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Are Lost Future Royalties Awardable Damages?

The Scales Now Lean in the Franchisor's Direction

By Rupert M. Barkoff

Over the last 16 years, there may have been no more-litigated franchise issue than the recovery of lost future royalties. Specifically, should the termination of, or by, a franchisee entitle the franchisor to recover lost future royalties from the former franchisee?

The trend toward unpredictability of how courts would address this issue began with the landmark case of *Postal Instant Press, Inc. v. Sealy*, 51 Cal. Rptr. 2d 365 (Ct. App. 1996). In *Sealy*, the California Court of Appeals held that the franchisor who terminated its franchisee because of the franchisee's failure to pay past due royalties was not entitled to recover lost future royalties for two reasons. First, contract law requires that in order for the franchisor to recover damages, the franchisee's breach must be the proximate cause of the damages. The *Sealy* court concluded that it was the franchisor's decision to terminate (as distinguished from its remedy of suing for damages as they accrued in the future) that caused the damages. Second, the court concluded that recovery of lost future royalties would be unconscionable. With respect to the first justification for its decision, the court noted that its holding might have been different if the franchisee, rather than the franchisor, had terminated the agreement.

Over the next decade and a half, the courts in various jurisdictions went in two different directions. One group followed *Sealy*; *see, e.g., Burger King Corp. v. Hinton, Inc.*, 203 F.Supp.2d 1357 (S.D. Fla. 2002). The second group adhered to traditional contract principles, as demonstrated recently in *Progressive Child Care Systems, Inc. v. Kids'R'Kids International, Inc.* (No. 2-07-127-CV, 2008 WL 4831339 (Texas App. Nov. 6, 2008)). In *Progressive Child*, the Texas Court of Appeals, applying Georgia law, announced that awards of lost future profits were consistent with the contract remedial principle of making the aggrieved party to a contract whole. Franchise agreements are almost always for fixed terms, and

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Taking Client Services in Another Direction

Stark & Stark, a law firm based in Princeton, NJ, is no different than other franchise law firms working with clients who have sought to cut costs during the Great Recession. One of the ideas that the firm hit upon is a little out-of-the-box: a set of intensive client services specifically designed to reduce franchisor-franchisee tensions and avoid litigation. In this Q&A, Adam Siegelheim, a shareholder in Stark & Stark's Princeton office, talks about the Proactive Franchise Legal Solutions program as the firm begins a roll-out to the franchise industry.

FBLA: What's the driving force behind Proactive Franchise Legal Solutions?

Siegelheim: It's borne out of the Great Recession. It became very clear to franchise companies that they needed to manage all of their costs better, including legal services. As outside counsel, we saw the impact, in terms of requests for negotiated fees, fixed-fee services, or clients just not wanting to call us as often. But cutting fees [in those ways] is just creating savings at the margin. As long as a business has a bucket of legal issues, you can't do much about substantially reducing your legal fees. We realized that our clients really needed to shrink that bucket by dealing with problems before they

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if the franchisee does not operate until the end of the term as a result of its material breach, the franchisor must be awarded lost future profits in order to put it in the same position it would have found itself had the franchisee complied with the franchise agreement's terms — if future damages could be proven with reasonable certainty. In *Progressive Child*, the court found that there were approximately 18 years and 22 years, respectively, remaining in the two franchise agreements under scrutiny; assumed that the franchisee's future sales would be consistent with past years' financial performances; and, after doing the arithmetic, concluded that the franchisor was entitled to recover almost $1.4 million from the franchisee, based on the remaining terms in the contracts.

At roughly the same time *Progressive Child* was decided, in *Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc.* (No. 06-cv-01212-PAB-BNB, 2009 WL 579516 (D. Colo. Mar. 4, 2009)), the U.S. District Court for the District of Colorado split the baby, but not in half. Here, the court seemed to accept the principle that lost future royalties were recoverable, but it concluded that while the franchisor produced evidence of the amount it would lose as a result of the franchisee's early termination of its franchise agreement, the franchisor did not prove the offsetting amounts it would save as a result of no longer having to service the terminated franchisee. The opinion only mentioned *Sealy* for its discussion of difficulties estimating net lost future royalties. Also, unconscionability, *Sealy*'s second justification for its result, was not mentioned in *Progressive Child* and was only mentioned in an earlier *Rocky Mountain* opinion that determined the franchise agreement was not unconscionable (No. 06-cv-01212-WYD-BNB, 2007 WL 4268962, at *5-*6 (D. Colo. Nov. 30, 2007)). Additionally, this earlier opinion alternatively concluded that the UCC unconscionability provision did not apply to the franchise agreement.

Further, in the published opinions in *Progressive Child* and *Rocky Mountain*, neither court appeared to consider the issue of mitigation of damages. Based on the published opinion in *Sealy*, the *Rocky Mountain* court only noted the likelihood that franchisors would not mitigate damages if awarded lost future royalties, and did not mention any franchisor obligation to show mitigation of damages.

And thus the stage was set for *Meineke Car Care Centers, Incorporated v. RLB Holdings, LLC*, where the trial court's decision granting the franchisee summary judgment on issues supporting non-recovery of lost future royalties was reversed by the Fourth Circuit (No. 09-2030, 2011 WL 1422900 (4th Cir. Apr. 14, 2011), *reversing Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC*, No. 3:08cv240-RJC, 2009 WL 2461953 (W.D. N.C., Aug. 10, 2009)). In this case, the franchisee essentially shut down operations, and the franchisor brought suit, asking for lost future royalties for a three-year period. The decision was decided under North Carolina law; the contracts at issue were silent on the issue of the recovery of lost future profits. The trial court, on motions for summary judgment brought by both parties, granted the franchisee's motion asking that claims for lost future royalties be denied, and it dismissed Meineke's motion arguing that such damages were recoverable. On appeal, the Fourth Circuit reversed the trial court's ruling and remanded. The appellate court concluded that

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Client Services

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became bigger. If you can address legal issues upstream, you can avoid expensive and protracted litigation. You'll also have happier franchisees, increased royalties, compliance with system standards and requirements, positive validation and general "buy-in" to what the franchisor is trying to achieve.

FBLA: What are these services you have in mind?

Siegelheim: Stark & Stark's Proactive Franchise Legal Solutions consists of six modules. The first is a Validation Audit. We will go to a representative sample of franchisees to ascertain any concerns or issues they are having with the franchisor or system. The focus is on assessing any potential issues at an early stage, before issues escalate and potentially become system-wide, as has happened recently with Quiznos, Burger King or Edible Arrangements, and with many other large systems over the years. The idea is to resolve problems now, rather than to have them become an adversarial proceeding in two years.

FBLA: Who's doing the Validation Audit? Are you experts in conducting surveys of franchisees?

Siegelheim: We will be retaining professionals who have "C" level franchise experience to conduct these surveys. We will then use our expertise to analyze the data and report back to the franchisor [about the findings]. We will work with the business experts and then help the franchisor to respond to what's written in the report. And we have designed the program to ensure that the information and data collected from the business professionals is protected by attorney-client privilege.

FBLA: What's the second module?

Siegelheim: Sales Compliance. A lot of our clients over the years have had problems with franchisees which can be traced back to flaws in their sales system. Sometimes it's that the franchise did not have sufficient finances to open, sometimes it's been a poor cultural fit with the franchise, or sometimes the expectations were not communicated properly. A law firm gets involved two or three years later when things have gone wrong, and the franchisee alleges that federal and/or state disclosure laws were violated.

Our sales compliance module begins with an assessment of the franchisor's current practices and knowledge of the disclosure laws. During the assessment phase, we quiz the franchisor's sales staff and mystery-shop the franchisor, posing as prospective franchisees. We also sit in on a franchisor's discovery day. Then, we will tailor a program to address what we have found and to educate the sales force. This will

If you can address legal issues upstream, you can avoid expensive and protracted litigation.

include making sure that the sales process is documented properly, including items such as signed receipts for disclosure documents and completed disclosure questionnaires are handled properly. We also work with the franchisor to help the franchisor communicate with prospective franchisees about its expectations, as well as to find out the expectations of the franchisees. It's all about checks-and-balances in the sales system, to make sure that the right prospects are being awarded franchises.

FBLA: The third module is about operations and compliance, right?

Siegelheim: Usually, compliance consists of a field rep coming to a franchisee's location with a checklist on a clipboard. He marks things that are wrong, and that generates a nasty letter from headquarters with all the violations. The letter makes the franchisee angry, and he or she becomes defensive and resists making the changes. Then the franchisor starts thinking about whether it is facing a default and, ultimately, a termination decision.

An effective compliance system results from the franchisees understanding that the franchisor is there to help them improve their operations and become profitable. We want our clients to understand that a franchisee will only make changes after it understands their importance and buys-in to the need to follow the system's standards. An effective compliance program also reflects that, as a general rule, none of us likes to be told we are doing things wrong. We've seen the relationship between the franchisee and field rep become adversarial very quickly, resulting in a complete communications breakdown. The franchisee must be aware that the field rep is pointing out issues to help them improve their business and help strengthen the brand overall.

FBLA: How are you doing that? What are you doing to change the typical routine of a compliance visit, write-up, and a possibly hostile exchange of e-mails and letters?

Siegelheim: First off, if there are recurring compliance issues, the franchisor has to understand what is motivating the franchisee's behavior. In some instances, a franchisee may not be following certain standards because he or she feels that they know better and do not believe that the franchise system works. In other instances, a franchisee may not be following system standards because he has grown frustrated with the inability to become profitable and may begin to give up on the system and his own business. A franchisor would want to deal with these situations differently. Our compliance module focuses on correcting compliance issues while also focusing on the underlying reasons for the noncompliance.

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Client Services

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FBLA: Compliance seems to be at the heart of many disputes, and maybe even more in a recession, when everyone feels that competitiveness is at its height. Can outside counsel reduce those tensions, or does it make it worse?

Siegelheim: Sometimes when a problem arises, franchisors do receive advice that can make a situation worse. They might be told: "You've got to send a message … "; "If you let the franchise get away with that … "; or "You have to protect your brand … ".

We believe we can offer a view based in practicality and on a broader perspective. In a challenging economic environment, when a franchisee's business is struggling and not performing up to expectations, it is easy for frustration to set in. It is also easy for frustrated franchisees to become emotional when discussing their business with the franchisor, and just as easy for franchisors to get drawn into an emotional exchange. The idea with our operational compliance module is to take the emotion out of a situation.

FBLA: It comes down to improving communications.

Siegelheim: Communications is our fourth module. When we get files from our clients [who are in a dispute], we see that things have escalated over time and that both sides have become emotional. Each side has been saying things it shouldn't say. So, if we can work at the outset of the disagreement and resolve it sooner, it won't escalate.

Our communications module takes place over a three-month period. In the first month, a client blind-copies us on all communication to franchisees, so we can assess their current communication methods. In the second month, they will show us what they are planning to send before they send it, and we will help them craft the messages. In the third month, they will go back to blind-copying us, but we will offer advice.

In addition to improving the way our clients communicate, another goal will be to help them develop consistency in their messages. This is important because franchisors communicate with franchisees in so many ways — from e-blasts to field reps to annual conventions. In a large system, a decision might be made at the board level, then work its way to the executives, the headquarters staff, field reps, franchise owners and then to their employees. That's a lot of steps, and it's easy for a message to be lost or changed. Inconsistency can come from something as simple as a field rep who rolls his eyes when he delivers a new policy from the office.

FBLA: Communications also comes into play on pre-sale disclosures. How does that fit into your service?

Siegelheim: We call our fifth module the Franchise Disclosure Document Audit. A common lawsuit or counterclaim by a franchisee is that the franchisor or its representative told us it would do this, and it didn't. Then, the FDD comes under close scrutiny. So we want to make sure that the FDD is airtight. As an example, in Item 7, a franchisor discloses the estimated cost of opening a unit. We will want to see the backup documentation to make sure it matches up with the FDD. If the FDD says that opening costs are about $220,000 to $250,000, but the documentation says the median cost is $290,000, that is a discrepancy we need to clear up. Same thing for promises about the amount and types of training franchisees will be receiving. We will ask if the franchisor is living up to its end of the bargain.

FBLA: What's the final module?

Siegelheim: Disaster preparedness. Disaster to a franchisor can take many forms, including a fire at its franchise headquarters, a key executive leaving unexpectedly, or a food-borne illness linked to a restaurant franchise or its supplier. We will work with franchisors to structure teams and backups to keep the system going in the event of a disaster.

These things do happen, by the way, and it's not just in areas like information technology, where key data should be backed up off-site. When Hurricane Katrina hit New Orleans, some franchises were without supplies for a long time because all of their supplies had been stored in that area. A franchise that stored some supplies in another location would have been able to get the supply up and running and its units operating more quickly.

FBLA: These seem like good ideas, but they seem costly and complicated to implement. What size or type of franchise is the system appropriate for?

Siegelheim: Our Proactive Franchise Legal Solutions are tailored to a franchisor's particular needs. We are working with a few long-term clients to beta-test the service, and we are getting excellent feedback. There is a need for this type of support for franchises at all stages. Franchise lawyers can point to problems that large franchise systems have had that can be traced to poor communications, for example. But you can see in a young franchise system the same potential problems because you might have an inexperienced franchisor executive team that does not know how to communicate well. Or if the system is rapidly growing, it could be changing quickly, and the existing franchisees could feel that they signed up for one thing, and now it's another. Yet, the franchisor made the changes for good reasons under new circumstances. We can help avoid the problems that can arise in those situations.

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COURT WATCH

By Darryl A. Hart

Right to Condemnation Award for Loss of Goodwill May Be Assigned to Franchisor

Under California law, the owner of a business conducted on condemned property can claim compensation for the loss of goodwill. Cal. Code of Civ. Proc. § 1263.510. A 1992 case held that a franchisor could not make a claim for loss of goodwill under that statute since it was not the owner of the concerned business, citing, among other things, the franchise agreement's disclaimer of any partnership, joint venture or agency relationship between the operator and the franchisor. *Redevelopment Agency v. International House of Pancakes, Inc.*, 12 Cal. Rptr. 2d 358 (1992).

The issue came up again in *Galardi Group Franchise & Leasing, LLC v. City of El Cajon*, 2011 WL 2184347 (Cal. Ct. of Appeal 4th Dist., June 7, 2011). When the city of El Cajon acquired the location in question under its power of eminent domain — it was a long-standing Wienerschnitzel restaurant — the city refused to pay either the franchisee or the franchisor for the loss of goodwill. The city maintained that Galardi, as a franchisor, had no right to claim goodwill damages under the *IHOP* precedent. Galardi claimed that its agreement with the Wienerschnitzel restaurant operator did not amount to a franchise agreement, a fact that the court did not find controlling as to whether Galardi was the "owner" of the business. In order to cover its bases and bring an action against the city, Galardi obtained an assignment of the restaurant operator's right to claim goodwill damages against the city and brought an action for its own loss of goodwill and, as its assignee, for that of the operator. The city maintained that a provision in the "Operator Agreement" in which the operator of the concerned facility "waives all right to or interest in any condemnation award or settlement" waived the operator's right to claim goodwill damages against the city and, as such, there were no rights to assign. The trial court found for the city on both counts.

In affirming the trial court finding that Galardi was not the owner of the business, the appellate court cited the *IHOP*-like disclaimers about partnership, agency, etc., in the Operator Agreement, as well as other provisions which sought, as do most franchise agreements, to immunize the franchisor against liability, operating expenses, etc. It then turned to the assignment to Galardi of the operator's right to goodwill damages.

Galardi argued that the waiver of condemnation damages provision in its Operator Agreement was intended to determine the right to such damages between itself and its operator, not to establish rights between it, its operator and a third-party public agency. The appellate court, reviewing the matter *de novo*, indicated that a party seeking the rights of a third-party beneficiary bears the burden of showing the provision was made for its benefit personally or as a member of a class of which it is a member. Here, there was no indication that was the case. The court held that the clear intent of the parties was to determine the right to goodwill damages among themselves and that they did not consider that right waived, citing, among other things, that the parties' execution of the assignment occurred after the property was acquired by the city, indicating that the parties considered the right to such damages to be in effect long after the Operator Agreement was signed.

In light of this case, those who write franchise agreements may want to craft their eminent domain provisions to be assignments of the appropriate rights, rather than merely having the franchisee disclaim its rights to the concerned compensation.

Exercising a Contract Right to Change Franchise Agreement Terms Is Not A 'Material Modification'

Unless an exemption is available under the statute, California Corporations Code § 31125 requires a franchisor that wishes to solicit a franchisee to agree to a material modification of an existing franchise agreement to make a filing with the California Department of Corporations and allow the franchisee five days to review, or if the change is already signed to rescind, the proposed change. *In re: ConocoPhillips Company Service Station Rent Contract Litigation*, Bus. Franchise Guide (CCH) ¶14,598 (USDC, N.D. California April 13, 2011), multi-district litigation between ConocoPhillips Company and many of its gasoline stations franchisees, arose out of Conoco's motion to dismiss the plaintiffs' Second Amended Consolidated Master Complaint. The Complaint, among other things, claimed that Conoco's increase in the stations' rent without complying with § 31125 violated the California Franchise Investment Law. The Dealer Station Lease at issue provided that the station operator would pay Conoco rent in accordance with Conoco's "Rent Policy" and that the Rent Policy could be amended by Conoco "at any time and from time to time." The leases stated that the Rent Policy would be adopted by Conoco "in good faith and in the ordinary course of business" and that the dealers would be given at least 90 days notice of any change. The station operators did not allege that the changes were not in good faith, outside of the ordinary course of business, or that the required notice was not given.

The court held that rent changes were contemplated and allowed by the lease agreement. As such, it

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Court Watch

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ruled that the disputed rent increases were not "material modifications" of the contract requiring compliance with § 31125.

While certainty is a favorable attribute in a franchise agreement, it is wise to allow flexibility when it can be foreseen that key provisions may change over time. However, placing reasonable restrictions on the nature, timing and amount of such changes, or other applicable parameters, may give franchisees and prospective franchisees who may be considering the advisability of purchasing the franchise some comfort when being asked to agree to provisions that may be modified in the future.

Single Unconscionable Provision in Franchise Agreement Will Not Defeat Arbitration Clause

In *Htay Htay Chin v. Advanced Fresh Concepts Franchise Corp.*, Bus. Franchise Guide (CCH) ¶14,602 (Cal. Ct. of Appeal 2nd Dist., April 20, 2011), the concerned franchise agreement contained an arbitration clause that delegated the issue of the validity of the arbitration provision to the arbitrator. The contract also contained provisions that required a waiver of punitive damages and specified that "[a]ny award shall be based on established law and shall not be made on broad principles of justice and equity."

The plaintiff maintained that the franchise agreement was a contract of adhesion, offered to her on a take-it-or-leave-it basis by a party with superior bargaining power — which she claimed satisfied the requirement for procedural unconscionability. In order to satisfy the requirement that there also be substantive unconscionability (inequitable provisions), the plaintiff pointed, among other things, to the delegation clause and the other cited provisions to show that the agreement was unfair.

Because neither party claimed that the Federal Arbitration Act, (9 U.S.C. § 1 et seq.) pre-empted the California law that had been selected in the franchise agreement, the case was resolved under California contract law. Under that law, the court held that precedent required that the provision that specified that the arbitrator decide arbitrability would not be enforced in an adhesion contract interpreted under California law, distinguishing *Rent-A-Center, West, Inc. v. Jackson*, 130 S.Ct. 2772 (2010). That unenforceability does not condemn the entire arbitration provision, however, unless it contains additional unconscionable terms, as claimed by the plaintiff.

The trial court found that the provisions requiring that the award of the arbitrator be based on "established law and … not on broad principles of justice and equity" was unconscionable because it would prevent equitable claims and defenses from being raised. The appellate court pointed out that "[w]hen an arbitrator's powers are unrestricted by agreement, judicial review must be narrow and differential." The cited language, however, would not prevent equitable relief but would, rather, merely limit the arbitrator's broad powers and allow judicial review on the merits of the arbitration award to see that they complied with the restrictions of the contract.

The plaintiff maintained, and the trial court agreed, that the provision limiting recovery to actual damages and waiving punitive damages was also unconscionable since it waived punitive damages that were available under a statute, the section of the California Franchise Investment Law ("CFIL") that allows damages for selling an unregistered franchise, citing a 1979 California appellate case, *Spahn v. Guild Industries Corp.*, 94 Cal.App.3d 143 (1979), that upheld a punitive damage award for the fraudulent sale of an unregistered franchise. Although the appellate court did not point out that the punitive damage award in *Spahn* was for fraud in the sale of the franchise, not the California Franchise Investment Law violation, the court stated that since the franchise at issue was registered and the complaint did not allege a violation of the registration provisions, that argument was inapposite in any event.

Since the delegation clause was the only improper provision in the franchise agreement, the appellate court held that the contract, although one of adhesion, was not "permeated with unconscionability." Therefore, the motion to deny arbitration granted by the trial court was reversed.

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Awardable Damages

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as a matter of law, the absence of a provision expressly permitting the recovery of lost future profits did not bar a franchisor from pursuing that theory. In the appellate court's eyes, absent an express provision in the contract, the intent of the parties was a material fact to be determined at trial; the intent was unclear from the terms of the agreement but should be ascertained by the jury or judge; and thus summary judgment was inappropriate. Meineke will now have an opportunity to prove its case, which the summary judgment in favor of the franchisee would have prohibited it from so doing.

Can Meineke Prove Its Damage Claim?

However, as the old saying goes, the proverbial Fat Lady has not yet made her appearance. Meineke must still prove its damage claim, and it is at this point that the *Meineke* case becomes extremely intriguing because of the appellate court's ruling. As in *Rocky Mountain*, the appellate court detailed who had the burden of proof with respect to each aspect of the damage claim, but the *Rocky Mountain* court, a district court, found that the franchisor had not sufficiently made its case; thus the damage claim was speculative. In *Meineke*, the appellate court noted several material issues of fact that must be resolved in Meineke's favor before Meineke can be awarded

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NEWS BRIEFS

IFA Files Amicus Briefs in Two Major Franchise Cases

In the last month, the International Franchising Association ("IFA") filed amicus briefs in two cases, indicating the importance of recent litigation to the franchising industry.

On June 3, IFA filed a brief (Friendly's Restaurants Franchise, LLC and Fantastic Sams Franchise Corp. were co-filers) with the Massachusetts Supreme Judicial Court in *Awuah v. Coverall North America, Inc.* Cleaning franchisor Coverall is appealing a decision from 2010 in which the U.S. District Court for the District of Massachusetts held that, based on Massachusetts' employment statutes, the franchisees of Coverall North America were actually employees of the franchisor who had been misclassified as independent contractors. Judge William G. Young found that franchisees met one of the three elements of the state's classification as employees of the franchisor, and he famously criticized the concept of franchising with this comment: "Describing franchising as a business in itself, as Coverall seeks to do, sounds vaguely like a description for a modified Ponzi scheme — a company that does not earn money from the sale of goods and services, but from taking in more money from unwitting franchisees to make payments to previous franchisees."

Not surprisingly, IFA is challenging Judge Young's decision. "Wrongfully defining franchisees as employees of the franchisors instead of as business owners, as the federal district court's ruling does, threatens the viability of franchising as a business model in Massachusetts," said IFA President and CEO Steve Caldeira. He added that IFA supports legislation in Massachusetts that would change how the independent contractor test is applied to franchising.

Speaking with *FBLA* in June 2010, attorney Shannon Liss-Riordan, who represented the plaintiffs in *Awuah v. Coverall North America*, said the scope of the ruling was smaller than members of the franchise industry fear, and it was not a broadside aimed at the entire industry. "The decision is significant for the franchising industry because it demonstrates that the mere use of the 'franchise' label does not protect a company from being subject to employment and wage-and-hour laws if its franchisees meet the state law test for being employees rather than independent contractors. In this case, we have alleged that, rather than providing a true entrepreneurial opportunity for its franchisees, Coverall essentially sold them low-paying jobs," she said.

In an unrelated matter, on June 1, IFA filed an amicus brief urging the U.S. Supreme Court to review and overturn the Iowa Supreme Court's ruling in 2010 to allow the state to tax out-of-state franchisors that do not have a physical presence in the state. The court held that the state of Iowa has the authority to impose its corporate income tax on franchisors based solely on the use of infrastructure and other state services by franchisees located in the state. The court agreed with Iowa's argument that those services enabled KFC's intellectual property to flourish, thus creating an economic nexus to justify a tax on the royalty paid to KFC by its Iowa franchisees.

IFA disagrees. "The current state of the law, with states split on the right to impose income taxes on out-of-state franchisors, creates tremendous uncertainty about franchisors' past and future tax obligations. This uncertainty is especially problematic for multi-state franchise systems with long-term contracts that cannot be modified to respond to fundamental changes in tax obligations," IFA wrote in its petition. "KFC Corp. is an appropriate candidate for this Court to resolve the mixed answers and at-odds approaches offered by the sixteen states that have addressed the physical presence/economic nexus issue outside of the franchise context. Granting the petition also provides an opportunity to reaffirm the Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and protect the long settled expectations of the thousands of franchisors and franchisees who have carefully arranged their economic lives in reliance on it."

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the big banana. The franchisor must prove reasonable certainty as to the amount of lost future royalties and present credible evidence as to any savings that might result from the franchisor not having to service the franchisee. The franchisor must also show that it was likely that the franchisee would remain in business. And finally, the franchisor must show that it had taken the necessary steps to mitigate damages resulting from the franchisee's breach.

While the appellate court was not in a position to resolve the controverted material facts, its decision suggests that Meineke is on track for success. The court essentially approved Meineke's method for determining the amount of royalties it would lose — basically looking at historical performance and projecting the historical results into the future. The court also suggested that Meineke's methodology in proving that the franchisee would stay in business was persuasive. And the court also seemed to approve of Meineke's approach to mitigation. In *Progressive Child*, the franchisor won the full ball of wax — asking for, and being awarded, royalties that would have been paid over a very long time (as much as 22 years). Meineke, on the other hand, limited its damage claim to three years, which is the period Meineke

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Movers & Shakers

Scott Walton joined **Cheng Cohen LLC**'s (Chicago) franchise litigation group in June. Prior to joining Cheng Cohen, Walton was an associate in **Winston & Strawn LLP**'s litigation department, where he concentrated on complex commercial litigation in antitrust, health care and intellectual property matters. He has represented clients in civil antitrust matters and class actions, as well as federal and state investigations, and he also provides counseling for mergers and acquisitions.

James Ullman, **Jeffrey Wolf** and **Aaron Schepler** left **Greenberg Traurig, LLP** and joined the Phoenix office of **Quarles & Brady LLP** in June. The firm's franchise and distribution practice now has 20 professionals in Phoenix, Tampa, and elsewhere. Ullman joined as a partner and brings more than 38 years of experience representing franchisors in domestic and international franchising, licensing, distribution and intellectual property law. Wolf, who also joined as a partner, is a litigator who has represented franchisors, manufacturers and marketers of products and services. Schepler, also a litigator, joined as of counsel status.

Sarah Brew joined the Minneapolis office of **Faegre & Benson LLP** in the spring. She has defended franchised food retailers, as well as food processors and distributors, in food-borne-illness and contamination cases.

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will have to prove is the time it will take it to find a substitute franchisee for the abandoned locations. Absent the appellate court's reversal, this would have been an aberration where the "hog" (the franchisor in *Progressive Child*) got rich, and the "pig" got slaughtered.

Mentioned above are two points that have not been emphasized in many, if not most, of the precedents that have addressed lost future royalties. The first is mitigation. As previously noted, mitigation balances the rights and wrongs of the parties and thus provides a rational business result: punish the franchisee for breach, but do not allow that to become a windfall for the franchisor. Mitigation is the tool that should allow courts to reach this result.

The second point of significance relates to the argument that if a franchisee would not have stayed in business, the franchisor might not be able to prove damages as being a reasonable certainty. I would predict that this point will become highlighted in the next set of decisions about lost future royalties. In some cases, when the franchisee has abandoned the business, the franchisor may be fighting an uphill battle. The *Meineke* appellate court itself suggests that this is an issue of material fact, and the franchisor must prove that unprofitability did not make certain that the franchisee would not have stayed open for the remainder of its term. On the other hand, when the situation involves a breakaway franchisee, the facts speak for themselves. *Progressive Children*, in which the franchisee broke away from the franchise system and continued to operate, suggests that a franchisee's staying in business puts one more arrow in a franchisor's quiver.

From the transactional lawyer's standpoint, there are also two points that *Meineke* teaches us. In drafting a franchise agreement, make sure to specifically note that lost revenues are a recoverable damage, as was noted in the Rocky Mountain franchise agreement. In other words, take away the issue of the parties' "intent" by making the intent clear from the outset. The second issue the transactional lawyer must consider is whether and what to say in his client's franchise disclosure document on the issue of lost future royalties. Silence is not a good strategy, but overemphasizing the risk of a large damage award for lost future royalties is certainly not appealing to the franchisor's sales department. Putting this risk in big, bold lettering may unnecessarily scare off prospective franchisees.

This problem of whether and how to disclose this risk also raises a philosophical issue for franchisor lawyers. How explicit must the franchisor be in explaining the consequences of its franchise agreement to its prospects? For example, franchisor lawyers typically do not recommend spelling out all the consequences of a franchisee violating its non-compete agreement — such as it may cost a fortune to reconfigure the bricks and mortar for use in a different line of business. Why should they have to spell out the risks in this situation?

The last of *Meineke* has yet to be heard, however. Absent settlement, there will be a trial in which the open issues will be put to a trier of fact. And despite the initial adverse decision by the trial judge, the appellate court's decision to remand and not dismiss nevertheless vastly improved Meineke's position if and when *Meineke* goes to trial. Thus, the proverbial Fat Lady has yet to make her appearance, but from Meineke's position, the song may be sweet.

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