

The Enforceability of Liquidated Damages Clauses in Hotel Franchise Agreements

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Liquidated damages provisions are found in many franchise agreements, particularly in those used in the hotel industry. The fundamental purpose underlying these provisions is to allow the parties, at the time of contract formation, to agree to a specific methodology or formula to compute potential damages for certain subsequent contract breaches. Liquidated damages provisions can be extremely beneficial in helping parties to avoid the difficulty and expense that otherwise might be incurred to prove damages, and they are most useful in those situations where the calculation of actual damages would be complex and would require the analysis and opinions of expert witnesses. The basic goal of such provisions is to allow the non-breaching party to recover a fair and reasonable approximation of its actual damages, without having to go through the inordinate trouble and expense required to prove actual damages.

While the legal test for determining the enforceability of liquidated damages clauses varies from state to state, two recent decisions illustrate that the courts will generally enforce liquidated damages provisions in hotel franchise agreements when three basic criteria are met: 1) there is proof that the parties intended to provide for liquidated damages and not simply a penalty; 2) the injury caused by the breach is difficult or impossible to estimate accurately; and 3) the stipulated liquidated damages sum is a reasonable estimate of the probable loss. Of these three criteria, the one that the litigants and the courts give the most attention to is that of the reasonableness of the stipulated damages, in the context of the actual damages presumed to have been caused by the contractual breach. In both of the recent cases, the courts determined that the stipulated sum was not grossly excessive or disproportionate to the damages that might reasonably have been expected to result from the contractual breach. Accordingly, the courts found the liquidated damages provisions in both of these cases to be enforceable.

LaQuinta Corp. v. Heartland Properties

In *LaQuinta Corp. v. Heartland Properties LLC*, Bus. Franchise Guide (CCH) ¶ 14, 376, 603 F.3d 327 (6th Cir. 2010), the Sixth Circuit Court of Appeals affirmed the trial court's award of \$111,325 in liquidated damages to the prevailing hotel franchisor, Baymont Franchising LLC. The liquidated damages clause in *LaQuinta* provided in pertinent part:

[I]f the Inn ceases to be operated under the System for any reason ... Licensee shall pay [Baymont] within 30 days ... "Liquidated Damages" (to compensate [Baymont] for lost revenues in an amount difficult to ascertain and not as a penalty) an amount equal to 100% of the aggregate Recurring Fees which accrued with respect to Inn operations during the immediately preceding 36 full calendar months. ...

In considering the enforceability of this liquidated damages provision, the Sixth Circuit first held that under applicable Wisconsin law, "liquidated damages provided for in a contract must be reasonable." The court then set forth the following three factors as determinative of the reasonableness of a liquidated damages clause under Wisconsin law:

1. Whether the parties intended to provide damages or for a penalty;
2. Whether the injury caused by the breach would be difficult or incapable of accurate estimation at the time of entering into the contract; and

3. Whether the stipulated damages are a reasonable forecast of the harm caused by the breach.

The court's analysis in *LaQuinta* did not explicitly address the first two factors, but instead was devoted primarily to the third factor of the "reasonable forecast of harm." In expounding on this critical factor, the Sixth Circuit cited the Wisconsin Supreme Court's holding in *Rainbow County Rentals & Retail Inc. v. Ameritech Publishing Inc.*, 286 Wis. 2d 170, 706 N.W.2d 95, 103 (2005), that "if the damages provided for in the contract are grossly disproportionate to the actual harm sustained, the courts usually conclude that the parties' original expectations were unreasonable." The Sixth Circuit observed further that the Wisconsin courts employ the "prospective-retrospective approach" in determining the reasonableness of liquidated damages clauses — this being that the courts look at the harm anticipated at the time of contract formation and the actual harm at the time of contractual breach.

In applying this test to the facts of the case, the Sixth Circuit found that the liquidated damages sum of \$111,325 was reasonable in light of the "concrete evidence" submitted by Baymont, the franchisor, that its lost royalties over the entire remaining term of the license agreement likely would have exceeded \$430,000.

The court in *LaQuinta* further found that the 36-month formula contained in the liquidated damages clause was based on "Recurring Fees" that actually accrued and, as such, was at the time of contracting not an "arbitrary calculation," but instead a "reasonable forecast" of the damages the franchisor would sustain in the event of a default by the franchisee. Additionally, the court found the liquidated damages clause to be reasonable because its formula was "based on common business practices and the parties' recent historical performance under the License Agreement."

While the court in *LaQuinta* focused primarily on the "reasonable forecast of harm" factor as its justification for the enforceability of the liquidated damages clause, it also alluded to the applicability of the second factor of the difficulty of accurately estimating the injury caused by the contractual breach. In this regard, the court held that "damages in the context of the hospitality industry are difficult to quantify and not strictly monetary." In addition to lost future royalties, the court observed "additional intangibles" were lost, such as brand recognition and loyalty, and the brand's competitive presence in a geographic region was damaged. The court found that the franchisee's breach resulted in the franchisor potentially losing those intangible benefits for the seven additional years in the franchise contract. Accordingly, this provided the court with an additional basis for the enforceability of the liquidated damages clause.

Finally, with regards to the first test factor of "the parties' intent to provide damages or for a penalty," the explicit language of the liquidated damages clause of the franchisor's agreement left no doubt as to the parties' intentions by stating that in the event of a breach, the franchisee was to pay "Liquidated Damages" to compensate the franchisor "for lost revenues in an amount difficult to ascertain and not as a penalty ... " Consequently, while the court in *LaQuinta* did not explicitly cite this factor, it was evident that this criterion was satisfied.

Noons v. Holiday Hospitality Franchising

In *Noons v. Holiday Hospitality Franchising, Inc.*, Bus. Franchise Guide (CCH) ¶ 14.511 (Ga. Ct. App. Sept. 30, 2010), the Georgia Court of Appeals similarly affirmed the trial court's determination that the liquidated damages provision in that case was enforceable. In so doing, the court reiterated the Georgia test for the enforceability of liquidated damages clauses, which is virtually identical to the Wisconsin test enunciated in *LaQuinta*.

In affirming the trial court's award of \$741,713 in liquidated damages to the franchisor, Holiday Hospitality Franchising, Inc., the court enunciated the following three-part test for the enforceability of liquidated damages provisions in Georgia:

1. If the injury caused by the breach is difficult or impossible to estimate accurately;
2. If the parties intended to provide for damages rather than a penalty; and

3. If the stipulated sum is a reasonable estimate of the probable loss.

The court in *Noons* observed that the first two factors — difficulty of injury estimation and the parties' intent — were not in dispute. Accordingly, just as in *LaQuinta*, the court's focus in *Noons* was on the third factor of the reasonableness of the stipulated sum as an estimate of the probable loss. The franchisee in *Noons* argued that the amount of the liquidated damages was unreasonable because there allegedly was no evidence of "a pre-estimate of probable lost revenue to Holiday from (the franchisor) before the agreement was entered into." In rejecting this argument by the franchisee, the court held that Holiday had presented evidence that the liquidated damages clause at issue was directly related to the past performance of the subject hotel because the clause's formula used a percentage of gross room revenue generated by the hotel in the 36-month period prior to termination. The court found further that the franchisee had presented no evidence that Holiday Inn's pre-estimate of its damages in the event of early termination was unfair, in light of Holiday's experience in finding a new franchisee and opening a new Holiday Inn facility.

The court also rejected the franchisee's argument that the liquidated damages clause was unreasonable because it provided for 36 months of revenue without regard to whether the remaining term of the license agreement was less than 36 months. The court ruled that this argument was unavailing to the franchisee because the license agreement in the instant case had been terminated two years into a 10-year term.

The court in *Noons* thus concluded that the trial court did not err in finding the liquidated damages provision "to be a reasonable pre-estimate of its probable loss upon early termination."

Choice Hotels International Inc. v. Smith Hotel Properties

In a third recent case, *Choice Hotels International Inc. v. Smith Hotel Properties, LLC* ¶ 14.610 (D.C., E.D. North Carolina 2011), the U.S. District Court for the Eastern District of Northern Carolina ruled that, under Maryland law, franchisor Choice Hotels was entitled to recover \$158,400 in liquidated damages.

The liquidated damages provision in Choice Hotels contained a formula to calculate damages based upon a percentage of the franchisee's average prior fees and revenue, but with a proviso that in no event would those damages be less than \$40, multiplied by the total number of rentable rooms, multiplied by the number of months remaining in the license agreement term, not to exceed 36 months.

In ruling that this liquidated damages provision was enforceable, the District Court applied Maryland law, which, like the laws in Wisconsin and Georgia, applies a three-part test. However, only one of the factors of the Maryland test is similar to the three factors that apply in the other states. The three factors of the Maryland test are as follows:

1. The clause must provide in clear and unambiguous terms for a sum certain;
2. It must reasonably compensate for damages anticipated by the breach; and
3. It may not be altered to correspond to actual damages determined after the fact.

The court in *Choice Hotels* found that the liquidated damages provision in the franchisor's hotel license agreement complied with the first prong of the Maryland test because it contained "a mechanism by which a specific dollar amount could be determined at the time of breach." Consequently, as of the date of termination "the exact dollar amount of liquidated damages is immediately ascertainable."

The court next addressed the second factor of reasonableness to "fix just compensation for an anticipated breach of the contract." This Maryland factor is clearly analogous to the "reasonable forecast" factor contained in the Wisconsin test and the "reasonable estimate of the probable loss" factor contained in the Georgia test. Just as the courts in *LaQuinta* and *Noons* found that this essential factor was satisfied, the court in *Choice Hotels* also found that the liquidated damages provision in that case satisfied this factor because the provision was "designed to put Choice Hotels back into the position it would have been in but

for the breach." Furthermore, the court held that the liquidated damages sum was not "grossly excessive and out of all proportion" with reasonably expected damages.

Finally, with regard to the third factor of the Maryland test, which requires that the liquidated damages clause not be susceptible to post-termination alternation, the *Choice Hotels* court found that the record demonstrated that the clause was "binding and may not be altered to correspond to actual damages."

Summary Observations

These three recent cases illustrate that the courts will generally uphold the enforceability of liquidated damages provisions in hotel franchise agreements that are drafted to comport with the tests set forth above. Specifically, judicial enforcement is likely when such provisions are designed to allow for a recovery of a reasonable approximation of the actual damages that can be estimated to result from a breach of the agreement. Significantly, the formula utilized in each of the three liquidated damages provisions was deemed to be "reasonable" primarily because each formula factored in actual historical financial data, specifically "Recurring Fees" in *LaQuinta*, "percentage of gross revenues" in *Noons*, and "average prior fees and revenues" in *Choice Hotels*. Furthermore, the formula in each provision limited liquidated damages to a maximum period of 36 months.

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