

Liquidated Damages Clauses

Hotel franchises are a long-term investment. Some franchise agreements can last 20 years. Depending on your financing, the real estate cycle, and the performance of your property, you may need to sell or terminate before the end of the agreement. But a restrictive liquidated damages clause can make it hard for you to exit when you need to, or it can leave you on the hook if Marriott decides to terminate.

You should think about how to hem in your liability in the event your franchise agreement is terminated, whether by you or by Marriott.

What are liquidated damages?

Liquidated damages clauses spell out the amount of money a franchisee must pay a franchisor in the event the franchise agreement is terminated early. Marriott has included liquidated damages clauses in at least one of its franchise disclosure documents (“FDD”) requiring a franchisee to pay liquidated damages even if the franchisor is the one to initiate termination. A similar clause may appear in your franchise agreement.

Context with Marriott

Terminations are not that rare. In 2017, Marriott deflagged 69 properties.¹ And Marriott takes in a substantial amount in termination fees. In Marriott’s Form 10Q from May 10th, 2018, the company wrote “termination fees increased results by \$21 million” compared to Q1 2017.² The form does not specify whether those termination fees were in liquidated or other forms of damages, but it’s clear that Marriott does collect a substantial amount of money from terminations.

However, Marriott has acknowledged the possibility of agreeing to forgo liquidated damages. In the 2017 FDD for the Courtyard brand, Marriott describes a scenario where a lender requests a franchise agreement in the context of a lender take-back. Marriott writes, “The terms of such franchise agreement may vary materially from the terms contained in the form franchise agreement attached as Exhibit B. Some examples of such variations include the following... *Liquidated damages may be reduced or eliminated.*”³ (emphasis added)

Are they enforceable?

Liquidated damages clauses are a contractual means of fixing in advance the amount of damages that one party will pay the other in the event of a breach. They are intended to permit parties to contract in situations of uncertainty over the damages that a future breach would cause. *UPS Store, Inc. v. Hagan*, No. 14CV1210, 2016 WL 1659188, at *1 (S.D.N.Y. Mar. 15, 2016) (“The purpose of a liquidated-damages clause is ‘to stipulate a pre-estimate of damages in order that the contracting parties may know with reasonable certainty the extent of liability in the event of breach.’”).

But as an exception to the general rule that contractual damages must be proven, liquidated damages clauses must reflect reasonable assumptions about the damages that a franchisee’s breach would actually impose on the

1 2017 Marriott Investor Factbook. Page E-5. Available at <http://files.shareholder.com/downloads/MAR/0x0x135543/1e9c6628-768a-425f-ac1f-349a47ca6c2a/factbook.pdf>.

2 Marriott International Form 10-Q. Filed 5/10/18. Page 28. Available at <https://www.sec.gov/Archives/edgar/data/1048286/000162828018006463/mar-q12018x10q.htm>.

3 Courtyard Marriott 2017 Franchise Disclosure Document. “Courtyard 1190837v7 (03/31/2017)”. Page 92.

franchisor. Liquidated damages that do not bear a reasonable relationship to actual damages are unenforceable penalties. *Ridgley v. Topa Thrift and Loan Ass'n*, 17 Cal.4th 970, 977 (1998) (liquidated damages clause is unenforceable “if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from the breach.”); *Ramada Worldwide Inc. v. Khan Hotels LLC*, No. 16–2477, 2017 WL 187384, at *6 (D.N.J. Jan. 17, 2017) (“A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.”).

One common formula for calculating damages is an average amount of fees the franchisor has already collected per month during the agreement, multiplied by the remaining number of months in the franchise. But some courts have found clauses that permit the franchisor to collect fees for the entire duration of the franchise agreement to be unreasonable, since the reasonable amount of time to replace a franchisee in a particular area may be much less than the time remaining on the franchise agreement. *Howard Johnson Int'l, Inc. v. Inn Development, Inc.*, 2009 WL 2920819, at *7–*8 (D.S.D. Sept. 11, 2009) (liquidated damages reflecting the entire 15-year franchise agreement unreasonable where agreement terminated after only 1.5 years).

In some states, the enforceability of the clause depends on whether it was reasonable *at the time the contract was signed*. If you signed your agreement while Starwood or Marriott were making preparations for the merger, but that was not known to you, then the clause may not reflect a reasonable reflection of actual, future damages. A liquidated damages clause based on an expectation of pre-merger royalties may not be reasonable measure of damages in the heightened competitive environment that the franchisee will face post-merger.

Marriott acknowledges that they may not collect liquidated damages in every case. In their March 2018 Form 10Q, they write: “Although our franchise and license agreements provide us with recourse and remedies in the event of a breach by the franchisee or licensee, including termination of the agreements under certain circumstances, it could be expensive or time consuming for us to pursue such remedies. We also cannot assure you that in every instance a court would ultimately enforce our contractual termination rights **or that we could collect any awarded damages** from the defaulting franchisee or licensee.” (emphasis added)

Franchisees should review their agreement carefully and consult with their attorneys to determine whether the existing liquidated damages clause is enforceable.

Ways to improve a liquidated damages clause

Make it a two-way street. If Marriott violates or terminates your franchise without cause, you should be able to collect liquidated damages for lost future profits. Include a liquidated damages clause that protects you.

Include business forecasts in the formula. Liquidated damages are appropriate when it is impossible to know what actual damages would be. But it is usually possible to have a rough estimate, at least in the short term. If there is a downturn in local tourism, holidays fall in inconvenient places, your city’s convention center is partially closed for renovations, or your city misses a major convention it had in prior years, then past royalties are not a fair approximation of what you would have paid in the future. Include an option to calculate damages based on occupancy forecasts, CVB reports about future tourism, actual group bookings, and other forward-looking information to more accurately assess what business at your property would have been in the future.

Subtract what Marriott would have spent. Marriott does not count 100% of your franchise fee as profit, because it has its own expenses in administering the franchise system. So Marriott should not get to earn

a greater profit from damages than it would have if you were still in business. Make sure that any formula used to calculate damages provides for the ability to subtract any funds that Marriott would have spent on administering its business that is attributable to *your* hotel.

Get a refund if Marriott replaces your property in the local market. One of the reasons for damages clauses is because the closure of your property represents a loss in Marriott's ability to maintain its brand position in your market. So if you pay Marriott damages worth the 5 years left on your terminated Le Meridien agreement, but Marriott is able to open a new Le Meridien in the same market 3 years later, then Marriott should refund you 2 years' worth of fees.

Link your damages to the commonness of your alleged default. For example, if Marriott deflags you citing brand standards, you should have the right to obtain information (e.g., quality inspections from other properties) about whether those brand standards are being enforced evenly across all properties with that brand. If you are the only franchisee being deflagged for something that every other franchisee is doing, your damages should be discounted.