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Technology Upgrade Refusal and Busted Transfer Produce Large Recoveries for Hotel Franchisors

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November 11, 2008

Franchisees often are led to believe that franchisors cannot recover their contracted liquidated damages unless the franchisee defaults under monetary payment or quality standard requirements in the franchise agreement. Two recent decisions underscore the fallacy behind that thinking.

A U.S. District Court in Kentucky awarded a hotel franchisor a significant recovery for termination of a hotel franchise agreement after the franchisee refused to install required new technology. After repeated attempts at resolution and notices of default, Baymont Franchising LLC terminated the franchisee in Shepherdsville, KY. The franchisee refused to remove its Baymont livery, and La Quinta Corporation filed suit to enforce termination and compel the franchisee to remove its Baymont marks and stop holding itself out as a Baymont Inn & Suites. After nearly $400,000 in legal fees, La Quinta (which retained the case when the Baymont brand was sold to Wyndham Hotel Group), won a judgment for unpaid royalties, liquidated damages of $111,000, and treble damages for the willful and unjustified holdover infringement, approximately, $120,000. Instead of the gross profit standard discuss above, the Court applied the standard from *Ramada v. Gadsden Hotel*, a leading case on this issue, which takes the franchise agreement royalty formula applied to the gross room revenue royalty calculation base for the period of infringement. The franchisee was able to exclude ancillary revenue, which is consistent with the franchise agreement royalty formula, so revenue derived from guests who mistakenly thought the hotel remained affiliated with the Baymont chain remained as a windfall for the franchisee. Such derivative revenue generation rewards an infringer, so the remedy fashioned by the Seventh Circuit produces a result with less benefit to the intentional infringer. However, coming on the heels of the Eighth Circuit decision in the Domino's case reported in our last issue, franchisees who refuse to adopt technology changes mandated by franchisors do so at the peril of their franchises and equity.

A Florida U.S. District Court enforced the liquidated damages clause in a hotel franchise agreement when the hotel was sold and the buyer and franchisor could not agree on terms for the franchise. After the franchisor passed on its right of first offer, the buyer completed the purchase and reflagged the property. The franchisor immediately terminated the franchise agreement to pursue the seller and guarantor for damages. The parties stipulated that Florida law applied, even though the franchisor was based in Minnesota. The seller and its guarantor were unsuccessful in their challenge to both the liquidated damage provision, requiring the payment of three years of royalties and marketing fees, and the standard transferee approval rights retained by the franchisor as a condition to avoiding termination for unauthorized transfer. The court held that the franchise agreement's requirement of franchisor approval of the buyer, and the buyer's entry into a new franchise agreement with the franchisor, were reasonable and did impose undue restraints on selling the real estate asset. The court found that allowing the franchisee to sell the hotel and the franchise to anyone would have "gutted" the franchise for the franchisor, so making unauthorized sale an event of default was reasonable. The franchisor's claim for $341,000 in liquidated damages was upheld. The opinion was silent as to whether the ultimate liability for this amount rested with the seller and guarantor, or the buyer under an allocation of risk in the sales contract for the hotel. As the case arises in the Orlando area, hotel buyers and sellers are advised to understand and allocate "brand continuity/change" risk in their contracts of sale for existing franchised hotels.