



Fox Rothschild Podcast

Featuring Litigation Partner John Gotaskie in Pittsburgh

We are talking today about the enforceability of liquidated damages clauses with John Gotaskie on Fox Rothschild Podcast. John is a partner and litigator with Fox Rothschild in Pittsburgh. He represents clients in diverse legal matters, including franchising and complex commercial litigation as well as creditor's rights and social media matters. John, good morning.

John Gotaskie: Good morning. Thank you.

Question: *John, maybe you could start by describing for us how most courts evaluate contractual liquidated damages clauses?*

John Gotaskie: Sure. I'd be happy to do that. Most states agree on a pretty standard formulation. Liquidated damages clauses in a contract are enforceable where the sum to which the parties agree constitutes a reasonable approximation of the expected loss at the time of contracting.

When considering this test, courts tend to evaluate a real laundry list of factors: They look at the intent of the parties, drawn from the words of the entire contract, examined in the light of its subject-matter and its surroundings. They also look at the relationship of the sum stipulated and what that bears to the extent of the injury. Third, they look at whether the injury is of the type that the clause is intended to protect against, and fourth, the ease or difficulty of measuring actual damages. Lastly, they will look at any unique any other matters that are inherent to this particular type of contract.

Question: *The question, then, seems to be when does a liquidated damages provision stop being reasonable and cross over the line to become unenforceable?*

John Gotaskie: That's a good question. A recent opinion from the Federal District Court in Ohio rejecting a liquidated damages clause offers some guidance. The case, known as *LSI v. Roundup*, involved the termination of franchisees by a franchisor for breach of the franchise agreement by those franchisees.

Question: *Is there anything significant to the fact that the LSI case involved a franchise relationship?*

John Gotaskie: In fact there is. In the franchising world, there is an influential liquidated damages clause called *Sealy*. This decision held that franchisors are not entitled to lost future royalties and/or lost advertising fees as part of a liquidated damages clause where the franchisor initiates termination of the franchise contract. This is true even when the termination was properly based upon a franchisee's breach.

Question: *Why is Sealy so influential?*

John Gotaskie: Well in *Sealy* and many cases that followed it, reasoned that the franchisor's decision to end the contract meant that it had the ability to re-sell the contract to another franchisee and, in that way,

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continue to earn lost future royalties and advertising fees. Consequently, the potential for dual recovery, combined with the franchisor's decision to terminate, convinced the *Sealy* court that any liquidated damages clause in a franchise contract terminated by a franchisor was per se unreasonable or, as courts often state it, an "unenforceable penalty."

Question: *Has Sealy been re-interpreted by other courts?*

John Gotaskie: Well indeed it has, and that's good news. Over time, courts re-visiting *Sealy* have concluded that the per se rule really was overbroad, and began to apply a more nuanced test to the question of enforcement of liquidated damages. Thus, in the franchise context, courts began to enforce clauses that provided for an award of lost royalties and advertising fees for a specified period of time. This is particularly true where a franchisor could show that the specified time period correlated to the amount of time it took the franchisor, on average, to replace the franchisee in a similar location.

Question: *Is LSI an example of this process of re-interpreting liquidated damages clauses?*

John Gotaskie: Yes, I believe that it is part of that process. A close reading of the Ohio case demonstrates that the court did not apply a per se rule. Instead, it applied a modern, nuanced analysis before concluding that the contractual liquidated damages clause was an unenforceable penalty and not a reasonable estimation of probable damages.

Question: *Can you tell our listeners a little more about the details of the LSI case?*

John Gotaskie: Yes, I'd be happy to do that. The case involved campgrounds operating under the Yogi Bear's Jellystone Park Camp-Resorts brand. The franchisor terminated three franchises for failure to make required royalty payments. Two of the franchise agreements contained a liquidated damages clause providing that the franchisor, upon termination of the franchisee, was entitled to damages equal to all sums then currently due and owing from the franchisee to franchisor PLUS the monthly average royalty and service fee paid or due by the franchisee for the three years immediately preceding termination. Now that number was to be multiplied by the number of months remaining on the franchise agreement. And that final amount was then to be reduced to net present value.

Question: *What was the outcome of the Yogi Bear case?*

John Gotaskie: The court started by stating that Ohio recognizes stipulated damages clauses where the amount of damages at time of contracting is likely to be uncertain and difficult of proof. Moreover, it agreed with the franchisor that lost future damages were likely to be difficult to predict with certainty and that the best indicator of future loss would be the amount of royalties, service fees and advertising fees paid by the franchisee prior to termination. Even more, the court agreed that it saw no evidence that the liquidated damages clauses were unconscionable or not entered into at arm's length by the parties.

Question: *That all sounds good, John, but I thought you said that the court rejected – that's the key word, "rejected" – the liquidated damages clause.*

John Gotaskie: That's right. I was just getting to that. I'd like to explain what the court did. What the court balked at was the inclusion of all sums due and owing in the formula used for the calculation of liquidated damages. It did not object to the inclusion of an award that included all sums due and owing in and of themselves, right. Instead, it was the inclusion of that amount in the damages calculation formula which was really troubling to the court. Specifically, the court calculated that a damages award including all

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sums due and owing in the formula would be roughly 11 times more than one simply including the monthly average royalty and service fee paid or due. Such a disparity would result in the imposition of stipulated damages not reasonably correlated with, and in fact disproportionate to, the probable harm suffered by the franchisor, according to the court.

Question: *So how did the court rule?*

John Gotaskie: The court granted summary judgment on liquidated damages to the franchisees, but the franchisor was ordered to go to trial and prove their actual damages. Now as we all know, trials are expensive, and this was a costly result for the franchisor. Interestingly, and perhaps a tacit acknowledgment that perhaps the damages formula as written was unreasonable, the franchisor argued to the court for the exclusion of the all sums due and owing portion from the formula used to calculate the liquidated damages. Now the court rejected this offer, stating that the law required him to evaluate the clause as written and did not empower the court to re-write the parties' contract.

Question: *Does the Yogi Bear case bear any good news for franchisors?*

John Gotaskie: Well I believe it does. The case demonstrates convincingly for franchisors and any other parties that are entering into liquidated damages clauses, that courts are now carefully considering liquidated damages provisions and applying them even where the party requesting them was the one who terminated the contract. Now this is true so long as the termination was induced by a breach. The takeaway for everyone is that courts will continue to carefully evaluate liquidated damages clauses so as to ensure that they are reasonably correlated with, and proportionate to, anticipated or probable harm. This LSI case shows, moreover, courts are unwilling to take a red pencil to unenforceable liquidated damages clauses so as to rewrite them in an enforceable way. And that makes sense when you think about it. This is a contract that they have to enforce. So the importance for everyone of carefully expressing any formula for liquidated damages is critical when writing the contract.

Narrator: *Well, thank you John. Listeners, to confidentially discuss whether your liquidated damages clauses are enforceable in court, please contact John at 412-394-5528 or at jgotaskie@foxrothschild.com.*

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