



54TH ANNUAL IFA LEGAL SYMPOSIUM



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INTERNATIONAL FRANCHISE ASSOCIATION



Quantifying Damages In A Franchise Case

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Introduction: Is the case worth it?



- Your case may seem like a “slam dunk” on liability, but if damages can not be established (or collected), the case may not be worth bringing.
- Litigation is often expensive and time consuming
- A damages analysis should be engaged in at the outset of a case, not after discovery

The Franchise Agreement

- Liquidated Damages Clauses
- Limitation on Damages Clauses
- Prevailing Party Clauses
- Personal Guarantees

Liquidated Damages Clauses

- Provide formula for how to calculate lost profit damages for early termination
- Often two to three years worth of expected fees
- Can run up against enforceability issues, depending on jurisdiction
 - See e.g., Dickey's Barbecue Pit, Inc. v. Neighbors, Docket No. No. 4:14-cv-484, 2015 U.S. Dist. LEXIS 179917 (E.D. Tex. Sept. 18, 2015) (refusing to enforce liquidated damages clause that provided for \$676,122.55 in damages, when past royalty due at the time of termination was \$5,463.00)

Limitation on Damages Clauses

- Common clause in franchise agreement that limits the type of damages either party can seek for breach of the agreement
- Examples of limitations: punitive and consequential damages
- State statutory laws may override certain limitation clauses
 - See e.g., Sanchez v. CleanNet USA, Inc., 78 F. Supp. 3d 747 (N.D. Ill. 2015) (clause waiving punitive damages and attorneys' fees and costs unenforceable)



Prevailing Party Clauses



- Typically provide that if any claim is brought by either the franchisor or franchisee, the “winner” of the claim will also receive their attorneys’ fees and/or costs in prosecuting/defending against the claim
- Who is the “winner” under a prevailing party clause?
 - What if your client only succeeds on some of the claims? What if both parties’ win claims? Does obtaining a preliminary injunction count as a “win”? Settlement?
 - The answers to these questions vary by jurisdiction.

Personal Guarantees

- The personal guaranty – required by the vast majority of franchise agreements – is often a critical document to maximizing damages for any claims brought by the franchisor.
- Owners cannot hide behind their franchise entity to shield themselves from personal liability for damages
 - Consider having spouses sign personal guarantees for further protection, so as to avoid potential collection issues.

Statutory Claims

- State Disclosure and “Little FTC” Laws
- Franchise Relationship Laws
- Antitrust/Robinson-Patman Act
- Federal and State Intellectual Property Statutes

State Disclosure and “Little FTC” Laws

- No private right of action under federal FTC Rule
- Certain state law disclosure statutes provide private right of action
 - California, Hawaii, Indiana, Illinois, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin
- Deceptive/Unfair Trade practice state statutes provide varying remedies
 - Compare: Florida Deceptive and Unfair Trade Practices Act vs. Connecticut Unfair Trade Practices

Franchise Relationship Laws

- These state laws govern a franchisor's conduct once the franchisor/franchisee relationship has commenced
- Can override language in the franchise agreement itself
- Franchisees often entitled to attorneys fees and costs of suit for successful claim
 - See e.g., N.J.S.A. 56:10-10 (New Jersey); Neb. § 87-409 (Nebraska)
- About half the states in the country have some form of franchise relationship law, which can provide damages for conduct such as:
 - Termination without “good cause”
 - Improper notice provided to franchisee of intent to terminate.
 - “Unreasonable” standards imposed on franchisee;
 - Failure to renew



Antitrust/Robinson-Patman Act

- Federal antitrust claims can entitle a claimant to not only attorneys fees, but also triple damages
 - See 15 U.S.C. 15(a) (“any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney’s fee”)
- Franchisors who offer advertising/promotional benefits to franchisees on an *ad hoc* basis – who compete with each other in the same market - are potentially susceptible to claims for violation of the Robinson-Patman Act
 - See e.g., Orologio of Short Hills Inc. v. Swatch Group, 653 Fed. Appx. 134 (3d Cir. June 24, 2016).

Federal and State Intellectual Property Statutes

- Defend Trade Secrets Act of 2016 (“DTSA”)
 - Provides a federal private right of action to franchisors (and access to federal courts) to pursue claims for misappropriation of trade secrets
 - Under the DTSA, a franchisor that can establish that misappropriation was willful/malicious can seek, without limitation, double damages and attorney’s fees.
- State trademark/intellectual property statutes
- Lanham Act

Damages Remedies

- Reliance vs. Expectation
 - Reliance = returns Plaintiff to position prior to entering the contract
 - Expectation = compensates Plaintiff had the contract not been breached
- Liquidated Damages – stated in contract
- Punitive Damages – punish the party
- Nominal – awarded when party does not suffer monetarily
- Restitution – equitable remedy to prevent unjust enrichment

Conceptual Issues In Measures of Economic Damages

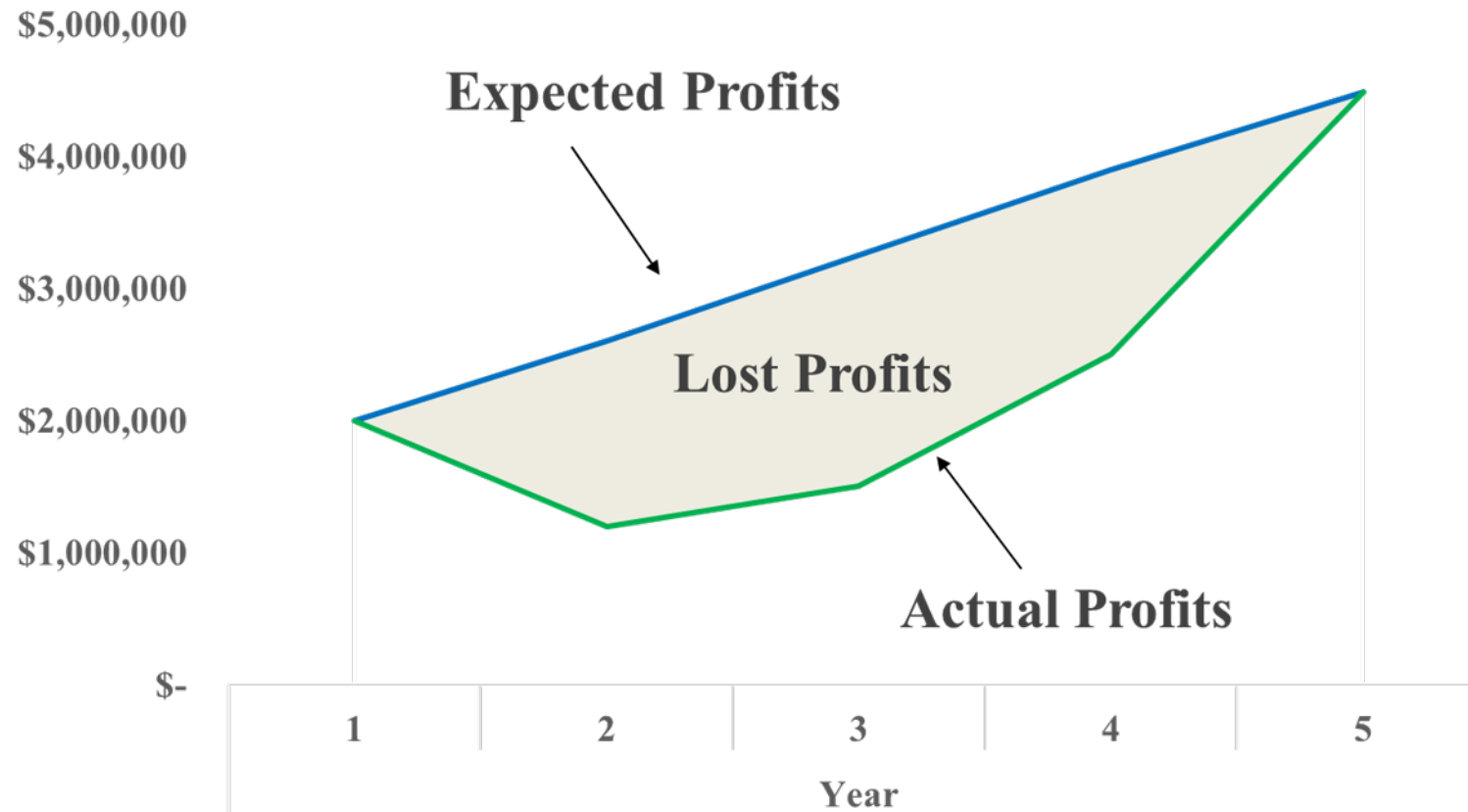
- Courts have stated the general rule permitting alternate theories of recover:
- “[I]f a business is completely destroyed, (then) the proper total measure of damages is the market value of the business on the date of the loss. If the business is not completely destroyed, then it may recover lost profits. A business may not recover both lost profits and the market value of the business.”¹

1. *Montage Group, Ltd. V. Athle-Tech Computer Systems, Inc.*, 889 So.2d 180, 191 (Fla. App.2004) (internal citations omitted). From “The Comprehensive Guide to Lost Profit Damages,” 2009, Chapter 8

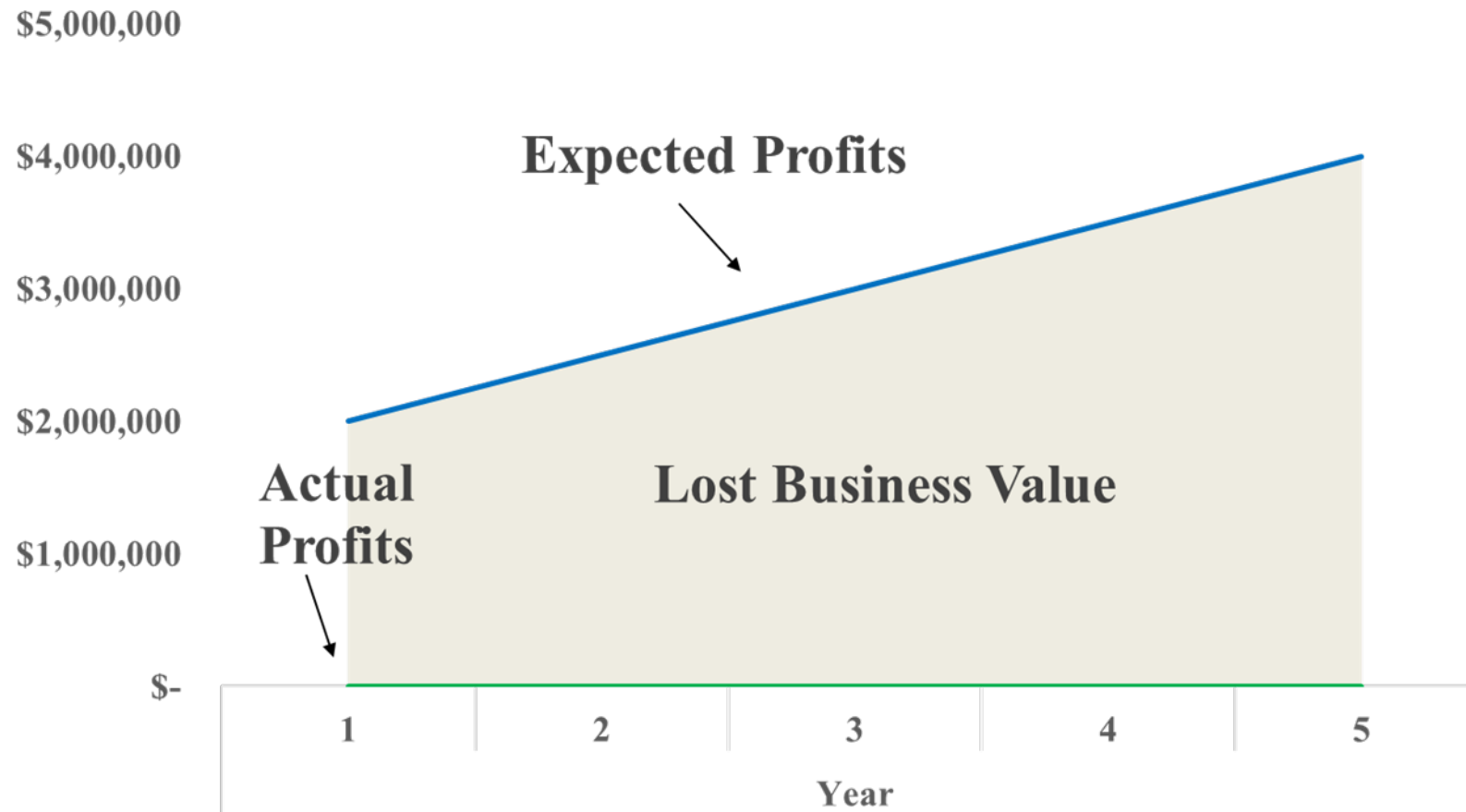
Conceptual Issues In Measures of Economic Damages

- Scenario 1: Temporary Impairment
- Scenario 2: Immediate Destruction of Business
- Scenario 3: Slow death of a Business
- Other Scenarios: Startup/Emerging Businesses

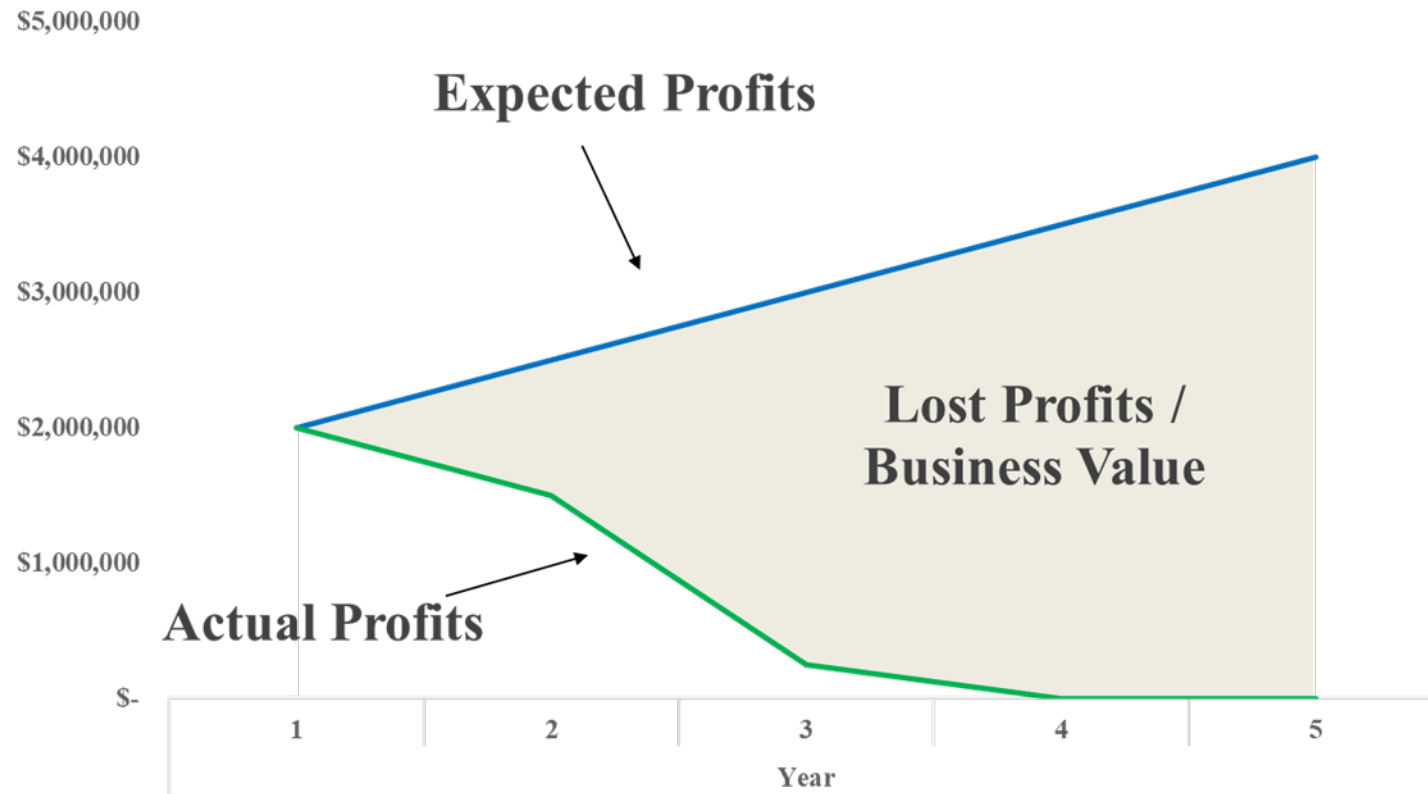
Scenario 1: Temporary Impairment



Scenario 2: Immediate Destruction of a Business



Scenario 3: Slow Death of a Business



Lost Profits vs. Lost Business

Attribute	Lost Profits	Business Valuation
Income stream	Incremental income stream net of avoided costs	Typically net after tax income
Income stream	Before income tax	Typically after tax income
Income stream	Typically limited life	Into perpetuity
Valuation methods	Present value of post trial lost incremental income added to pretrial lost incremental income including appropriate pre-judgment interest added to the date of trial	Discounted net income or net cash flow model, supported by other valuation methodologies as needed
Discount rate	Based on either risk assessment, risk-free rate, or plaintiff's use of funds depending on circumstances (see Chapter 10A)	Based on risk assessment
Prejudgment and post judgment interest	Considered	Considered
Use of hindsight (the "Book of Wisdom")	Typically considered	Seek guidance

Damages Must Be Reasonable Certain and Foreseeable

- Can't recover damages beyond amount established with reasonable certainty
 - Courts resolve in favor of P
 - Past performance predicts future performance
 - Startup businesses
 - Must use best available evidence
- Proximate Cause
 - Damages don't continue indefinitely
 - Fact specific
- Foreseeability
 - Reasonably foresee the consequences
- Mitigation
 - P must take reasonable steps to reduce/avoid damages

Lost Profits

- Lost profits are based upon the alleged harm suffered by the Plaintiff(s).
- Calculated as the amount necessary to place the Plaintiff in the position that it would have been had the event not occurred.
- Only “Net Lost Profits” are allowable in economic damages – (Net Lost Profits = Lost Revenues – Avoided/Incremental Costs)

Lost Sales

“But for” the Event... Quantify:

A = Expected Sales

B = Actual Sales

Lost Sales = **A** – **B**

The “lost sales” are the incremental sales that would have been made “but for” the event.

Lost Profits

- Sales - Costs = Profits
- Total Costs = Fixed Costs + Variable Costs
- Lost Sales – Incremental Costs = Lost Profits
- Incremental Costs = Variable Costs + Portion of Semi-Variable that are Variable

Income Statement

Income Statement				
		<u>Dollar</u>	<u>Percentage</u>	
	Gross Sales	\$1,005		
less	Returns	\$5		
equals	Net Sales	\$1,000	100%	
less	Cost of Goods Sold	\$150	15%	
equals	Gross Profits	\$850	85%	
less	Selling	\$200	20%	
	General	\$250	25%	
	Administrative	\$150	15%	
equals	Net Profits before Taxes	\$250	25%	
less	Taxes	\$100	10%	
equals	Net Profits after Taxes	\$150	15%	

“Profits” Mentioned 3 Times

- Gross Profits
- Net Profits (Income) before Taxes
- Net Profits (Income) after Taxes

But we need:

Incremental Profits...

Incremental Costs

- Profits = Sales - Costs
- Total Costs = Fixed Costs + Variable Costs
- Lost Profits = Lost Sales - Variable Costs

- To quantify lost profits, only subtract those costs necessary to make the lost sales. These costs are the incremental costs. These lost profits are often referred to as incremental profits. When expressed as a percentage, this is referred to as the incremental profit margin.

Business Valuation – Standard and Premise

- Standard of Value
 - Fair Value, Fair Market Value, Investment Value
- Premise of Value
 - Going Concern, Liquidation

Business Valuation - Approaches

- Market Approach
 - Based on economic principle of substitution
- Income Approach
 - Based upon present value theory
- Asset Approach
 - Current value of all assets (tangible and intangible) less current value of all liabilities

Document Wish List

- Financial Statements
- Tax Returns
- General Ledger Detail
- Monthly Operating Reports
- Forecasts/Budgets
- Correspondence
- Bank Statements, Purchase Orders, Invoices
- Payroll Records
- Industry Data
- Inventory Reports
- Agreements (license, royalty)
- Cash Receipts and Disbursements Journals
- Contracts/Insurance Policies
- Loan Applications

Breach of Franchise Agreement Example

As part of a franchise agreement, Franchisor was to supply Franchisee with a two year supply of its brand name protein powder. The terms of the agreement were for a supply of at least one million units for \$5 a unit annually. Franchisor was unable to meet the terms of the agreement and stopped supplying the protein powder after six months. The Franchisee sells the protein powder for \$10 a unit. What are the damages?

- Damages period
- Lost Sales
- Lost Profits
- Mitigation
- Reputational Harm