state's law could be unenforceable under another state's law, even when the standard of review is essentially the same.<sup>13</sup> Moreover, although the determination of whether the provision is reasonable is generally a question of law,<sup>14</sup> the facts—the amount of actual damages arising from the breach, whether or not the franchisor mitigated its damages, the reason for the breach, etc.—can play a significant role in a court's determination of whether to enforce a liquidated damages provision.<sup>15</sup> Indeed, courts purporting to apply the same law have reached opposite results when construing an identical liquidated damages provision.<sup>16</sup> At the same time, in construing liquidated damages provisions, a court will always start by examining the language of the provision. Thus, our analysis begins with a discussion of

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reasonableness of a liquidated damages provision is ordinarily its reasonableness at the time of contracting, when there is an unbridgeable discrepancy between liquidated damages provisions as written and the unfortunate reality in application, we cannot enforce such provisions.” (internal quotations omitted).

11. See, e.g., *id.*; UPS Store, Inc. v. Hagan, No. 14CV1210, 2016 WL 1659188, at \*2 (S.D.N.Y. Mar. 15, 2016); Dickey's Barbecue Pit, Inc. v. Neighbors, No. 4:14-CV-484, 2016 WL 3878224, at \*1–2 (E.D. Tex. Jan. 7, 2016); 911 Restoration Franchise, Inc. v. Blakeney, No. CV 15-629-R, 2015 WL 12698290, at \*3 (C.D. Cal. Sept. 22, 2015); Creative Am. Educ., LLC v. Learning Experience Sys., LLC, No. 9:14-CV-80900, 2015 WL 4655087, at \*49–52 (S.D. Fla. July 31, 2015), *aff'd sub nom.* Creative Am. Educ., LLC v. Learning Experience Sys., LLC, 668 F. App'x 883 (11th Cir. 2016); Gator Apple, LLC v. Apple Texas Rests., Inc., 442 S.W.3d 521, 535–36 (Tex. App. 2014); Rescucom Corp. v. Chumley, No. 5:07-CV-0690, 2011 WL 1204758, at \*11 (N.D.N.Y. Mar. 28, 2011); *Majestic Towers, Inc.*, 488 F. Supp. 2d at 959–61; Days Inn of Am., Inc. v. Patel, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000); DAR & Assocs., Inc. v. Uniforce Servs., Inc., 37 F. Supp. 2d 192, 201–03 (E.D.N.Y. 1999); *Cusack Dev., Inc.*, 1999 WL 165702, at \*6–8.

12. See, e.g., 911 Restoration Franchise, Inc., 2015 WL 12698290, at \*3; *Rescucom Corp.*, 2011 WL 1204758, at \*11; Lager's, LLC v. Palace Laundry, Inc., 543 S.E.2d 773, 778–79 (Ga. Ct. App. 2000); Ramada Franchise Sys., Inc. v. Motor Inn Inv. Corp., 755 F. Supp. 1570, 1577–80 (S.D. Ga. 1991).

13. Compare Howard Johnson Int'l Inc. v. HBS Family, Inc., No. 96 CIV. 7687 (SS), 1998 WL 411334, at \*8 (S.D.N.Y. July 22, 1998) (holding that liquidated damages provision that required payment of a minimum of \$2,000 per each guest room was unenforceable under New York law) with Howard Johnson Int'l, Inc. v. SSR, Inc., No. CV 14-4611, 2017 WL 1246348, at \*4 (D.N.J. Apr. 3, 2017) (holding that liquidated damages provision that required payment of a minimum of \$2,000 for each room was enforceable under New Jersey law).

14. See e.g., *SSR, Inc.*, 2017 WL 1246348, at \*4 (“[W]hether a liquidated damages clause is enforceable is a question of law for the court to decide.”); but see Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 28 (1st Cir. 2001) (“Determining the validity of a liquidated damages clause is usually a fact-specific exercise.”).

15. See *infra*, Section IV.

16. Compare Shree Ganesh, Inc. v. Days Inns Worldwide, Inc., 192 F. Supp. 2d 774, 786–87 (N.D. Ohio 2002) (applying New Jersey law but holding liquidated damages provision in Days Inn franchise agreement was unenforceable because “the 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”) with Days Inns of Am., Inc. v. P & N Enters., Inc., 164 F. Supp. 2d 255, 261–63 (D. Conn. 2001) (applying New Jersey law and holding that identical provision was enforceable as a reasonable estimate of potential damages).

issues to be considered when drafting liquidated damages provisions for franchise agreements.

### III. Drafting Considerations for Liquidated Damages Provisions

There are a number of issues to consider when drafting a liquidated damages provision in a franchise agreement, several of which are examined in this section.

#### A. *The Breach Being Addressed*

First, the drafter must consider the breach sought to be addressed. The most commonly litigated liquidated damages provisions in the franchise context provide for liquidated damages to be paid when the franchisor terminates the franchise agreement as the result of the franchisee's breach or default.

However, franchisors also often include other types of liquidated damages provisions in their agreements. Many franchise agreements provide that the franchisee must pay interest or a specified late fee for royalties, marketing fees, or other contractually required payments that are not paid when due. Franchisors might also include provisions that charge a fixed amount for a specific breach, such as for violation of post-termination obligations to de-identify a location or noncompliance with a post-termination non-compete or non-solicitation covenant.<sup>17</sup> Another example arises from a prohibition against a franchisee offering the franchisor's branded products from any location other than the location for the franchised business specified in the franchise agreement. Because the damages from such unauthorized sales are difficult to determine at the time of contracting, franchisors might include a provision that obligates a franchisee to pay an increased royalty percentage (say ten percent instead of five percent) on those sales. Courts will often carefully scrutinize whether damages flowing from the specific breach will be difficult to ascertain or whether the provision merely imposes an additional monetary obligation in an attempt to compel compliance; if the latter, the provision is more likely to be deemed a penalty.<sup>18</sup>

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17. See, e.g., *Doctor's Assocs., Inc. v. Vinnie's Smokehouse/Meat Specialty, LLC*, No. CIV.A. 10-3661, 2011 WL 2748668, at \*2 (E.D. La. July 13, 2011) (holding that provision in franchise agreement requiring payment of \$250 per day for failure to cease using franchisor's copyrighted materials after termination was a reasonable measure of the franchisor's daily loss); *Ace Hardware Corp. v. Mam, Inc.*, No. 06-CV-5335, 2008 WL 4286975, at \*11-15 (N.D. Ill. Sept. 16, 2008) (holding that provision imposing a "\$10,000.00 fee per month for non-compliance with signage removal post-termination" was an enforceable liquidated damages provision).

18. See, e.g., *Lelli's Inn, Inc. v. Steven Lelli's Inn on the Green, L.L.C.*, No. 13-14766, 2017 WL 6521325, at \*14 (E.D. Mich. Oct. 24, 2017), *report and recommendation adopted*, No. 13-14766, 2017 WL 6513009 (E.D. Mich. Dec. 20, 2017) (enforcing liquidated damages provision requiring payment of \$10,000 for each instance of noncompliance with post-termination obligation to de-identify as to some violations but not others because "the treatment of a failure to meet the conceal deadlines as having the same value as a failure to meet the modify/remove deadlines operates as a penalty because a breach of the conceal deadline is plainly less severe").

## B. Reasonable Estimate of Damages

The next consideration—and perhaps the most important—is whether the formula used to calculate the damages is a reasonable estimate of the potential damages that will result from the breach. This question is tied to the type of provision being evaluated.

### 1. Provisions Relating to Termination

In the case of termination arising from a franchisee breach, the damage to the franchisor is the loss of an open and operating business generating both goodwill for the brand and revenue (via royalties) for the franchisor. Without a liquidated damages provision, a franchisor would likely seek to recover lost future royalties as a measure of damages. Thus, a reasonable estimate of the damage to the franchisor from a premature termination might be the lost royalty stream. As result, franchisors will often include a provision that calculates liquidated damages as royalties that the franchisee would have paid for some period after termination, based on a franchisee's operating results prior to termination. For example, liquidated damages could be calculated by (1) determining the franchisee's average monthly sales, based on the franchisee's monthly sales for the prior 24 months;<sup>19</sup> (2) multiplying the average monthly sales figure times the royalty percentage due under the franchise agreement;<sup>20</sup> and (3) multiplying that monthly royalty figure times some number of months for which the franchisor seeks future royalties as damages.<sup>21</sup>

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19. Instead of determining the average periodic sales, some provisions use the sales from the period during some historical time frame that were the greatest during that time frame. For example, over a twenty-four month period, the sales in the month in which the franchisee's sales were the largest would be used to calculate the liquidated damages. See, e.g., *Creative Am. Educ., LLC*, 2015 WL 4655087, at \*51, *aff'd sub nom.* *Creative Am. Educ., LLC v. Learning Experience Sys., LLC*, 668 F. App'x 883 (11th Cir. 2016) (enforcing provision that relied on "the single highest monthly Gross Revenues from the previous thirty-six (36) month period before the termination" to calculate liquidated damages); *DAR & Assocs., Inc. v. Uniforce Servs., Inc.*, 37 F. Supp. 2d 192, 202 (E.D.N.Y. 1999) ("[P]laintiffs' assertion that the use of the highest monthly service charge in the year preceding termination turns the damage formula into a penalty has no merit.").

20. Some provisions base the calculation on the average periodic royalties the franchisee paid over some time period prior to termination as opposed to calculating the liquidated damages by determining the average periodic sales over some time period prior to termination and multiplying that amount times the contractual royalty percentage. However, the former provision might understate the actual damage to the franchisor in lost future royalties, to the extent that the franchisor reduced the royalty percentage for some limited period prior to termination as a development, remodel or other incentive, or as an accommodation to a struggling franchisee, or the franchisee was underpaying royalties. On the other hand, the franchisee might argue that a provision that is not based on the actual royalties it paid is unreasonable.

21. A franchisor also might consider including in the formula the amount paid for marketing fund fees. See *Shoney's N. Am., LLC v. Smith & Thaxton, Inc.*, No. 3:12-CV-00625, 2014 WL 7369987, at \*14 (M.D. Tenn. Dec. 29, 2014) (rejecting franchisee argument that marketing funds fees were improperly included in the calculation of liquidated damages based on terms of franchise agreement). In addition, a franchisor could include a separate formula to account for lost profits from payments made to the franchisor (or an affiliate) for purchases of branded products from the franchisor (or its affiliate). For that formula, the franchisor would need to calculate the average profit it received from those purchases over some historical period and use a

In drafting such a provision, the franchisor should carefully consider each element of the formula. First, how many years of historical operating results will be considered? From the example above, if the look-back is too long, the average monthly sales figure derived might be not be an accurate indicator of the current performance of the franchised business and, therefore, would not be a reasonable estimate of actual damages. If the look-back is too short, it may capture disappointing operational results that led to the default and termination, which would not accurately reflect the business's actual operating capacity prior to the issue that resulted in the termination. Ideally, the franchisor should select a time period for determining the average sales that is based upon demonstrably reasonable considerations. One option is selecting a time period that courts have enforced under similar circumstances. Perhaps a better alternative is selecting a time frame the franchisor has used in evaluating the value of similarly situated businesses for purposes of purchasing a franchised business from a franchisee under a right of first refusal or otherwise, or for purposes of selling a corporate location to a franchisee.

Second, what multiplier (i.e., number of weeks, months, years) should the franchisor use in the formula? As discussed in more detail below,<sup>22</sup> some courts have accepted a specified multiplier as reasonable in the context of liquidated damages provisions covering certain types of franchised businesses.<sup>23</sup> Other courts have enforced provisions in which the time period was the remaining term of the agreement, no matter how much time remained.<sup>24</sup> However, similar to selecting the time period of historical sales to calculate an average, the better course may be to tie the multiplier to a sound business rationale. For example, the franchisor could collect system data on the average amount of time it takes for the franchisor to develop a replacement franchised business in the applicable territory or market. This analysis would

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multiple similar to that used to calculate lost royalties. One additional consideration would be to determine the net profit from those purchases. It might be deemed an unreasonable estimate of damages if the calculation did not account for the expenses the franchisor would have incurred in providing the products that generated the revenue. See *Honey Dew Assocs. Inc.*, 81 F. Supp. 2d at 358, vacated, 241 F.3d 23 (1st Cir. 2001) ("Common sense dictates that [the franchisor] will save an unstated amount because it does not have to supervise the operation of the shop and regularly send personnel to Rhode Island to ensure that [the franchisee] complies with the Franchise Agreement. . . . Additionally, plaintiffs will no longer be bound to provide services and support for [the franchisee] as required by the Franchise Agreement. Therefore, the damages clause which calls for an acceleration of future royalty payments is an unenforceable penalty since it is not a true estimate of the damages."). But see *Days Inn of Am., Inc. v. Patel*, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000).

22. See *infra*, Sections IV.A.1, IV.B.2.

23. See, e.g., *Captain D's, LLC v. Arif Enters., Inc.*, No. 3:09-00809, 2010 WL 5060289, at \*10 (M.D. Tenn. Dec. 6, 2010) ("Numerous courts have found that in the hotel context, two years is a reasonable time estimate for damages as that is the average time it takes a franchisor to find a replacement franchise."); *Majestic Towers, Inc.*, 488 F. Supp. 2d at 961 ("It is also useful to note that other courts have also upheld liquidated damages clauses based on two years of lost future royalties.")

24. See, e.g., *Captain D's*, 2010 WL 5060289, at \*11 (enforcing liquidated damages provision that calculated amount based on remaining term of franchise agreements); *Shoney's, Inc. v. Morris*, 100 F. Supp. 2d 769 (M.D. Tenn. 1999) (same).

include the time period to identify a qualified prospect and complete a sale, the time frame to build out a location and train and hire employees,<sup>25</sup> and the time period after opening a new location for that location to reach a level of sales that is on par with other franchised locations in the same market or similar markets. This analysis also might segregate this information between new markets for the franchised system and markets in which the franchisor already has a presence, either with franchised or corporate locations.<sup>26</sup> Because the average time period to develop a new franchised location is based on actual business realities, using that time period as the multiplier is more likely to result in a reasonable estimate of actual damages.<sup>27</sup> Of course, that time period might change over time, so a franchisor should also consider undertaking this analysis periodically and revising its liquidated damages provision to account for such changes (while maintaining past analyses to ensure there is evidentiary support for older versions to the extent they are challenged).<sup>28</sup>

## 2. Provisions Relating to Other Specific Breaches

In contrast to provisions addressing damages arising out of premature termination, it may be more difficult to determine a reasoned basis for liquidated damage designed to compensate for other specific breaches. For provisions that charge interest on late payments, the rationale is fairly straightforward (and consistent with similar provisions in other commercial and consumer contracts, leases, mortgages, etc.): in addition to not receiving

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25. In determining this time period, the franchisor should also consider any deadline the franchise agreement places on completing construction and/or opening the location. If the average calculated and used in the liquidated damages provision is longer than the period that the franchise agreement actually affords a franchise to complete construction and open the location after execution, the liquidated damages provision might be deemed unreasonable. Alternatively, rather than calculating the average time period it takes to get a location open after the prospect purchases the franchise and the franchise agreement is entered, the franchisor could simply use the time period that the franchise agreement affords the franchisee to open the location after execution. However, to the extent the franchisor routinely extends that time period, the multiplier will understate the potential actual damage to the franchisor. The better course, obviously, would be to ensure that the time period to open afforded in the franchise agreement is consistent with the reality of how long on average it takes to open a franchised location.

26. The franchisor might also determine the average cost of developing a new location (both in existing and new markets) and add that amount in as an additional element of the liquidated damages calculation. However, to the extent that cost is offset by the payment of an initial franchise fee (particularly where those fees are recognized for accounting purposes as payment to compensate for the costs incurred by the franchisor in developing a new franchised business), the franchisor does not really realize those costs as damages. It might therefore be unreasonable for the franchisor to include the cost of developing a new franchised business as liquidated damages.

27. *See, e.g., HLT Existing Franchise Holding LLC v. Worcester Hosp. Grp. LLC*, 994 F. Supp. 2d 520 (S.D.N.Y. 2014).

28. Some provisions may also include a formula to discount the amount of lost future royalties calculated to a present value. *See, e.g., Century 21 Real Estate, LLC v. Ramron Enters.*, No. 1:14-CV-00788-AWI, 2015 WL 521350, at \*8 (E.D. Cal. Feb. 9, 2015) (“The present value of the total calculated [pursuant to formula] at a discount rate of 8%, assuming payment is made at the end of each month, will constitute our liquidated damages.”).

the actual payment (which can be calculated at the time of breach without any difficulty), the franchisor has been damaged by the lost investment value of that money. In light of state laws mandating maximum amounts that can be charged as interest on late payments under commercial lending agreements, provisions in franchise agreements obligating the franchisee to pay interest on late payments are commonplace and routinely enforced without challenge.

Other provisions that seek to charge the franchisee a fee in connection with a specified breach require a bit more analysis:

- Late fees, charged in addition to or in lieu of interest, can often be justified based on the fact that is difficult to determine with reasonable certainty the internal cost to a franchisor from a franchisee's failure to timely pay fees. Employee time spent contacting the franchisee, preparing statements of account, and negotiating payment schedules could arguably be spent on other business matters. Because these nuisance costs cannot easily be determined, a small late fee can often be justified as reasonable. However, if the late fee is not proportional to the amount unpaid, it may instead be deemed a penalty. So, for example, if the late fee is \$500 but the average weekly royalty payments are \$2,500, the late fee—20% of the average royalty payment—might be deemed a penalty.<sup>29</sup>
- Provisions for the payment of a higher royalty percentage on unauthorized sales (outside of an assigned territory or from an unapproved location) may be more difficult to justify. Arguably, if the franchisee pays standard royalties on those sales, the franchisor is not really damaged. And if the franchisee does not pay royalties on those sales, the franchisor's damages would be the lost royalties. On the other hand, if the franchisee is selling outside of its assigned territory or from another location, a second franchised location is potentially viable (or the franchisee is taking sales away from another franchised location). In that case, the franchisor's damages also include the fact that the unauthorized sales are inhibiting growth of the system and preventing the franchisor from capturing that growth through the establishment of new franchised business (along with any initial franchise fees the franchisor would receive). Because those damages are not easily quantified, assessing a higher royalty percentage on such sales may be reasonable.

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29. See, e.g., *Mattvidi Assocs. Ltd. P'ship v. NationsBank of Virginia, N.A.*, 639 A.2d 228, 238 (Md. Ct. App. 1994) (collecting cases from multiple jurisdictions and noting that “[t]he modern view seems to be that [late charge provisions] are not penalties but reasonable compensation in commercial transactions, because of the difficulty and impracticality of fixing the amount of actual damages for administrative expenses that will be sustained in the event of late payments”) (internal quotation marks omitted).

- A franchisor might charge a set amount as liquidated damages arising out of a franchisee's failure to de-identify after termination. In at least one case, such a provision has been deemed enforceable.<sup>30</sup>
- Franchisors might also provide for the franchisee to pay costs associated with the franchisor addressing a particular breach. For example, a franchisor might wish to charge a franchisee for the cost of conducting a follow-up inspection after the franchisee fails an inspection, the cost of a financial audit after a franchisee fails to report sales for some period of time, or the cost of providing training to employees when the franchisee fails to maintain the required number of trained staff. However, in these circumstances, the franchisor's damages—the costs incurred as a result of the particular breach—can be readily ascertained at the time they are incurred. As result, the better course in these circumstances is to obligate the franchisee to reimburse the franchisor for the actual costs rather than specifying a liquidated amount that may not accurately reflect the actual damage to the franchisor.

### 3. Provisions Particular to Certain Industries—Specific Amount per Room for Hotel Franchise Agreements

In franchise agreements for hotels and motels, liquidated damages are commonly calculated based upon the number of rooms in the franchised hotel or motel. The question in those situations is whether the dollar figure per room is a reasonable estimate of the actual damages at the time of contracting, i.e., the estimated revenue a hotel room will generate for the franchisor over a period of time. Not surprisingly, courts have both enforced<sup>31</sup> and failed to enforce<sup>32</sup> such provisions, based upon the facts presented.

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30. *Ace Hardware Corp. v. Marn, Inc.*, No. 06-CV-5335, 2008 WL 4286975, at \*11–15 (N.D. Ill. Sept. 16, 2008).

31. *See, e.g., HBS Family, Inc.*, 1998 WL 411334, at \*7 (Sotomayor, J.) (finding that liquidated damages calculation based on royalty revenues for twenty-four months after termination reasonable, but finding that “the alternative method . . . for calculating liquidated damages . . . that ‘in no event shall be less than the product of \$2,000.00 multiplied by the number of guest rooms in the Facility’” was “not a reasonable estimate of the potential loss likely to be suffered because it does not take into account the length of time remaining on the unexpired License Agreement at the time of default” and was therefore not proportional to the possible loss).

32. *See, e.g., Howard Johnson Int'l, Inc. v. SSR, Inc.*, No. CV 14-4611, 2017 WL 1246348, at \*4 (D.N.J. Apr. 3, 2017) (holding liquidated damages provision that require payment of \$2,000 per room enforceable “[b]ecause it is difficult to estimate these damages due to the transient lodging business” and because “the liquidated damages clause represents a good faith estimate of the monetary damages that [the franchisor] sustains when a franchisee causes the premature termination of a franchise agreement”); *Knights Franchise Sys., Inc. v. P.C.P.S. Corp.*, No. CIV. 06-5243, 2009 WL 3526229, at \*5 (D.N.J. Oct. 21, 2009), *aff'd*, 420 F. App'x 155 (3d Cir. 2011) (“[T]he Court is satisfied that the liquidated damages provision, which assesses damages as \$500 per guest room authorized to operate at the time of the termination . . . provides a reasonable forecast of future lost recurring fees that would otherwise be nearly impossible to predict.”); *Howard Johnson Int'l, Inc. v. Goodland Inns, Inc.*, No. CIV. A. 06-5137 (JAG), 2008 WL 2229826, at \*4 (D.N.J. May 28, 2008) (enforcing liquidated damages provision of “no less than the product of \$2,000.00 multiplied by the number of guest rooms in the Facility” on motion for default judgment).

This method for providing for liquidated damages may also be applicable to franchise business models outside of the lodging industry. Arguably, a franchisor could estimate damages based on a dollar amount per customer for concepts that provide repeat services to specific customers, such as home cleaning and maintenance services, tax preparation business, rent-to-own businesses, tutoring and educational service businesses, and other businesses where one asset of the business is customer accounts. Premature termination of the franchise agreement would result in an unmeasurable loss of customer accounts that could be estimated via a set amount for each customer of the business. However, unlike the hotel/motel model, where the number of rooms is certain both at the time of contracting and at the time of breach, the number of customer accounts may not be as easily ascertainable. In any event, the franchisor would still need to establish that the amount per customer stated in the contract is a reasonable estimate of the amount of revenue or profit each customer of the franchisee would have generated for the franchisor.

### C. *The Issue of Intent*

One final consideration in drafting a liquidated damages provision is whether the franchisor intends the provision to be a penalty or not. In some jurisdictions, the parties' intentions are irrelevant to the evaluation of a liquidated damages provision.<sup>33</sup> However, a number of other jurisdictions require that the parties intend to provide for liquidated damages.<sup>34</sup> Absent that intent, whether demonstrated by the circumstances, the language of the entire agreement, or the use of the term "liquidated damages" (which courts do not often find to be dispositive),<sup>35</sup> courts in those jurisdictions

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33. See, e.g., *Leisure Sys., Inc. v. Roundup, LLC*, No. 1:11-CV-384, 2012 WL 5378302, at \*14 (S.D. Ohio Oct. 31, 2012) ("In determining whether a stipulated damages clause is enforceable, neither the parties' actual intention as to its validity nor their characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid.") (internal quotation marks omitted) (quoting *In re Graham Square, Inc.*, 126 F.3d 823, 829 (6th Cir. 1997)).

34. See e.g., *Rainbow Country Rentals & Retail, Inc. v. Ameritech Publ'g, Inc.*, 2005 WI 153, 706 N.W.2d 95, 103 (Wis. 2005) (explaining the test to determine reasonableness of liquidated damages clause includes whether the parties intended to provide for damages or for a penalty); *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88, 100 (Tenn. 1999) (addressing the recovery of liquidated damages and noting that Tennessee courts focus on the intentions of the parties based on the language in the contract and the circumstances that existed at the time the contract was formed); *Ramada Franchise Sys., Inc. v. Motor Inn Inv. Corp.*, 755 F. Supp. 1570, 1578 (S.D. Ga. 1991) (Georgia law) ("Although the specific words 'liquidated damages' are not required for a court to find the provision enforceable, there must be some clear manifestation of the parties' intent to agree to liquidated damages.")

35. See e.g., *Airport Square Holdings, LLC v. GCCFC 2007-GG9 Colomary Facilities, LLC*, No. CV JFM-16-02883, 2017 WL 639230, at \*8 n.12 (D. Md. Feb. 16, 2017) ("[T]he language expressly denying that the liquidated damages clause is a penalty is highly probative of the parties' intentions when entering into the contract."); *In re Galleria Investments LLC*, No. A06-62557-PWB, 2008 WL 7842107, at \*14 (Bankr. N.D. Ga. Apr. 4, 2008) ("[T]he use of the term 'liquidated damages' is not necessarily dispositive."); *Guiliano*, 995 S.W.2d at 97 ("A contractual provision need not explicitly include the term 'liquidated damages' to constitute a liquidated

may deem the provision a penalty rather than an enforceable liquidated damages provision.<sup>36</sup>

#### IV. Enforcement of Liquidated Damages Provisions

The enforceability of a liquidated damages provision will often turn on how the provision is drafted. However, there are a number of additional considerations to assess, many of which are discussed in this section.

##### A. Procedural Issues

###### 1. Is Reasonableness of the Provision a Question of Law or an Issue of Fact?

In most jurisdictions, the enforceability of a liquidated damages provision is deemed to be a question of law for a court to decide.<sup>37</sup> As a result, this issue can often be resolved on a motion for summary judgment.<sup>38</sup> Indeed, courts will often evaluate a provision based on whether similar provisions have been deemed to be enforceable, without addressing the particular facts or circumstances of the case before the court.<sup>39</sup> However, many courts have noted that the questions of whether the provision is a reasonable esti-

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damages provision.”); *Circle B Enters., Inc. v. Steinke*, 584 N.W.2d 97, 101 (N.D. 1998) (“[T]he characterization of agreed damages for nonperformance as a ‘penalty’ is not conclusive.”).

36. See, e.g., *Holt’s Cigar Co. v. 222 Liberty Assocs.*, 591 A.2d 743, 749 (Pa. Super. Ct. 1991) (“We find it abundantly clear from the trial testimony and accompanying arguments that Holt’s . . . chose the stipulated sum not as a reasonable forecast of anticipated damages due to delay, but rather solely as a penalty to discourage breach (delay). That the sum was chosen to insure ‘adherence’ with the schedule, that appellee would construe it to apply even on days that the store ordinarily was closed for business, and that appellee repeatedly referred to, and contended that, the stipulation was a “penalty,” clearly forecloses any claim that it was intended as a measure of compensation.”).

37. See e.g., *JMD Holding Corp. v. Congress Fin. Corp.*, 828 N.E.2d 604, 609 (N.Y. 2005) (“Whether the early termination fee represents an enforceable liquidation of damages or an unenforceable penalty is a question of law. . . .”); *Naporano Assocs., L.P. v. B & P Builders*, 706 A.2d 1123, 1127 (N.J. Super. Ct. App. Div. 1998) (“Whether a liquidated damages clause in enforceable is a question of law for the court to decide.”); *Dickey’s Barbecue Pit, Inc. v. Neighbors*, No. 4:14-CV-484, 2016 WL 3878224, at \*2 (E.D. Tex. Jan. 7, 2016) (“[A] court is not required to find that there is a fact issue regarding actual damages when it considers whether the amount is a penalty.”); *Guiliano*, 995 S.W.2d at 95 (“The interpretation of a contract is a matter of law that requires a *de novo* review on appeal.”).

38. See, e.g., *Shoney’s N. Am., LLC v. Smith & Thaxton, Inc.*, No. 3:12-CV-00625, 2014 WL 7369987, at \*14 (M.D. Tenn. Dec. 29, 2014) (holding determination of enforceability of liquidated damages provision was appropriately resolved on motion for summary judgment).

39. See, e.g., *Arif Enters., Inc.*, 2010 WL 5060289, at \*8 (relying on other cases in holding that liquidated damages equal to all future royalties was enforceable and not a penalty); *Majestic Towers, Inc.*, 488 F. Supp. 2d at 961 (rejecting franchisor’s evidence that it would take two years to replace franchised hotel but at the same time determining liquidated damages equal to two years of royalties was reasonable because, in part, “other courts have also upheld liquidated damages clauses based on two years of lost future royalties” and citing *Ramada Franchise Sys. v. Cusack Dev., Inc.*, No. 96 CIV. 8085 (MGC), 1999 WL 165702, at \*7-8 (S.D.N.Y. Mar. 24, 1999)); *Hosp. Int’l v. Mahtani*, No. CIV.A.2:97-CV-87, 1998 WL 35296447, at \*16 (M.D.N.C. Aug. 3, 1998) (relying on *Motor Inn Inv. Corp.*, 755 F. Supp. at 1577, which “held a similar liquidated damages provision contained in a motel franchise agreement enforceable under Georgia law” without analyzing the provision at issue).

mate of potential damages and whether damages would be difficult to calculate require an examination of facts.<sup>40</sup> Parties seeking to enforce or invalidate a liquidated damages provision should therefore present both legal authority and evidence to support their arguments.<sup>41</sup> Otherwise, a court may decide that, although enforceability is a legal question for the court to decide, there is a lack of evidence to support a finding of whether the provision should or should not be enforceable.<sup>42</sup> And, while the ultimate question may be one for resolution by the court, the enforceability of a liquidated damages provision will not often be resolved on a motion to dismiss.<sup>43</sup>

## 2. Does the Governing State Law Deem Liquidated Damages Provisions Presumptively Valid?

Historically, liquidated damages provisions were strictly scrutinized in many jurisdictions because of the assumption they were simply a means of compelling performance under a contract, i.e., a penalty.<sup>44</sup> For example, prior to 1977, California Civil Code Sections 1670 and 1671 provided that

40. See *e.g.*, *Honey Dew Assocs., Inc. v. M & K Food Corp.*, 241 F.3d 23, 28 (1st Cir. 2001) (“Determining the validity of a liquidated damages clause is usually a fact-specific exercise.”); *UPS Store, Inc. v. Hagan*, No. 14CV1210, 2016 WL 1659188, at \*3 (S.D.N.Y. Mar. 15, 2016) (“It was the [franchisees’] burden to set forth specific facts showing that there is a *genuine issue* as to the enforceability of the liquidated-damages clause . . . [a]nd after prompting from this Court, they do not offer evidence on which this Court can invalidate the clause.”); *Caudill v. Keller Williams Realty, Inc.*, No. 13 C 4693, 2013 WL 5874761, at \*4 (N.D. Ill. Oct. 31, 2013) (“Before this Court answers the legal question [defendant] posits of whether this liquidated damages provision is a penalty, factual issues must be resolved. To determine the reasonableness of the liquidated damages provision would require this Court to make certain determinations—like the circumstances that existed when the parties executed the Settlement Agreement—that it is presently unprepared to make.”); *Rescuecom Corp. v. Chumley*, No. 5:07-CV-0690, 2011 WL 1204758, at \*10 (N.D.N.Y. Mar. 28, 2011) (“It is well established that whether a clause represents an enforceable liquidation of damages or an unenforceable penalty is a question of law, giving due consideration to the nature of the contract and the circumstances.”).

41. See Section IV, *infra*.

42. See, *e.g.*, *Shoney’s N. Am., LLC*, 2014 WL 7369987, at \*15 (granting summary judgment for franchisor because “[t]he defendants . . . do not refute any part of [the franchisor’s] declaration or . . . assertions regarding the damages owed, and they have presented no evidence to suggest that the liquidated-damages clause . . . functions as a penalty or unenforceable forfeiture”); *Captain D’s*, 2010 WL 5060289, at \*8 (enforcing liquidated damages provision because “[w]hile Defendants have asserted that the liquidated damages provisions function as penalties, they have not offered any support for that contention”); *Days Inn of Am., Inc. v. Patel*, 88 F. Supp. 2d 928, 936 (C.D. Ill. 2000) (holding that because franchisee had “failed to offer any proof, other than mere argument by counsel, as a basis for setting aside the liquidated damages provision. . . . , the liquidated damages clause . . . is reasonable, valid, and enforceable”); *HBS Family, Inc.*, 1998 WL 411334, at \*8 (refusing to enforce liquidated damages provision because “there is nothing to show that the sum of \$2,000 per each guest room in the 112–room facility bears any reasonable relationship to the pecuniary harm plaintiff would have likely suffered in the event of a breach”).

43. See, *e.g.*, *Caudill*, 2013 WL 5874761, at \*4 (“The issue of reasonableness [of the liquidated damages provision] pertains more to the merits, and a Rule 12(b)(6) motion tests the sufficiency of the complaint, not the merits of the case.”); *Blasko v. Petland, Inc.*, No. 2:08-CV-01105, 2010 WL 11537972, at \*4 (S.D. Ohio Mar. 9, 2010) (denying motion to dismiss claim for liquidated damages and affording the parties “the opportunity to engage in discovery, and evidence outside the pleadings and the agreement” to “demonstrate at the summary judgment phase, or at trial, that the agreed damages provision is an unenforceable penalty”).

44. See *LaFiura & Sager*, *supra* note 2, at 175.

“Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void” except to the extent “[t]he parties to a contract . . . agree . . . upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.”<sup>45</sup> This statutory framework placed the burden on the party seeking to enforce the liquidated damages provision to present evidence to prove the exception to the general rule.<sup>46</sup> However, in 1977, these sections of the Civil Code were amended to provide that “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.”<sup>47</sup> Under this new standard, California courts are required to deem liquidated damages provisions to be presumptively valid.<sup>48</sup>

Several other jurisdictions also presume the validity of liquidated damages provisions.<sup>49</sup> In those jurisdictions, that presumption can only be overcome with proof the provision is actually a penalty or the amount of liquidated damages is either an unreasonable estimate of possible damages or bears no reasonable relationship to actual damages.<sup>50</sup> For example, in Montana, that presumption may only be overcome with a showing that the provision is unconscionable.<sup>51</sup> In contrast, as noted earlier, Utah courts review liqui-

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45. Stanley M. Arndt, *Liquidated Damages in California*, 10 CAL. L. REV. 8, 9 (1921) (quoting original CAL. CIVIL CODE §§ 1670–1671).

46. See *Better Food Markets v. Am. Dist. Tel. Co.*, 253 P.2d 10, 14 (Cal. 1953) (“Unless a clause providing for liquidated damages falls within the provisions of section 1671 it is invalid, . . . and except on admitted facts this is generally a question to be resolved by the trier of fact. . . . It is settled law that the burden is on the party seeking to rely upon a liquidated damage provision in a contract to plead and prove facts showing impracticability.”) (Citations omitted).

47. CAL. CIV. CODE § 1671(b).

48. *Majestic Towers, Inc.*, 488 F. Supp. 2d at 958–59 (“The modern form of California’s liquidated damages statute has switched the presumption from invalidity to validity. . . . [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.”) (internal quotation marks omitted) (quoting CAL. CIV. CODE § 1671(b)).

49. *CRS Proppants LLC v. Preferred Resin Holding Co., LLC*, No. CVN15C08111 MMJCCLD, 2016 WL 6094167, at \*3 (Del. Super. Ct. Sept. 27, 2016) (“Delaware’s contract law allows parties to agree to a good faith estimate of actual damages which may result from termination of a contract. Liquidated damages clauses are presumed valid.”); *P.G.S., LLC*, 2012 WL 3550764, at \*6 (“New Jersey law favors contractual provisions that fix specified amounts of damages in the event of a breach of contract. . . . [and] New Jersey law also provides that liquidated damages provisions in a commercial contract between sophisticated parties are presumptively reasonable”); *Nat’l Bedding Co. v. Am. Realty Capital, L.L.C.*, No. 08-CV-6552, 2010 WL 3842370, at \*10 (N.D. Ill. Sept. 27, 2010) (“Under Illinois law, liquidated damages provisions are presumptively enforceable.”).

50. See Section IV.B, *infra*.

51. *Highway Specialties, Inc. v. State, Dep’t of Transp.*, 215 P.3d 667, 670 (Mont. 2009) (“[L]iquidated damages provisions are presumed enforceable and will be enforced unless the party opposing the provision has established that it is unconscionable.”).

dated damages provisions in the same manner as other contract terms and will invalidate those provisions only on grounds on which contract provisions are generally deemed unenforceable (mistake, fraud, duress, unconscionability, etc.).<sup>52</sup> In these jurisdictions, enforcement may be more likely due to the presumption of validity.

### 3. Who Bears the Burden of Proving Enforceability of the Provision?

Another procedural consideration is the determination of which party bears the burden of proving that the liquidated damages provision is: (1) enforceable or unenforceable; (2) reasonable or unreasonable; or (3) valid or a penalty. In those states where such provisions are presumed to be valid, the burden obviously falls on the party seeking to overcome the presumption.<sup>53</sup> Indeed, the majority of other states also place the burden on the party seeking to avoid enforcement of the liquidated damages provision.<sup>54</sup> In fact, very few states place the burden of proof of reasonableness or enforceability on the party seeking to enforce a liquidated damages provision.<sup>55</sup> At the same time, even though a franchisor may not have the burden of proof, in most cases (discussed more fully below) the franchisor is better served to present evidence to support a finding of enforceability, particularly to avoid a disputed issue of material fact when moving for summary judgment.

52. *Commercial Real Estate Inv., L.C. v. Comcast of Utah II, Inc.*, 285 P.3d 1193 (Utah 2012) (holding that liquidated damages clauses should be evaluated in the same manner as other contractual provisions and not subject to heightened judicial scrutiny).

53. *See, e.g., Wingate Inns Int'l, Inc.*, 2012 WL 3550764, at \*6 (“New Jersey law . . . provides that liquidated damages provisions in a commercial contract between sophisticated parties are presumptively reasonable, and the party challenging the clause bears the burden of proving its unreasonableness.”); *O’Brian v. Langley Sch.*, 507 S.E.2d 363 (Va. 1998) (explaining that the party challenging the validity of liquidated damages clause bears the burden of proof on that issue); *Kim Shin Hosp. Inc.*, 27 F. Supp. 2d at 1383 (explaining that under California law, a liquidated damages clause is presumed valid and the burden is on the party seeking invalidation to establish that the provision is unreasonable).

54. *See* 24 WILLISTON ON CONTRACTS § 65:30 (4th Ed.) (“The more widely held view appears to be that the burden is on the party seeking to invalidate a stipulated damages provision to prove that it constitutes an unenforceable penalty.”); *Honey Dew Assocs., Inc. v. M & K Food Corp.*, 241 F.3d 23, 27 (1st Cir. 2001) (applying Massachusetts law, and finding 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.”); *O’Brian*, 507 S.E.2d at 366 (collecting cases).

55. *See Hendricks Prop. Mgmt. Corp. v. Birchwood Props. Ltd. P’ship*, 741 N.W.2d 461, 467 (N.D. 2007) (“A party seeking to enforce a contractual clause for liquidated damages has the burden of proof under N.D.C.C. § 9–08–04.”); *Robins Motor Transp., Inc. v. Associated Rigging & Hauling Corp.*, 944 F. Supp. 409, 412 n.2 (E.D. Pa. 1996) (“[T]he party seeking to enforce a liquidated damages clause has the burden of demonstrating its reasonableness.”); *AT & T Info. Sys., Inc. v. Smith*, 593 So. 2d 673, 676 (La. Ct. App. 1991) (“Plaintiff is seeking the award of liquidated damages and has the burden of proving reasonableness.”); *Pacheco v. Scoblionko*, 532 A.2d 1036, 1039 (Me. 1987) (“We adopt the rule that the party seeking enforcement of a liquidated damages clause in a contract has the burden of proving its validity . . .”); *Waggoner v. Johnston*, 408 P.2d 761, 768 (Okla. 1965) (“[T]he burden of establishing that the damages were difficult of ascertainment rests on the party seeking the enforcement of the liquidated damage clause, and the fact that the parties have expressly stated in the contract that the damages are difficult to determine does not shift the burden of proof on this issue.”).

B. *What Evidence Should Be Presented to Prove That a Liquidated Damages Provision Is or Is Not Enforceable?*

As discussed earlier, the enforceability of liquidated damages provisions is often a question of law, and the law presumes that such provisions are valid. And in some cases, courts will ignore the facts of a particular case when a specific liquidated damages provision has been held enforceable or unenforceable in a prior case. However, more often than not, when dealing with liquidated damages provisions in franchise agreements, whether or not the provision is enforceable usually turns on the circumstances and factual evidence presented by the parties.

Under the general standard recited earlier, the provision will be enforced if the amount of liquidated damages is a reasonable estimate of the presumed actual damages that a breach would cause and the amount of actual damages that would result from a breach were difficult to ascertain; in some states, the parties must also be found to intended to liquidate damages, as opposed to impose a penalty for nonperformance. The party seeking to recover liquidated damages is obligated, at a minimum, to provide evidence sufficient for a court to calculate the amount of the liquidated damages. Regardless of who bears the burden of proof, the questions remain: how do you prove (1) whether actual damages would be difficult to determine; (2) what a reasonable estimate of actual damages would be; and (3) what the parties intended?

1. Proving that Actual Damages Would Be Difficult to Ascertain

In the context of franchise cases—and depending on the type of liquidated damages provision at issue—the issue of whether actual damages will be difficult to ascertain is usually decided in favor of enforcement of the liquidated damages provision. As discussed earlier, the most common liquidated damages provision in a franchise agreement is a provision that calculates damages arising from a termination of the franchise agreement. At the time the parties enter the agreement, the damages to a franchisor from termination are almost impossible to ascertain, given that the franchised business has yet to generate any revenues or contribute to the goodwill of the brand.<sup>56</sup> Even when considered at the time of termination, the damages to the franchisor are likely still difficult to calculate.

A franchisee could argue<sup>57</sup> that the actual damages—the amount of lost royalties for some period of time after termination—can be calculated and

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56. See *Kim Shin Hosp., Inc.*, 27 F. Supp. 2d at 1383 (“The resulting harm from the premature termination would be lost future profits. Factors that can affect future profitability include the future business ability of the franchisee, changes in the formation of highways and occurrence of traffic, gas and oil shortages, and the general ability of the public at large to use the facilities. . . . Thus, it would be very difficult to estimate future profits at the time of the contract.”) (internal citations and quotations omitted)

57. Of course, a franchisee might want to avoid this argument if a lost future royalty calculation might actual result in a damages calculation that exceeds the amount of liquidated dam-

actually are calculated in many cases where liquidated damages provisions are not included in the contract.<sup>58</sup> In limited cases—particularly when the court also determines that the actual damages would likely be much less than the calculated liquidated damages—courts have agreed with this argument.<sup>59</sup> However, more often, courts have concluded that actual damages to a franchisor arising from a premature termination are not readily ascertainable. Factors such as (1) an inability to determine how much revenue the franchised business would have continued to generate for the balance of the term of the agreement<sup>60</sup> and (2) the difficulty in calculating the value of the goodwill lost from the closure of a franchised business in a market<sup>61</sup> have been deemed material to a determination that the actual damages are too speculative to calculate with any certainty. Again, although the franchisor may not bear the burden of proving the liquidated damages provision is enforceable, a franchisor is well-served by presenting these arguments and

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ages. Moreover, by making this argument, a franchisee would be hard pressed to argue that a lost future royalty calculation is too speculative.

58. See, e.g., *Days Inns of Am., Inc. v. P & N Enters., Inc.*, 164 F. Supp. 2d 255, 262 (D. Conn. 2001) (franchisee argued that liquidated damages provision was unenforceable because actual damages could be calculated based on franchisor's knowledge of "1) the room rates that [franchisee] planned to charge, 2) the occupancy rates of the Facility from the time period when it had previously been operated as a Days Inns franchise, 3) the average occupancy rates for Days Inns' other franchisees, 4) the percent of gross room revenue due Days Inns under the License Agreement, and 5) the average time period to replace a franchisee").

59. See, e.g., *Coleman Co. v. Hlebanja*, No. 96 CIV. 1288 (MBM), 1997 WL 13189, at \*5 (S.D.N.Y. Jan. 15, 1997) (holding that liquidated damages provision related to breach of post-sale noncompetition covenant was unenforceable because, among other things, it . . . would not seem difficult to determine actual damages from defendants' improper sale of camping equipment" in violation of the noncompete).

60. See, e.g., *P & N Enters., Inc.*, 164 F. Supp. 2d at 262 ("[T]he court concludes that actual harm was very difficult to accurately estimate, both at the time of contract formation and at the time of the breach. The court finds persuasive the plaintiff's recitation of variables which would have made the prospective calculation of actual damages very difficult: whether P & N would comply with Days Inns' quality assurance standards, whether room rates would increase if occupancy rates increased, whether competitors would enter the Meriden market, the state of the national and regional economies, and whether fuel prices would rise to the extent of curtailing travel."); *Cusack Dev., Inc.*, 1999 WL 165702, at \*7 (finding actual damages from early termination were difficult to ascertain at time of contracting based on affidavit testimony that "there is no way to determine precisely what royalties Ramada would have received during the remainder of the Agreement's term" because "future hotel revenue is a function of variable factors including the national, regional and local economies, travel patterns of vacationers, the entry or withdrawal of competitors from the market and the effort, skill and resources of the licensee").

61. See, e.g., *La Quinta Corp. v. Heartland Props. LLC*, 603 F.3d 327, 340 (6th Cir. 2010) ("Actual damages, in the context of the hospitality industry, are difficult to quantify and not strictly monetary; a franchise operation yields not only future royalties, but additional intangibles such as brand recognition and loyalty, and a competitive presence in a geographic region."); *Creative Am. Educ., LLC*, 2015 WL 4655087, at \*50, *aff'd sub nom.* *Creative Am. Educ., LLC v. Learning Experience Sys., LLC*, 668 F. App'x 883 (11th Cir. 2016) ("The difficulty in estimating damages under the facts of this case warrants an application of liquidated damages. TLE was required to incur expenses related to seizing the centers, staffing the centers, and repairing the damage done to its brand. These expenses are difficult to quantify, particularly expenses related to the damage CAE's actions caused to the TLE brand.")

evidence to aid the court in concluding that the actual damages resulting from a premature termination are not easy to determine.<sup>62</sup>

## 2. Is the Calculated Amount a Reasonable Estimate of Damages?

Perhaps the most litigated issue in franchise cases involving liquidated damages is whether or not the amount specified in the franchise agreement is a reasonable estimate of the potential damages from the breach. The answer often will turn on two questions: (1) whether the court looks at the estimate prospectively or retrospectively; and (2) what weight the court gives to the actual damages sustained by the franchisor.

### *a) Prospective versus Retrospective Approaches*

Under the prospective approach, the court will assess whether or not the liquidated damages provision provided a reasonable estimate of actual damages at the time the parties entered the contract.<sup>63</sup> When the calculation is based on estimated lost royalties for some period of time after termination, courts have generally held that the calculation is a reasonable estimate of the potential damages,<sup>64</sup> particularly when the time period used to calculate the damages is less than the time remaining on the term of the franchise agreement.<sup>65</sup> To support enforcement, franchisors should submit evidence of the historical payments received from the franchised business to calculate what the expected payments might have been if the relationship had continued.<sup>66</sup>

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62. See, e.g., *Days Inn of Am., Inc. v. Patel*, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000) (“Based upon Miller’s affidavit, the Court finds that Days Inns’ actual damages are difficult to calculate.”).

63. See *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88, 98–99 (Tenn. 1999) (“One method, commonly referred to as the ‘prospective approach,’ focuses on the estimation of potential damages and the circumstances that existed at the time of contract formation.”) (collecting cases from jurisdictions applying this approach).

64. See *La Quinta Corp.*, 603 F.3d at 340 (holding that formula based on historical fee accruals over a term of years was “based on common business practices and the parties’ recent historical performance under the License Agreement, resulting in ascertainable losses in the event of breach”); *Country Inns & Suites By Carlson, Inc. v. Interstate Props., LLC*, No. 6:07-CV-104-ORL-28DA, 2008 WL 2782683, at \*4 (M.D. Fla. July 16, 2008), *aff’d*, 329 F. App’x 220 (11th Cir. 2009) (noting that “liquidated damages provisions with similar fee-based formulas have been upheld by numerous other courts in the hotel franchise context”); *Cusack Dev., Inc.*, 1999 WL 165702, at \*8 (“The reasoning of these cases is persuasive. The liquidated damages formula is intended to compensate Ramada for premature termination of the franchise. Past fees accrued to Ramada under the Agreement [are] a reasonable means by which to estimate future fees lost by Ramada during a period in which it has no replacement franchisee.”).

65. See, e.g., *Patel*, 88 F. Supp. 2d at 935 (“[B]ecause Patel breached the franchise agreement in its third year, Days Inns lost twelve years of revenue and recurring fees.”); *Kim Shin Hosp., Inc.*, 27 F. Supp. 2d at 1383 (“The computation of damages based on five years worth of franchise payments is not unreasonable considering the License Agreement’s unexpired term of eighteen years.”). The failure to submit such evidence can be fatal—even on a motion for default judgment. See *Knights Franchise Sys., Inc. v. Imperial Lodgings, LLC*, No. 14-cv-6121, 2017 WL 1535090, at \*4 (D.N.J. Apr. 26, 2017) (refusing to award liquidated damages where affidavit submitted by franchisor did not specify historical average monthly fee amount or multiplier used to calculate liquidated damages).

66. See, e.g., *P.G.S., LLC*, 2012 WL 3550764, at \*7 (franchisor submitted evidence of recurring fees paid over an eight-month period (\$160,000) to support claim for liquidated damages

Franchisors have also submitted evidence about the average amount of time it takes to replace a franchised business and recoup the lost goodwill from an early and unexpected termination.<sup>67</sup> And in some instances, a franchisor will present evidence of what its actual lost royalty stream would be for the remaining term of the contract<sup>68</sup> or evidence that it has been unable to replace the lost franchised business.<sup>69</sup> All such evidence should be accurate and come from an executive who is competent to provide the information.<sup>70</sup>

Franchisees will often argue that the historical royalties overstate the likely future royalties due to a decline in business that was a factor in the termination or that the franchisor can more quickly replace a lost unit than the amount of time used to calculate the liquidated damages.<sup>71</sup> These arguments may be compelling in some circumstances. For example, if the historical royalty look-back is a long period of time and the franchisee's revenues (and by extension royalty payments) declined significantly in more recent periods, the court might deem the average payment an inaccurate estimate of the likely payments going forward.<sup>72</sup> Similarly, if the term remaining on the con-

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for fixed amount of \$250,000 as reasonable estimate of loss of those fees for remaining term of the contract); *Noons v. Holiday Hospitality Franchising, Inc.*, 705 S.E.2d 166, 169 (Ga. Ct. App. 2010) (finding that evidence franchisor submitted regarding past performance of franchise hotel was appropriate to calculate liquidated damages). *Cf. 911 Restoration Franchise, Inc. v. Blakeney*, No. CV 15-629-R, 2015 WL 12698290, at \*3 (C.D. Cal. Sept. 22, 2015) (holding liquidated damages provision unenforceable as a penalty where franchisor failed to demonstrate "what the average value of the royalties paid during the last twelve months were; which of the two multipliers were used (twenty-four or the number of months remaining in the Agreement); or how such a formula even bears a reasonable relationship to the range of harm that [franchisor] might have reasonably anticipated").

67. *See, e.g., Radisson Hotels Int'l, Inc. v. Kaanam LLC*, No. 09-CV-1575 PJS/JJK, 2011 WL 98129, at \*4 (D. Minn. Jan. 12, 2011) (citing assertions by franchisor in an affidavit that "it routinely takes upwards of two to four years or more for Radisson to recruit, identify, evaluate, approve, and train a qualified Radisson hotel franchisee to replace a terminated franchisee" and that "when one franchisee replaces another, it typically takes an additional period of time for that franchisee to reach the level of profitability achieved by the former franchisee") (citations and internal quotation marks omitted); *Cusack Dev., Inc.*, 1999 WL 165702, at \*8 (citing affidavit testimony from franchisor that "a hotel franchise company requires two years on average to replace a lost franchisee in a given market").

68. *See, e.g., Downtowner/Passport Int'l Hotel Corp. v. Norlew, Inc.*, 841 F.2d 214 (8th Cir. 1988) (holding that that liquidated damages that did not exceed the actual damage amount are not a penalty, and are enforceable where the franchisee owed the franchisor \$630 a month, and the liquidated damages clause required one half that amount for each month remaining in the franchise agreement).

69. *Patel*, 88 F. Supp. 2d at 935 (noting actual loss of future royalty revenue for balance of term and fact that "[s]ince Patel's breach, Days Inns has been unable to operate or maintain a replacement facility in Lincoln, Illinois").

70. *See Majestic Towers, Inc.*, 488 F. Supp. at 960 (giving no weight to testimony of in-house attorney for franchisor about length of time needed to replace a terminated franchisee because her experience "does not qualify her to testify to Radisson's experience in finding replacement franchisees").

71. *See infra* notes 95-97.

72. *But see Leisure Sys., Inc. v. Roundup, LLC*, No. 1:11-CV-384, 2012 WL 5378302, at \*16 (S.D. Ohio Oct. 31, 2012) (concluding that use of historical monthly fee payments to calculate liquidated damages was reasonable because that "royalties and service fees are averaged using the monthly averages for the three-year period immediately preceding termination, which accounts for possible peaks and valleys in the revenues of the franchisees due to seasonal demand or oth-

tract is less than the amount of time used to calculate the liquidated amount, the court might deem the calculation an overstatement of the likely actual damages.<sup>73</sup> Likewise, a franchisee might argue that the estimate of future payments should be net of expenses or be discounted to a present value.<sup>74</sup> However, in most cases, these types of arguments have been unsuccessful absent proof that the calculated damages are significantly greater than the actual damage to the franchisor (discussed more fully later).

In contrast, when the liquidated damages are based on a fixed amount, courts are more likely to conclude that the calculation is not a reasonable estimate of the actual damages. For example, some courts have determined that calculations based on the number of rooms in a hotel multiplied by a fixed amount are not a reasonable estimate of the actual damages to the franchisor arising out of a premature termination of a franchised hotel property.<sup>75</sup> When faced with this type of provision, a franchisee would be well served to present evidence that the fixed amount is not a reasonable estimate of what the franchisee would have paid in royalties per room. On the other hand, when a franchisor can present evidence that the fixed amount is tied to the amount of revenue it could expect to receive on each room at a hotel over some period of time within the remaining term of a franchise agreement, courts have been willing to enforce these types of provisions.<sup>76</sup> Similarly, where the franchisee has not submitted any evidence to challenge

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erwise, thereby minimizing the concern that the franchisees would be paying damages for months when they were earning little or no revenue”).

73. *Lager’s, LLC v. Palace Laundry, Inc.*, 543 S.E.2d 773, 778 (Ga. Ct. App. 2000) (holding that liquidated damages provision did not reasonably estimate potential damages because “the liquidated damages clause demanded payment for the remainder of the contract. There was no evidence, however, that Linens would not be able to find a replacement for Lager within the weeks remaining in the contract.”).

74. *See Country Inns & Suites By Carlson, Inc. v. Interstate Props., LLC*, No. 6:07-CV-104-ORL-28DA, 2008 WL 2782683, at \*4–5 (M.D. Fla. July 16, 2008), *aff’d*, 329 F. App’x 220 (11th Cir. 2009) (rejecting franchisee’s arguments that applying a three-year multiple of royalty revenue would result in a windfall to the franchisor “because it is based upon gross income and not the profits . . . [and] because the liquidated damages amount is payable within ten days of the Agreement’s termination but is not reduced to its present value”); *Holiday Hosp. Franchising, Inc. v. 174 W. Street Corp.*, Civ. Action No. 1:05-CV-1419-TWT, 2006 WL 2466819, at \*8 (N.D. Ga. Aug. 22, 2006) (rejecting argument that liquidated damages provision was not a reasonable estimate because it did not account for expenses incurred by franchisor in calculating amount based on gross revenues).

75. *See, e.g., HBS Family, Inc.*, 1998 WL 411334, at \*7 (holding that provision that required minimum liquidated damages payment of \$2,000 for every room in a hotel was “not a reasonable estimate of the potential loss likely to be suffered because it does not take into account the length of time remaining on the unexpired License Agreement at the time of default” and because “there is nothing to show that the sum of \$2,000 per . . . guest room . . . bears any reasonable relationship to the pecuniary harm plaintiff would have likely suffered in the event of a breach”).

76. *See, e.g., Holiday Hosp. Franchising, LLC v. Morning Star Hotel Victorville 4, LLC*, No. 1:12-CV-3809-ODE, 2014 WL 11393569, at \*9 (N.D. Ga. May 2, 2014) (enforcing formula used to calculate the liquidated damages that multiplied the number of rooms in the proposed Hotel by 500 then multiplied that fee by a factor of 2.5, finding the formula was a reasonable pre-estimate of the probable loss to the franchisor from the failure of the franchisee to open the hotel for a period of 20 months after entering into the franchise agreement); *see also P.G.S., LLC*, 2012 WL 3550764, at \*7 (enforcing fixed liquidated damages amount of \$250,000 where

the reasonableness of this type of provision, courts have in some cases presumed such provisions are reasonable.<sup>77</sup>

Under the retrospective approach, the court will look at whether the calculated amount is a reasonable estimate of damages at the time of the breach.<sup>78</sup> This analysis essentially turns on a comparison of the calculation of liquidated damages and the calculation of the franchisor's actual damages.

*b) The Role of Evidence of Actual Damages at the Time of Breach*

Many courts, particularly those that follow the prospective approach, deem evidence about actual damages immaterial to the analysis of whether the liquidated damages provision is enforceable.<sup>79</sup> However, under the retrospective approach, the actual damage is a key consideration for deciding whether or not to enforce a liquidated damages provision. Even courts that apply the prospective analysis may sometimes consider the actual damages in determining whether or not a provision is reasonable.<sup>80</sup> In some cases, the franchisor may present the amount of actual damages to support

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franchisor submitted evidence that recurring fees paid over an eight month period would be \$160,000).

77. See, e.g., *Howard Johnson Int'l, Inc. v. Tyler Texas Lodging, LLC*, No. CV 15-3692, 2016 WL 3436402, at \*4 (D.N.J. June 16, 2016) (awarding liquidated damages based on fixed fee per room because franchisee had not challenged calculation on motion for default judgment); *Days Inns Worldwide, Inc. v. Hosp. Corp. of the Carolinas*, No. 13-CV-8941 JPO, 2015 WL 5333847, at \*4 (S.D.N.Y. Sept. 14, 2015) (holding that it was "reasonable for the parties to agree that [franchisor's] liquidated damages would be based on the greater of two years' Recurring Fees or a fixed sum of \$2,000 per room (coupled with a reasonable cap on those damages)—especially since the [franchise agreement] had more than three years to run when it was terminated due to [franchisee's] breaches").

78. *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88, 99 (Tenn. 1999) ("[A] second approach has developed in which courts not only analyze the estimation of damages at the time of contract formation, but also address whether the stipulated sum reasonably relates to the amount of actual damages caused by the breach. Under this retrospective approach, the estimation of potential damages and the difficulty in measuring damages remain integral factors for the courts' review. . . . However, as part of that review, the actual damages at the time of breach are also relevant in determining whether the original estimation of damages was reasonable.") (collecting cases from jurisdictions that apply this approach).

79. *Choice Hotels, Int'l, Inc. v. Chewl's Hospitality, Inc.*, 91 F. App'x 810, 817 (4th Cir. 2003) ("The fact that actual damages turn out to be less than those stipulated in the liquidated damages provision does not characterize or stamp the provision 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 reasonably been expected to result from a breach."); *UPS Store, Inc. v. Hagan*, No. 14CV1210, 2016 WL 1659188, at \*2 (S.D.N.Y. Mar. 15, 2016) ("The amount of damages actually suffered has no bearing on the validity of the liquidated damages provision."); *Gator Apple, LLC v. Apple Texas Rests., Inc.*, 442 S.W.3d 521, 536 (Tex. App. 2014) ("If the amount of actual damages is made an issue in the enforcement of every contract with a liquidated damages provision, the very purpose of the agreement is undermined."); *DAR & Assocs., Inc. v. Uniforce Servs., Inc.*, 37 F. Supp. 2d 192, 202 (E.D.N.Y. 1999) ("If a disparity between actual and liquidated damages has any relevance at all, it is only to the extent it sheds light on the reasonableness of the agreement viewed *ex ante*.").

80. *But see* *Guiliano*, 995 S.W.2d at 99 (noting that under the prospective approach "the amount of actual damages at the time of breach is of little or no significance to the recovery of liquidated damages").

its argument that the liquidated amount is reasonable.<sup>81</sup> More often, however, it is the franchisee that presents evidence either that the franchisor will suffer no actual damages or that the amount of actual damage is significantly less than the liquidated amount, all in an effort to establish the calculation was not a reasonable estimate of potential damages.

There are several arguments franchisees can make based on actual damages. First, a franchisee may simply argue that the calculated amount of liquidated damages is far in excess of the actual damages—or there are no actual damages—rendering the liquidated damages calculation an unreasonable estimate of damages; this argument has been the most successful where it is supported by evidence of the actual damages.<sup>82</sup> To the extent the franchised business has been unprofitable prior to the termination, a franchisee could argue that the business was unlikely to generate any future revenues for the franchisor and that the liquidated damages provision is therefore an unreasonable estimate of the actual damages to the franchisor. Under a retrospective approach, this argument might be compelling, because at the time of the breach, the franchisor could have expected very little in future royalty payments. However, under a prospective approach, this argument would be less compelling because at the time the parties entered the agreement, neither contemplated that the business would not be profitable. Moreover, this argument does not account for the loss to the franchisor beyond the royalty stream—the loss of goodwill and a presence in the market that will need to be replaced.<sup>83</sup> At the same time, if there is evidence that the franchisor has no plans to replace the franchised business or is abandoning the market, the franchisee’s argument might be more persuasive.<sup>84</sup>

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81. See *Downtownor/Passport Int’l Hotel Corp. v. Norlew, Inc.*, 841 F.2d 214 (8th Cir. 1988).

82. See, e.g., *Dickey’s Barbecue Pit, Inc. v. Neighbors*, No. 4:14-CV-484, 2015 WL 11199080, at \*5 (E.D. Tex. Sept. 18, 2015) (concluding that liquidated damages provision was unenforceable because past royalty fees at time of termination totaled \$5,463.00 and liquidated damages demanded totaled \$676,122.55; because the “the ratio of liquidated damages to actual damages is 123.58,” the court concluded the provision was an unenforceable penalty); *Creative Am. Educ., LLC*, 2015 WL 4655087, at \*52, *aff’d sub nom. Creative Am. Educ., LLC v. Learning Experience Sys., LLC*, 668 F. App’x 883 (11th Cir. 2016) (refusing to enforce liquidated damages provision with respect to location that franchisor took over prior to termination and was operating at a profit because “[t]his profit would easily be anticipated to exceed the amount of revenue [the franchisor] would receive from [the franchisee] in the form of royalty payments”); *Ramada Franchise Sys., Inc. v. Motor Inn Inv. Corp.*, 755 F. Supp. 1570, 1579 (S.D. Ga. 1991) (enforcing liquidated damages provision but noting that “if it is shown that the franchisor did not actually suffer any harm as a result of the breach, in that particular case, the liquidated damages provision would be construed as a penalty”).

83. See *La Quinta Corp.*, 603 F.3d at 340 (noting that losses to a franchisor from premature termination include “not only future royalties, but additional intangibles such as brand recognition and loyalty, and a competitive presence in a geographic region”).

84. *But see Cusack Dev., Inc.*, 1999 WL 165702, at \*8 (rejecting argument that liquidated damages were not proportional to the actual loss despite franchisee’s evidence that the franchisor opened a new hotel less than a year after termination and had been seeking replacement hotels in the market over a year prior to termination).

A franchisee might also argue that the period of time over which the future royalties are calculated is too long and, thus, the actual damages to the franchisor are far less than the liquidated amount. If the calculation is based on the balance of the term, without any limitation to account for how long it might take the franchisor to replace the franchised business or the calculation is based on a time period that exceeds the time remaining on the term of the contract, this argument might be compelling.<sup>85</sup> However, even under those circumstances, courts have sometimes ignored what the actual damages might be for some lesser amount of time and enforced a liquidated damages provision calculating the lost recurring fees for the balance of the term.<sup>86</sup>

Finally, when the liquidated damages are based on a fixed amount, courts may consider—but will often reject—the amount of actual damages in determining whether the liquidated amount is not a reasonable estimate and the provision is unenforceable.<sup>87</sup>

### 3. What Courts Consider When Determining Intent

In states that require a showing that the parties intended to liquidate damages rather than impose a penalty for nonperformance, what constitutes sufficient evidence of intent varies. In most cases, the fact that the provision states that it is intended to calculate liquidated damages rather than impose a penalty is not conclusive;<sup>88</sup> however, courts will often note such language in discussing the intent of the parties.<sup>89</sup> Instead, courts will look at the agreement as a whole, the nature of the contractual relationship, and the type of breach that the liquidated damages seek to remedy.<sup>90</sup> Courts may also con-

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85. See, e.g., *Dickey's Barbecue Pit, Inc. v. Neighbors*, No. 4:14-CV-484, 2016 WL 3878224, at \*1 (E.D. Tex. Jan. 7, 2016) (holding liquidated damages provision was an unenforceable penalty because “[i]t forecasts twenty years of damages against a restaurant that was open for less than one year”); *Lager's, LLC v. Palace Laundry, Inc.*, 543 S.E.2d 773, 778 (Ga. Ct. App. 2000) (refusing to enforce liquidated damages provision that calculated payment for the full balance of the contract term); *Guesthouse Int'l Franchise Sys., Inc. v. British Am. Props. MacArthur Inn, LLC*, No. 3:07-0814, 2009 WL 792570, at \*3 (M.D. Tenn. Mar. 23, 2009) (holding that liquidated damages calculation was not reasonable to the extent it permitted the franchisor to “round up” and collect the amounts of fees due for an entire year instead of the amount due for the actual portion of the year remaining under the agreement’s term).

86. See, *infra*, notes 97–98.

87. See *Days Inns Worldwide, Inc. v. Hosp. Corp. of the Carolinas*, No. 13-CV-8941 JPO, 2015 WL 5333847, at \*4 (S.D.N.Y. Sept. 14, 2015) (awarding liquidated damages based on capped fixed amount per room even though calculation of the sum of the accrued recurring fees for the twenty-four month period prior to termination of the franchise agreement was half of the liquidated amount); *Days Inn of Am., Inc. v. Patel*, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000) (rejecting franchisee argument that actual damages to franchisor were less than amount calculated based on a fixed amount per hotel room).

88. *Ramada Franchise Sys., Inc. v. Motor Inn Inv. Corp.*, 755 F. Supp. 1570, 1578 (S.D. Ga. 1991) (“[T]he use of the specific words ‘liquidated damages’ as those recoverable under the License Agreement will not, by themselves, constitute the requisite intent.”).

89. *Id.* (“Although the words used in the provision are by no means conclusive, they are a critical factor in determining the intent of the parties.”) (internal quotation marks omitted).

90. *Id.*

sider other circumstances, such as the prevalence of similar provisions in franchise agreements of nonparties in the same industry.<sup>91</sup> As a result, the contract itself is critical to this determination, but evidence regarding the use of liquidated damages in other franchise agreements or within a particular industry may also serve as evidence of an intent to liquidate damages and not impose a penalty.

### C. Other Potential Defenses to Enforcement

Aside from arguing that the provision is an unenforceable penalty because it is not a reasonable estimate of potential damage arising from a breach, there are very few other defenses to enforcement of a liquidated damages provision. In some cases, franchisees have argued that because the franchisor chose to terminate the franchise agreement, the franchisor should not be entitled to collect liquidated damages.<sup>92</sup> Although that argument has been accepted by some courts in the context of claims for lost future royalties as damages arising from premature termination,<sup>93</sup> courts have usually rejected that argument in the context of liquidated damages calculations.<sup>94</sup>

In some cases, the franchisee has argued that the franchisor's breach of the agreement or the implied covenant of good faith and fair dealing led to the termination and therefore the franchisor should not be permitted to recover liquidated damages. However, that challenge goes more to the propriety of the termination and whether or not the franchisor has a right to make a claim to recover liquidated damages, not whether the liquidated damages provision is enforceable. And absent evidence of an actual breach that would have foreclosed the franchisor's right to terminate, courts are likely to reject this argument as well.<sup>95</sup>

Franchisees have also argued that the liquidated damages clause should not be enforced or the amount should be reduced based on principles of mit-

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91. *Id.* (noting testimony of franchisee admitting "that in his experience with the hotel business, which is far-reaching, he has found liquidated damages provisions to be in the average franchise agreement").

92. *See, e.g., Majestic Towers, Inc.*, 488 F. Supp. 2d at 961–62 (relying on *Sealy, infra*, note 93, for proposition that franchisor could not collect liquidated damages because event triggering payment of liquidated damages—termination—was caused by franchisor's decision).

93. *See Postal Instant Press, Inc. v. Sealy*, 51 Cal. Rptr. 2d 365 (Cal. Ct. App. 1996) (holding that a franchisor could not recover lost future royalties as damages after terminating a franchise agreement because the loss of future royalties was not proximately caused by the franchisee's failure to pay past royalties but by the franchisor's decision to terminate the agreement).

94. *Majestic Towers, Inc.*, 488 F. Supp. 2d at 963 ("Sealy's default rule does not apply when the parties have mutually agreed to a different assignment of risk via an indemnification/liquidated damages clause.").

95. *See, e.g., HLT Existing Franchise Holding LLC v. Worcester Hosp. Grp. LLC*, 994 F. Supp. 2d 520, 537 (S.D.N.Y. 2014) (holding that, because a franchisor's alleged motivation for termination was irrelevant when the franchisor has a valid legal basis under the contract for termination, there was no basis for claim that termination breached of the implied covenant of good faith and fair dealing and franchisor was entitled to recover liquidated damages).

igation.<sup>96</sup> For example, where the liquidated damages provision calculates estimated future royalties for the balance of the term of the franchise agreement, as opposed to for some shorter period, franchisees have asserted that the provision does not account for the fact that if the franchisor were seeking lost future royalties as actual damages it would have an obligation to mitigate those damages. This is really just another way of arguing that the calculation is not a reasonable estimate of actual damages. Although several courts have deemed that argument compelling in the context of a franchisor seeking to recover lost future profits as actual damages for the balance of the franchise term,<sup>97</sup> it does not appear that courts have followed this rationale with regards to liquidated damages provisions.<sup>98</sup>

As discussed earlier, franchisees have also argued that the franchisor can replace the franchised location in a time period that is less than the time period used in calculating the liquidated damages. Or, in some cases, there is evidence that the franchisor has replaced or is in the process of replacing the business. However, courts have routinely rejected this evidence, holding that the franchisor has no obligation to mitigate its damages when it seeks to recover under an otherwise enforceable liquidated damages provision.<sup>99</sup>

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96. See, e.g., *Days Inn Worldwide, Inc. v. Sonia Investments*, No. CIV.A. 304CV2278D, 2006 WL 3103912, at \*7 (N.D. Tex. Nov. 2, 2006) (“Although [the franchisor’s] alleged failure to mitigate damages is only one element of the multi-faceted reasonableness inquiry, [the franchisee] may be able to prove at trial that [the franchisor’s] failure to mitigate is substantial enough to render the damages fixed by the liquidated damages clause unreasonably large in light of actual loss.”).

97. See, e.g., *Days Inns Worldwide, Inc. v. Miller*, No. 3:16-CV-03004-RAL, 2017 WL 2829810, at \*3 (D.S.D. June 29, 2017) (refusing to grant summary judgment on claim for fees for balance of the term of the franchise agreement as damages, despite addendum that required such payment upon termination for franchisee’s default, because fact issues existed about whether damages for balance of term were reasonable); *HBS Family, Inc.*, 1998 WL 411334, at \*8 (refusing to enforce fixed-amount-per-room formula and noting that “while [franchisor] is entitled to recovery of actual damages, it must show that it has mitigated its damages”).

98. See, e.g., *Arif Enters., Inc.*, 2010 WL 5060289, at \*10 (liquidated damages provision that calculated amount owed based on remaining term of each franchise agreement was reasonable estimate of potential damages absent any evidence from franchisees to the contrary); *Century 21 Real Estate LLC v. Bercosa Corp.*, 666 F. Supp. 2d 274 (E.D.N.Y. 2009) (enforcing a liquidated damages provision in a franchise agreement that calculated royalty payments for the ninety-eight months remaining under the agreement); *Shoney’s, Inc. v. Morris*, 100 F. Supp. 2d 769, 776–77 (M.D. Tenn. 1999) (enforcing liquidated damages provision requiring payment of estimate royalties for balance of franchise agreements’ terms).

99. *Days Inn Worldwide, Inc. v. Hazard Mgmt. Grp., Inc.*, No. 10 Civ 7545 (CM)(KNF), 2012 WL 5519356, at \*3 (S.D.N.Y. Nov. 13, 2012) (rejecting argument by former franchisee that liquidated damages provision could not be enforced after franchisor entered agreement with a third party to operate the former franchisee’s hotel because “[w]hen a party signs a contract containing a liquidated damages clause, he is bound by it; recovery is a simple matter of contract and is not subject to equitable defenses or mitigation”); *Majestic Towers, Inc.*, 488 F. Supp. 2d at 963 (“Requiring Radisson to prove its mitigation efforts would wholly undermine the rationale for employing liquidated damages provisions in the first place.”); *Ramada Franchise Sys., Inc. v. Cusack Dev., Inc.*, No. 96 CIV. 8085 (MGC), 1999 WL 165702, at \*8 (S.D.N.Y. Mar. 24, 1999) (“Regardless of the actual date on which a new Ramada was opened, the reasonableness of the liquidated amount under New York law must be assessed as of the time of contracting.”).

Some courts have refused to enforce liquidated damages provisions where the parties to the contract had unequal bargaining power.<sup>100</sup> Evidence of unequal bargaining power turns on the sophistication and business experience of the franchisee as well as whether the franchisee had counsel in entering into the franchise agreement.<sup>101</sup> However, most of those cases also found that the formula was not a reasonable estimate of the damages or that the calculation was not proportional to the actual damages and cited the unequal bargaining power as another issue.<sup>102</sup>

Finally, note that both Minnesota and North Dakota prohibit the inclusion of liquidated damages provisions in franchise agreements.<sup>103</sup>

## V. Strategic Considerations

### A. *The Impact of Seeking Liquidated Damages on a Request for an Injunction to Enforce a Post-Termination Covenant Not to Compete*

When a franchisor terminates a franchise agreement due to a franchisee's default and the franchisee continues to operate in violation of a post-termination non-competition covenant, the franchisor will often sue and seek injunctive relief to enforce the non-competition covenant.<sup>104</sup> Under the federal standard for obtaining injunctive relief, and under most state standards, the party seeking an injunction must show, among other things, that absent an injunction that party

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100. See, e.g., *Rescuecom Corp. v. Chumley*, No. 5:07-CV-0690, 2011 WL 1204758, at \*10 (N.D.N.Y. Mar. 28, 2011) ("When analyzing the reasonableness of a liquidated amount, a court must . . . give due consideration to the nature of the contract and the attendant circumstances. . . . Relevant to this inquiry is the sophistication of the parties and whether both sides were represented by able counsel who negotiated the contract at arms length without the ability to overreach the other side.").

101. *Id.* ("For example, Defendant Chumley was not represented by counsel, and the Franchise Agreement was non-negotiable. . . . Moreover, Defendant Chumley, while an educated individual with some industry experience, was not a sophisticated business person.") (internal citations omitted).

102. *Id.* at \*11 ("The dollar amount that [the franchisor] seeks to recover as stipulated damages . . . does not appear to bear a reasonable relationship to the pecuniary harm that Plaintiff most likely suffered as a result of [the franchisees'] breach.")

103. *Days Inn Worldwide, Inc. v. SBSB, LLC*, No. CIV 08-6474 JRT/LIB, 2010 WL 3546958, at \*5 (D. Minn. Sept. 7, 2010) (quoting Minn. Reg. 2860.4400(J)) ("It shall be unfair and inequitable for any person to . . . [r]equire a franchisee to waive his rights to a trial or consent to liquidated damages, termination penalties, or judgment notes."); *Securities Commissioner's Policy Regarding Conduct that is Unfair, Unjust, or Inequitable to North Dakota Franchisees*, BUS. FRANCHISE GUIDE (CCH) ¶ 5340.05 ("The Securities Commissioner Has Held the Following to be Unfair, Unjust or Inequitable to North Dakota Franchisees (Section 51-19-09, N.D.C.C.): . . . D. Liquidated Damages and Termination Penalties: Requiring North Dakota franchisees to consent to liquidated damages or termination penalties.") (also available at <http://www.nd.gov/securities/franchise-registration/franchise-registration-renewal>).

104. Of course, a franchisor often will also seek injunctive relief to prevent unauthorized, post-termination use of its trademarks under the Lanham Act. The author is unaware of any case in which the presence of a liquidated damages provision was held to foreclose a franchisor from enjoining violations of the Lanham Act by a former franchisee.

will be irreparably harmed.<sup>105</sup> Harm that is irreparable is harm that cannot be compensated by money damages alone.<sup>106</sup> When courts determine that the injury can be remedied through a claim for damages, requests for injunctive relief are denied.<sup>107</sup> Although courts do not always grant injunctions to enforce non-competition covenants in franchise agreements, most courts recognize that the harm resulting from the violation of a covenant not to compete—loss of goodwill, customers, etc.—is irreparable.<sup>108</sup>

But what happens when the franchise agreement at issue also provides for liquidated damages in the event of a default and premature termination? Franchisees have argued that because the liquidated damages provision sets an amount that the franchisee must pay the franchisor in the event of a premature termination, the harm to the franchisor is compensable in monetary damages.<sup>109</sup> Indeed, the franchisor has determined the amount of its damages.

The success or failure of this argument should really depend on how the franchise agreement is worded. Assuming the liquidated damages provision purports to calculate the franchisor's damages arising from a premature termination, it should have no bearing on whether a violation of the noncompetition covenant can be enjoined. The damage flowing from the premature termination is the lost royalty revenue and expenses that will be incurred in replacing the franchised business.<sup>110</sup> A violation of the post-termination noncompete is a separate breach for which there is a separate harm. In addition to the damages incurred from the loss of the franchised business in the market, there is the added harm that the former franchisee's ongoing operation of its business will cause—namely, the unauthorized use of some or all

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105. See generally KIRSTIN STOLL-DEBELL, NANCY L. DEMPSEY & BRADFORD E. DEMPSEY, INJUNCTIVE RELIEF 77–82 (2009).

106. *Id.* at 82 (“Ordinarily, courts will not grant preliminary injunctive relief if the movant’s harm may be remedied through an award of money damages.”).

107. *Id.*

108. *Id.* at 125–26 (“[S]ome courts hold that there is a presumption of irreparable injury for breach of noncompete agreements.”) (collecting cases); *Bad Ass Coffee Co. of Hawaii v. JH Enterprises, L.L.C.*, 636 F. Supp. 2d 1237, 1249 (D. Utah 2009) (“[T]he majority of courts that have considered the question have concluded that franchising companies suffer irreparable harm when their former franchisees are allowed to ignore reasonable covenants not to compete.”).

109. See, e.g., *Harvey Barnett, Inc. v. Shidler*, 143 F. Supp. 2d 1247, 1255 (D. Colo. 2001) (“Any difficulty in calculating damages . . . has been addressed by the Licensing Agreement. That Agreement includes a liquidated damages clause requiring Defendants to pay \$50,000 for a breach of the Agreement. . . . Therefore, any loss to [the franchisor] is not “irreparable,” as [the franchisor] wrote the clause and chose the amount that it felt would compensate its loss. I therefore conclude that [the franchisor] has failed to meet its burden to show irreparable loss.”)

110. See, e.g., *Bad Ass Coffee*, 636 F. Supp. 2d at 1250 (“While the court agrees that there may be some circumstances in which a liquidated damages clause would make it clear that monetary damages are sufficient, this is not one of those cases. As discussed above [the franchisor’s] intangible assets, such as goodwill and the strength of its franchise, have been or will be damaged by Defendants’ breaches. This type of damage is difficult to measure in money. The court does not agree that the damages clause in the Franchise Agreement would be a reliable guide to attempt to do so.”).

of the franchisor's operating system and the impediment that the former franchisee's continued operation from the same location or in the same market will place on the franchisor's effort to replace the franchised business and recoup its goodwill in the market. Moreover, the franchisor's right to liquidated damages is no different whether the franchisee complies with a post-termination noncompete or violates that covenant. If the franchisor's right to recover liquidated damages is independent of compliance with the noncompete, the liquidated damages are not a monetary calculation of the harm the franchisor will suffer if the franchisee violates the noncompetition covenant.

On the other hand, if the liquidated damages provision is drafted to address a breach of any covenant against competition (either in-term or post-term), then the franchisee likely has a much better argument that the franchise agreement contemplates redressing violations of the noncompetition covenants through damages rather than injunctive relief. However, at least one court has held that where the franchise agreement reserved to the franchisor the right to seek injunctive relief for violation of a noncompete in addition to providing for liquidated damages for breach of a noncompete, the franchisor could seek to enjoin the post-termination violation of the noncompete.<sup>111</sup>

One additional caveat: a franchisor should be careful in using the liquidated damages calculation in its franchise agreement to calculate a "termination fee" that a franchisee must pay to mutually terminate the franchise agreement and allow the franchisee to exit the system. To the extent the franchisor also includes a waiver of the noncompete as part such agreements to terminate early, those agreements could be considered evidence that the franchisor considers the liquidated damages calculation to include the value of the noncompete. In that situation, a franchisee might have a good argument that injunctive relief is not available to the franchisor because the value of the noncompete is included in the liquidated damages formula because the franchisor has used that same formula to calculate a "termination fee" that includes a waiver of the noncompete.

### B. *The Impact on Recovery of Other Damages and Relief*

Another consideration when seeking to enforce a liquidated damages provision is what impact it will have on the ability to collect other damages. Generally, courts will not permit a party to recover both the liquidated

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111. H&R Block Tax Servs. LLC v. Kutzman, 681 F. Supp. 2d 1248, 1253 (D. Mont.), *order clarified sub nom.* H&R Block Tax Servs. LLC v. Kutzman, No. CV 10-03-M-DWM, 2010 WL 11534361 (D. Mont. Feb. 23, 2010), and *aff'd*, 373 F. App'x 797 (9th Cir. 2010) (entering preliminary injunction against a franchisee to enforce post-termination covenants against competition and solicitation because "the fact that the agreement contains both a right to an injunction and liquidated damages does not mean the loss of goodwill is not irreparable, or that liquidated damages will provide an adequate remedy").

amount and the actual damages arising from a particular breach.<sup>112</sup> As a result, the impact of a liquidated damages provision on the availability of other damages or relief will depend on whether the additional damages or relief sought relate to the same breach or some different breach or wrongdoing. For example, courts have routinely held that franchisors can recover both liquidated damages for the premature termination of a franchise agreement and also recover damages, both contractual and under the Lanham Act, for failure to de-identify the franchised business after termination.<sup>113</sup> However, courts will not permit a party to recover both liquidated damages arising from premature termination and lost future royalties for the balance of the franchise term.<sup>114</sup> Nor are courts likely to award a franchisor its lost future royalties instead of awarding liquidated damages. If the franchisor includes the liquidated damages provision for certainty, it cannot later decide it would rather try to recover what might be a greater amount of lost future royalties in actual damages. Finally, where the liquidated damages provision applies to a variety of conduct but the calculation is the same regardless of the severity of the breach, the provision may not be deemed a penalty.<sup>115</sup>

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112. See *Arcese v. Daniel Schmitt & Co.*, 504 S.W.3d 772, 784 (Mo. Ct. App. 2016), *reb'g and/or transfer denied* (Oct. 13, 2016), *transfer denied* (Dec. 20, 2016) (“[T]o avoid duplicative damages, generally, both liquidated damages and actual damages may not be awarded as compensation for the same injury.”); *Super 8 Worldwide, Inc. v. Shri Narayan, LLC*, No. CIV. 2:14-1034 KM, 2015 WL 4509813, at \*6 (D.N.J. July 23, 2015) (“Because liquidated damages exist to compensate [the franchisor] for any forecasted recurring fees lost as a result of the premature termination of the Franchise Agreement, . . . [the franchisor] may only recover whatever recurring fees were unpaid as of the date of termination of the contract. Otherwise, the liquidated damages and recurring damages amounts would be duplicative in part.”).

113. See, e.g., *La Quinta Corp.* 603 F.3d at 341; *Ramada Inns, Inc. v. Gadsden Motel Co.*, 804 F.2d 1562, 1566–67 (11th Cir. 1986). *But see* *Travelodge Hotels, Inc. v. S.S.B. & Assocs., LLC*, No. 14-CV-883 KM, 2015 WL 4530432, at \*10 (D.N.J. July 27, 2015) (“[T]he Lanham Act infringement damages would be unfairly duplicative of [the franchisor’s] liquidated damages. Both are aimed at compensating [the franchisor] for the lost benefit of the franchise agreement, post-termination. Both are measured by the Recurring Fees that [the franchisor] would have, but did not, receive post-termination. And in both cases, the amount of such post-termination Recurring Fees is estimated with reference to the historical amount of fees received in the 24 months preceding termination.”).

114. See, e.g., *Ramada Worldwide Inc. v. Khan Hotels LLC*, No. CV 16-2477 (KM)(JBC), 2017 WL 187384, at \*7 (D.N.J. Jan. 17, 2017), *amended*, No. CV 16-2477 (KM)(JBC), 2017 WL 2831168 (D.N.J. June 30, 2017) (awarding liquidated damages calculated pursuant to formula in franchise agreement but denying franchisor’s request for unpaid recurring fees and interest, “to the extent the requested amount reflects post-termination charges”); *Baymont Franchise Sys., Inc. v. Shree Hanuman, Inc.*, No. CIV. 2:13-5796 KM, 2015 WL 1472334, at \*6 (D.N.J. Mar. 30, 2015) (“Because liquidated damages exist to compensate [the franchisor] for any future lost fees . . . , [the franchisor] may only recover whatever recurring fees were unpaid as of the date of termination of the contract. Otherwise, the liquidated damages and recurring damages amounts would be duplicative in part.”); *Days Inns Worldwide, Inc. v. Savita Hosp. Grp., Inc.*, No. CIV. 13-2863 KM MCA, 2014 WL 3748204, at \*4 (D.N.J. July 28, 2014) (awarding liquidated damages but refusing to award post-termination fees because “[t]he franchise agreement explicitly provides that ‘Liquidated Damages are paid in place of our claims for lost future Recurring Fees under this Agreement.’”).

115. See, e.g., *Lelli’s Inn, Inc. v. Steven Lelli’s Inn on the Green, L.L.C.*, No. 13-14766, 2017 WL 6521325, at \*14 (E.D. Mich. Oct. 24, 2017), *report and recommendation adopted*, No. 13-14766, 2017 WL 6513009 (E.D. Mich. Dec. 20, 2017) (“The element common to most liqui-

## VI. Conclusion

Under the more modern view, the question of whether a liquidated damages provision in a franchise agreement is enforceable is often answered “yes.” In that sense, the admonition of the authors of the 2001 *Franchise Law Journal* article that “courts should recognize the important benefit of these provisions for franchisors and franchisees alike”<sup>116</sup> seems to have taken root. However, enforcement is not automatic; it requires careful drafting and evidentiary support to establish that the provision sufficiently satisfies applicable legal standards.

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dated damages clauses that get struck down as penalty clauses is that they specify the same damages regardless of the severity of the breach.”). In the *Lelli's* case, however, rather than refuse to enforce the liquidated damages provision at all, the court reformed the provision and applied it to award liquidated damages for certain material breaches but not for other more technical breaches. *Id.*

116. LaFiura & Sager, *supra* note 2, at 175.

