What makes a liquidated damages provision reasonable?

SCOTT OPINCAR, MARIA CARR | INDUSTRY INSIGHTS | AUG 04, 2017

Liquidated damages provisions are common in many franchise agreement contracts, and many franchisees unwittingly agree to these provisions without much consideration. However, a franchisee who breaches a franchise agreement may be faced with paying significant, pre-negotiated damages – otherwise known as liquidated damages – to the franchisor. Because the income the franchisor receives under the franchise agreement through royalties or fees is often variable based on the income of the franchisee, pre-negotiated damage clauses – damages the franchisor is entitled to receive in the event of a breach – help ensure that the franchisor is adequately protected in the event of a breach of the agreement. If a franchisee breaches a contract, the franchisor is likely entitled to some type of damages for the breach. In Ohio, for example, it is well established that damages for breach of contract for a party's ""expectation interest," i.e., damages sufficient to place the nonbreaching party in as good a position as the party would have been had the contract been performed." *In re Highland Superstores, Inc.,* 154 F.3d 573, 579-80 (6th Cir. 1998).

Depending on the circumstances involved in the breach, however, a court may find that the liquidated damages provision is not reasonable. An analysis of whether or not a liquidated damages provision accurately reflects the circumstances of the case often includes an evaluation of whether the liquidated damages provision is an unenforceable penalty. *Samson Sales, Inc. v. Honeywell, Inc.,* 12 Ohio St. 3d 27 (1984). This includes an evaluation of whether the damages would be "(1) uncertain as to amount and difficult to prove, and if (2) the contract as a whole is not so manifestly unconscionable, unreasonable, and disproportionate in amount as to justify the conclusion that it does not express the true intention of the parties, and if (3) the contract is consistent with the conclusion that it was the intention of the parties that damages in the amount stated should follow the breach thereof." *Boone Coleman Constr., Inc. v. Piketon*, 145 Ohio St. 3d 450, 2016-Ohio-628 (2016), quoting *Samson Sales*, 12 Ohio St. 3d 27 (1984).

A stipulated damages provision may also be more appropriate if the amount of lost revenue is difficult to measure or forecast for a long time into the future. However, all of these considerations must be viewed in light of what the parties knew "at the time the contract was formed," not at the time a dispute arises. *Jones v. Stevens*, 112 Ohio St.43, 146 N.E. 894 (1925). For example, while treble damages of three times all franchise fees due might seem more appropriate if a franchise agreement has a 15 year term and the breach occurred in the first year, treble damages may be significantly less appropriate if the breach occurs in the 14th year of the contract. Ohio courts will likely enforce such provisions regardless of when the dispute arises, however; "[t]his court has made clear for over 150 years that judges have no more power to disregard a valid liquidated-damages provision than they do to disregard any other contractual provision." *Boone Coleman*, 145 Ohio St. 3d at 515, citing *Lange v. Werke*, 2 Ohio St. 519, 533 (1853).

If a franchisee is entering into a franchise agreement with a liquidated damages provision, a careful analysis of the situations in which the liquidated damages provision might apply – and the estimated cost associated with this provision – might help prevent unexpected surprises in the future.

SCOTT OPINCAR

Read More

MARIA CARR

Read More