Liquidated damages clauses in hotel franchise agreements

In this article I will discuss one of the most critical provisions of any hotel franchise agreement: the liquidated damages or "LD" clause. An LD clause is an agreement between franchisor and franchisee regarding the computation of potential damages resulting from an early termination of the franchise agreement (usually due to franchisee default). LD clauses avoid the need for franchisors to quantify their damages in court, which can be extraordinarily difficult and time consuming.

The typical LD clause provides that in the event of an early termination, the franchisee pays LDs to the franchisor in an amount to cover a reasonable approximation of the franchisor's losses resulting therefrom. As any franchisee who has attempted to negotiate a hotel franchise agreement knows, most franchisors are loathe to modify the LD clause. For that reason, savvy franchisees should negotiate other parts of the agreement to make it less likely that LDs will come into play. For example, reasonable notice and cure periods are critical, so that franchisees will be less likely to default. Similarly, franchisees should request termination rights upon substantial prior notice, or seek "windows" of time when the franchise agreement may be terminated by the franchisee, in either case without LDs. Finally, any development deal should have a termination right without LDs if permits or financing can't be obtained.

The typical LD provision uses a formula to compute liquidated damages. LD formulas vary from franchisor to franchisor. Most often, LD formulas require the franchisee to pay an LD amount approximately equal to 2 or 3 years worth of franchise fees (and sometimes marketing fees), calculated by multiplying the average monthly fees by some number of months (i.e., if 3 years, then 36 months). To "back stop" the franchisee's obligations under the franchise agreement (including LDs), franchisors often require credit-worthy persons or entities to guarantee the franchise agreement, which dramatically increases the franchisor's leverage. Some franchisors may cap the amount of liability under such guarantees. However, such caps are difficult to obtain and will usually leave plenty of pain for the guarantor if the franchisee defaults.

Are LD clauses enforceable? The answer depends on the relevant facts and the state law governing the franchise agreement. In most states, if the LD amount is considered a "penalty", then it is not enforceable. To determine whether an LD amount is a penalty, most courts examine whether: (a) it appears that the parties intended to agree on an LD amount; (b) at the time of franchise agreement execution, the amount of the LDs was a reasonable approximation of what the actual damages would be in the event of an early termination of the franchise agreement and (c) at the time of franchise agreement execution, it was difficult to determine the actual amount of damages in the event of an early termination. If all three hurdles are cleared, usually a court will decide that the LD clause will not be a penalty.

In the context of a hotel franchise agreement, it should be easy for the franchisor to establish that both parties agreed on the LD clause and that damages were difficult to determine. Thus, the franchisee's only real argument is usually whether the amount of the LDs is or was a reasonable approximation of actual damages. I say "was" because in many states, courts limit their evaluation to the belief of the parties at the time the franchise agreement was signed. However, in some states courts deem LD amounts to be unenforceable penalties if they are unreasonable in light of the actual loss, regardless of what the parties believed at the time of contract execution. This is known as the "second look" doctrine.

Given the above, it should not be surprising that courts have enforced LDs in most reported cases. However, there does not seem to be any reported case law enforcing LDs for failed "development deals". Many hotel franchise agreements impose LDs even if the hotel is never built or never opens. In such circumstances, franchisors calculate LDs by using market data from other franchised hotels around the country. Given the highly speculative and risky nature of development, that no one derived any income from the property, and that the franchisor has probably been compensated for administrative fees through franchise application fees, this might be an area where, if tested in court, LDs may be ruled to be a penalty.

A franchisee may also successfully challenge LD enforcement if they have a particularly strong set of facts. For example, is it reasonable for a franchisee to pay 36 months of fees to the franchisor if another hotel enters the franchisor's system 1-year, 1-month or 1-day after termination? What if the new system hotel is superior to the old hotel? What if the franchisor makes more money with the new system hotel? What if the existing hotel is transferred to a third party who enters into a new franchise agreement on the same or better terms? Shouldn't cost savings be netted out of the LDs? Is it reasonable to use marketing fees to calculate LDs (as some franchisors do)? Don't such fees essentially reimburse the franchisor for marketing expenses that it no longer has to incur?

The answers to the above questions depend on the specific facts and the law of the relevant state. If a court only analyzes the belief of the parties at the time the franchise agreement was signed, the comparison of the LDs versus the actual damages may not be relevant to the court. Moreover, even if a court determines that an LD amount is unreasonable, the court may simply adjust the LD amount to one it deems more reasonable. Despite all of these unknowns, the one certainty is that hotel franchisees face an uphill battle to avoid paying LDs. For that reason, it is critical that hotel franchisees and their guarantors understand what they are getting into before signing on the dotted line.

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About this month's author

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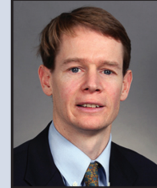
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