IN DEFENSE OF THE FRANCHISOR
THE FRANCHISOR'S PERSPECTIVE ON LIQUIDATED DAMAGES

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A. Introduction.

The hotel franchise agreement is a contractual agreement between a hotel chain, the franchisor, and the hotel owner, the franchisee. In the context of a franchise relationship, the hotel chain is required to let the franchisee use the hotel chain's name, services, trademarks, and reservation systems in return for payment to the franchisor of a franchise fee by the franchisee.

For a hotel chain to become profitable, it must develop a brand name, image, and winning concept to attract customers.[1] To be successful as a hotel franchisor, the hotel chain will recommend procedures for the hotel chain to implement. Naturally, if the "brand name, image, and winning concept" are successful, then the hotel chain will succeed in franchising its concept and procedures to prospective franchisees.

A hotel chain that wants to grow and become a major player in the hotel industry will use franchising as a mechanism for growth, because the capital investment costs are relatively reasonable, compared with "developing" or "acquiring" hotel properties on their own.[2] Furthermore, establishing a franchising company does not require significant personnel as opposed to that of a hotel management company.[3] Of course, this does not imply that costs for developing and maintaining a successful franchisor are insignificant, which they are not.

In today's competitive hotel industry, franchisors are constantly improving their brand awareness and recognition which is necessary to "survive and thrive." To be successful and attract franchisees, a franchisor must (i) provide instant name recognition so that hotel patron's will want to stay at the franchisor's branded hotel; (ii) develop a market segment for the franchisor's branded hotel, whether it be leisure, resort, convention and meeting, government, and/or commercial; (iii) develop state of the art manuals, procedures, and training programs as internal guidelines for operation and product merchandising;[4] and (iv) the development of chain wide standards to ensure "uniform mode of operating and image."[5]

And along with this "infra-structure" to establish, maintain, and grow the franchisor's brand, and thereby ensure the franchisee's optimum degree of success, come growing pains associated with being a franchisor. Specifically, the "difficulty" with owners and management companies. In that regard, the objectives of a franchisee might not always be the same as the franchisor, and consequently, the franchise company will spend time and money attending to the problems with its franchisees to maintain the success of

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[1] *See* STEPHEN RUSHMORE ET AL., HOTEL INVESTMENTS HANDBOOKS 2002, HOTEL FRANCHISES § 18.01 INTRODUCTION, at 18-2 (2001).
[2] *Id.* § 18.02 ADVANTAGES FOR FRANCHISORS, at 18-2.
[3] *Id.*
[4] *Id.* § 18.04 ADVANTAGES FOR FRANCHISEES, at 18-9.
[5] *Id.* § 18.05 DISADVANTAGES FOR FRANCHISEES, at 18-13.

the franchise, in terms of chain growth and economic return, which directly benefits its customers, the franchisees.[6]

B. Early Termination Of The Franchise Agreement, By Default Or Otherwise.

The early termination of a franchise agreement, with or without cause, has been an issue of concern in the franchise relationship for many years. Whether the early termination right is exercised by the franchisee or by the franchisor for cause due to breach of the franchise agreement, a problem area has arisen as to the amount of damages the franchisee must pay. To alleviate the concern over the amount of monetary damages the franchisee must pay, the franchisor and franchisee have attempted to structure a compromise on the method and amount of the monetary damages for early termination by the franchisee, or termination of cause by the franchisor, for two simple reasons - the franchisee wants to put a "cap" (in other words, a limitation) on its damages, while the franchisor wants to prevent the agreed upon amount to be classified as a "penalty" and avoid forfeiture of such an amount.

C. Enforcement Of "Liquidated Damage" Clauses.

Over the past five years or so, franchisors have seen an onslaught of litigation by disgruntled franchisees for virtually every conceivable wrong befallen on the franchisee. According to some franchisees, if the franchised hotel fails, it's often the "franchisors" fault" for failing to provide brand support. To say the least, the franchisor has become the "poster child" for franchisees looking to blame others for the economic decline of their franchised asset and in many cases, poorly managed hotels. We all know, however, that if the truth be told, the franchisee shares most, if not all, of the responsibility in the failure of its franchised hotel.

In an increasing litigious society, especially in the context of the franchise relationship, the franchisor and franchisee have attempted to provide a solution to the ability of the franchisee to terminate the franchise relationship based upon a pre-negotiated termination fee without the necessity of filing a lawsuit. The right of the franchisee to terminate the franchise relationship for non-performance by the franchisor or to strictly terminate the franchise relationship at some time in the future without cause, has been a 'hotly" negotiated item during the past few years. Both the franchisor and franchisee have attempted to strike a balance, where on the one hand, the franchisor can be compensated for an early termination of the franchise agreement, and on the other hand, the franchisee may terminate the franchise agreement for a pre-set or pre-negotiated amount. To accomplish this task, the franchisor and franchisee will agree to a pre-set amount or formula as damages for the right to terminate. This provision is called a "liquidated damages" clause.

[6] *Id.* § 18.03 DISADVANTAGES FOR FRANCHISORS, at 18-5.

1. Validity of Liquidated Damage Clause.

A liquidated damage clause allows the franchisor and franchisee to agree in advance on the amount of damages as just compensation for breach of contract, or in the case of a franchise agreement for an early termination by the franchisee, justified or not, for the payment of money damages. This type of an agreement is binding and furnishes the measure of damages. However, a liquidated damage clause is an invalid penalty unless it "is impossible or impractical to estimate damages without a degree of certainty at the time of contracting. The amount specified as liquidated damages must also be a reasonable forecast of just compensation" which is incapable or very difficult to measure.[7]

A clause that limits liability may be enforceable if a suit is based on negligence, provided the clause takes into account loss through negligence and there is no disparity of bargaining power between the parties.[8]

2. Breach of Contract Required.

Before the franchisor may recover under a liquidated damage clause, there must be a breach of contract. Once the breach of contract occurs, the franchisor's demand becomes liquidated. In cases where no actual damages were suffered, the courts are somewhat reluctant to find the franchise agreement was one for liquidated damages. In other words, the absence of actual damages could indicate the contract was one for a "penalty" as apposed to one for "liquidated damages." It should be noted, however, "that a contract [that is] construed to be liquidated in [the] event of [a] total breach may be declared to be a penalty in event of partial breach."[9]

3. "Penalty" or "Liquidated Damages!".

The enforceability of a liquidated damage clause depends on the legal distinction between a "penalty" and "liquidated damages." A penalty is security for the performance of a contract. Liquidated damages constitute the measure of recovery in the event of a breach. Therefore, the determination of whether a contract clause is "enforceable as a liquidated damages provision or void as a penalty is a question of law."[10]

If a court determines a liquidated damage clause unenforceable as a penalty to secure performance, then the franchisor asserting a breach must show actual damages to recover. Moreover, a liquidated damage clause in a franchise agreement "may become a penalty if it provides for unreasonable damages for trivial breaches, as well as reasonable damages for major breaches."[11]

4. Intent of Franchisor and Franchisee.

In order for a liquidated damage clause to be enforceable, evidence that the franchisor and franchisee intended for such a result must appear in the franchise agreement. In construing a liquidated damage clause, the burden is on the franchisor to establish the liquidated damage clause was the intent of the franchisor and franchisee. Unless such an intent is established, the liquidated damage clause will be declared a penalty.

It should be noted that if the intention of the franchisor and franchisee is unclear, then the court will look at the totality of the circumstances surrounding the insertion of the liquidated damage clause into the

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[7] *See Permian Petroleum Co. v. Petroleos Mexicanos*, 934 F. 2d 635, 645 (5th Cir. 1991), *reh den*, 1991 US App. LEXIS 18457.
[8] *See Fox Elec. Co. v. Tone Guard Sec. Inc.,* 861 SW2d 79, 83 (Tex. App. - Forth Worth, 1993, n.w.h.).
[9] *See Sanders Nursery Co. v. J.C. Engelman, Inc.,* 109 SW2d 1131,1133-34 (Tex. App. - San Antonio, 1937, writ dism woj).
[10] *See Baker v. Int'l Record Syndicate, Inc*., 812 SW2d 53, 54-55 (Tex. App. - Dallas, 1991, n.w.h.).
[11] *See Community Dev. Ser. Inc. v. Replacement Parts Mfg., Inc.*, 679 SW2d 721, 727 (Tex. App. - Houston (1st Dist.), 1984, n.w. h.).

franchise agreement. Specifically, the court would analyze the following factors: (i) the subject matter relating to the liquidated damage clause; (ii) the actual language used; (iii) the situation of the franchisor and franchisee during the relevant time period; (iv) the reason for the liquidated damage clause; (v) the circumstances relating to the liquidated damage clause; and (vi) the intention of the parties. Even though a liquidated damage clause in a franchise agreement declares a stipulated sum will be liquidated damages, the court may find the parties actually contemplated a penalty and if so, then the franchisor's recovery would be limited to actual damages incurred by the franchisor. In other words, the use of the term "penalty" or "liquidated damages" does not conclusively establish the subject clause is in fact a "penalty" or "liquidated damages" clause.

5. Damages Must Be Incapable of Determination.

A liquidated damage clause will be enforceable by the franchisor if the harm to the franchisor is "incapable or difficult to estimate."[12] The difficulty of estimating the amount of damages is based on the circumstances existing at the time the franchise agreement was negotiated, not when the actual harm occurs. The clause in question will be a liquidated damage clause, and not a penalty clause, "if the actual damages, because of the circumstances of the case, are uncertain, intangible, or not ascertainable by a satisfactory, known rule."[13]

To establish an entitlement to liquidated damages, not only must the harm caused by the breach be difficult to estimate or incapable to determine, but the actual amount of the liquidated damages must be a reasonable "forecast" of a reasonable and just compensation.[14] It should be noted that if the specified amount is disproportionate to the actual damages, the actual damages will become the measure of damages. The determination of whether the specified sum is a reasonable forecast of damages is viewed at the time the franchise agreement is executed.

6. Avoiding the "Penalty" classification.

Ever mindful of the distinction between a "liquidated damages" clause and a "penalty" clause, the franchisor, in its negotiation with the franchisee, should insist that the predicate for the "liquidated damage" clause be spelled out in the franchise agreement. Specifically, the language relating to the "liquidated damage" clause should reference the inability of the parties to determine damages to the franchisor, should the franchisee seek to terminate the franchise agreement early. Conversely, if the franchisor terminates the franchise agreement for cause, the method of determining damages should also be spelled out clearly in the franchise agreement, for the failure to do could very well result in the outright forfeiture of the franchisor's contractual right to the payment of such damages and a "windfall" to the franchisee.

To address this problem, the franchisor should consider "quantifying" a method to determine damages which would survive an attack by the franchisee accusing the franchisor of specifying a certain amount for future damages, and thereby making the "liquidated damage" clause a penalty. A method to avoid the classification of a "liquidated damage" clause as a "penalty clause" is for a franchisor to charge a certain dollar amount on a "per-key" basis for a breach or early termination. For instance, the contractual provisions set forth below are from national hotel chains relating to "liquidated damage" clauses:

a. " If Termination occurs during the last two License Years of the Term, Liquidated Damages will be the lesser of (i) [One Thousand Dollars ($1,000.00) for each guest room of the Facility

[12] *See In re Independent American Real Estate, Inc.*, 146 B.R. 546, 553 (Bankr. N.D. TX 1992).
[13] *See* 28 TEX. JUR. § 44 LIQUIDATED DAMAGES, at p. 45 (3rd. 2003).
[14] *See In re Independent American Real Estate, Inc.*, 146 B.R. at 553.

[licensee is] authorized to operate at the time of Termination]; or (ii) the average daily fees based on a percentage of Gross Room Revenues accruing under during the 12 full calendar months preceding the month in which Termination occurs multiplied by the number of days remaining in the unexpired Term…at the date of Termination.";

b. "(i) the amounts owed to [franchisor] for periods prior to the date of termination, plus (ii) as liquidated damages for the future Monthly Royalty Fees and Monthly Program Fees [franchisor] will lose, a "Termination Fee" determined by multiplying the average of the Monthly Royalty Fees and Monthly Program Fees (collectively, "Average Monthly Fees") with respect to the Hotel for the twenty-four (24) month period immediately preceding the month of termination, by thirty-six (36), or by such lesser multiply as would represent the remaining full or partial months between the date of termination and the expiration of the License Term. If the Hotel has been open for less than twenty-four (24) months, then in calculating the Termination Fee [franchisor] will multiply thirty-six (36) by the greater of a) the Average Monthly Fees owed [franchisor] from the Opening Date through the month immediately preceding the month of termination, and b) the average Monthly Royalty Fees and Monthly Program Fees per Guest Room owed to [franchisor] by all System Hotels in operation throughout the same twenty-four (24) month period, multiplied by the number of Guest Rooms in the Hotel. The Termination Fee is intended to compensate [franchisor] only for the value lost in Monthly Royalty Fees and Monthly Program Fees as a result of the early termination of the Agreement, and [franchisee will] agree that [franchisee] remain liable for all other obligations and claims under the Agreement, including …. and liabilities arising out of [franchisee's] breach or default."

D. <u>Summary.</u>

At the time a franchisor and franchisee negotiate a franchise agreement, both sides are optimistic of a long and mutually rewarding relationship. Unfortunately, that relationship is often tested in severe economic downturns in the hotel industry, especially since the terrorist attacks of September 11, 2001 in the United States of America. Nonetheless, contractual provisions that are negotiated on the front-end of a franchise agreement should be upheld at the end of the franchise relationship, <u>unless</u> the parties fail to learn the lessons of prior litigation in the hospitality industry as it relates to "liquidated damage" clauses. Structured correctly on the front-end, the franchisor should be entitled to the "liquidated damages!"

It should be understood that generally, it is the franchisee that wants the "liquidated damage" clause in the franchise agreement in the first place. Accordingly, the courts should be more adept at "piercing" the franchisee's attempt to invalidate the "liquidated damage" clause as a "penalty clause" to avoid paying what is correctly owed to the franchisor.

II.

<u>THE FRANCHISOR'S RIGHT TO UPGRADE THE CHAIN</u>

Successful franchisors share a common goal - to provide a consistent brand so the traveling guest will have an expectation that each and every branded hotel will be similar. In other words, the franchisor provides quality assurance as one of its services.[15] But more importantly, quality assurance is critical to the guests who are loyal to the brand.[16] The quality assurance programs are important to keeping the quality of the

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[15] See Peggy Berg, ISHC, *Franchising in the Hotel Industry*, Hotel Investments Issues & Perspectives (3rd. Edition, 2003), Chapter 5, at pp. 115-116).

[16] *Id.*

hotels in the system up to system standards.[17] Both the franchisor and franchisee should agree the guest "perception" is critical to the success of the brand and franchise.

Franchising has been successful because independent hotels that deteriorate with age do not have a third-party to "address cleanliness, wear-and-tear, service, and other aspects of quality."[18] A franchisor, as apposed to an independent operator, will inspect and issue annual reports on "how well each hotel in the system meets brand standards."[19] It should be noted that in most instances, the inspection and annual reports are beneficial to the franchisor and franchisee. Notwithstanding, the inspection and report process can test the relationship between franchisor and franchisee. For instance, the hotel brand may change or upgrade its standards, resulting in increased and unplanned expenditures to the franchisee. But in many instances, the requirement to upgrade may occur when the franchised hotel is not performing to pro-forma.

Most franchisees would not disagree with the decision to renovate an obsolete hotel in order to increase the hotel's bottom line. After all, the franchisee is in the business to make a return on its investment, and if the internal rate of returns are too low, the hotel will struggle to cover its debt service, and operating expenses. At this point, if the net operating income ("NOI") continues to decrease, the franchisee will be faced with critical decisions -- to renovate, to terminate the franchise, or to close the hotel. Equally important, the franchisor must have the absolute right to protect its "brand" from competition and to promote brand "loyalty."

Notwithstanding, there is a real bone of contention in the hotel industry between a franchisor and franchisee over a franchisor's decision to require the franchisee to do renovations to maintain the "flag." In a competitive hospitality environment, as we now have, the franchisor is entitled, if not mandated, to be successful as a franchisor for and on behalf of its ultimate customer, the franchisee, to require the franchisee to do these upgrades. By doing so, the franchisor will keep the brand competitive and provide more hotel guests for its franchised hotels. For example, the franchisor's marketing experts may determine that a new "logo," signs, or facades will re-position the hotel chain. Obviously, the franchisor and franchisee would be required to pay for the renovation costs to their respective hotels.

But if the franchisor does not own any hotels, then the franchisee is the only party required to upgrade its hotel. Although franchisee's should acknowledge the franchisor's right to inspect hotels, to develop product improvement plans for their brands, and make certain the quality of each brand in the system is up to standard,[20] franchisees sometimes resist making the capital improvement (or cosmetic) changes to their respective hotels, due to the costs associated with such improvements.

In order to avoid having the franchisee make these "annual" or "periodical" capital improvements at the "whim" of an aggressive franchisor, the franchise agreement should specify that a certain amount of capital improvements be made over the term of the franchise agreement. The "when" and "dollar" amounts of such improvements could be specified in the franchise agreement. From the franchisees' perspective, it should have no argument on this point, because it benefits the franchisee and franchisor equally.

The real dilemma is how much renovation work should be required. Should a certain amount of FF&E be mandated annually or every other year? Should there be a limitation on how much the franchisee is required to pay? Should there be a limitation on how much the franchisor can require the franchisee to renovate, to do "cosmetic" changes, or to do major capital improvements?

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[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.* at 120.

Common sense would dictate that a franchised hotel will be renovated over the years. In that regard, the franchise agreement should spell out exactly the nature of the improvements required and a dollar limitation on the amount of improvements the franchisee is required to make. Moreover, some consideration should be given to using a "formula" to determine if the franchisee is required to make capital improvements or not. For example, the formula might state the franchisee must achieve a certain annual rate of return on its investment ("ROI") before the renovation obligation is triggered. In that regard, if the franchisee is making an acceptable return on its investment, then the franchisee should want to make the necessary capital improvements to "survive" and "thrive" in a competitive hotel market. On the other hand, if the franchisee is not making an acceptable return on its investment, then the options are simple - - renovate the hotel, terminate the franchise, or close the hotel. Remember, the goal of the franchise relationship is to protect the "brand" and for the franchisee to make money.

III.

THE FRANCHISOR'S RIGHT TO EXPAND THE CHAIN

One of the most contentious matters in the hotel industry deals with "impact" or "encroachment" issues. But is it true that when the franchisor expands its chain in the same market a franchised hotel exists, "[i]mpact occurs [and the new hotel] takes away from an existing [franchised] hotel[?]"[21] And if so, is there a resolution to this dilemma short of litigation?

From the franchisor's perspective, the "value" of the brand is based on distribution.[22] In other words, the more franchised hotels that exist, the more successful the brand and franchise will be. If the franchisor does not expand in a given market, the brand will suffer, and so will its franchisees. Furthermore, if the systems does not expand and create new hotel rooms, then reduced marketing funds will be available to promote the brand and its franchisees.[23] Competition in the hotel industry is fierce. If the franchisor is precluded from expanding in a given market because of "impact" issues, then those hotel room nights will go to the competition.

It is not always true that expansion of the brand in a given location will necessarily "impact" an existing franchise. For instance, the existing franchisee may not be up to standards for the chain. Also, the franchised hotel could be functionally obsolete. Or, the franchised hotel may be located in a deteriorating sub-market, from a social, economic, governmental, or environmental standpoint. Furthermore, the franchised hotel may be located "too far" from the proposed hotel to be impacted. In addition, the geographical neighborhoods and boundaries between the franchised hotel and proposed hotel may be significant. Moreover, the proposed hotel may cater to a different segment of the market than the franchised hotel. Therefore, a rush to judgment that the proposed hotel will impact the franchised hotel is not correct.

Most franchise agreements properly reserve the right for franchisors to add hotels at any location. Notwithstanding, franchisors' recognize the concerns of the franchisees regarding "impact" or "encroachment" issues. To address these concerns, franchisors have given franchisees certain rights, such as an area of protection clause and/or a right to an "impact" study.

The area of protection is a "protected territory around the [franchised] hotel in which the franchisor agrees not to license new [hotel] properties."[24] The term of the area of protection is typically limited to two (2) to five (5) years. The limitation on the term should allow the existing franchisee time to "ramp-up," meet

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[21] *Id.* at 111.
[22] *Id.* at 112.
[23] *Id.* at 112.
[24] *Id.* at 111.

its pro-forma, and stabilize its average daily rate, occupancy rate, and REVPAR. Once the term on the area of protection expires, the franchisor should be able to franchise or build another branded hotel in that area.

Another method to alleviate the franchisee's concern is to allow an impact study to be prepared. "An impact study is an estimate of the revenues the existing franchisee will lose if the additional hotel is licensed."[25] Franchisors that have impact-study policies generally require a certain threshold be established to deny the proposed franchise. For instance, the franchisor may require the franchisee's hotel to quantify it will lose 3 percent of occupancy or 5 per cent of room sales. If the impact study quantifies these numbers, the proposed application for a franchised hotel is denied.

The impact study should be performed by qualified appraisers, such as ones with the MAI Designation. The franchisor should submit the list of qualified appraisers to the existing franchisee. Both the franchisor and franchisee should agree to the use of an appraiser. If the parties are unable to do so, then a tie-breaker clause should be used such as "if the parties are unable to agree on an appraiser, then a panel of three of the appraisers ("Panel") (not including the appraisers selected by the parties) will select one appraiser by majority vote of the Panel." It is important the list of appraisers be qualified and established by the franchisor to ensure quality candidates. The appraisers should have substantial experience in preparing, performing, and analyzing impact studies. To be fair to both sides, the list of appraisers should have experience in preparing impact studies on behalf of the franchisor and franchisee.

The goal of growing the chain of franchised hotels is essential to the survival of the franchisor, as well as the franchisee, because at the end of the day, both sides should benefit. The contentious issues surrounding "impact" or "encroachment" does not have to exist <u>if</u> mechanisms, such as area of protection rights or rights to an impact study, are provided in the franchise agreement.

[25] *Id.* at 111.