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California Federal Court Delineates Circumstances Under Which Lost Future Royalties Are Recoverable Under California Law

By Lane Fisher

In July, the U.S. District Court for the Southern District of California held that Postal Instant Press v. Sealy, 51 Cal.Rptr.2d 365 (1996) ("PIP") did not preclude a claim for lost future royalties as a matter of California law if the franchisee terminates the agreement, or if the franchisor terminates the agreement but the franchisee's conduct proximately causes the damages, and the award is neither excessive, oppressive nor disproportionate. It's Just Lunch Franchise LLC v. BFLA Enterprises, LLC, No. 03-CV-0561, 2003 WL 21735005 (S.D.Cal. July 21, 2003) ("IJL").

In IJL, the franchisor sued a former franchisee for past due and lost future royalties. In its complaint, Its Just Lunch Franchise LLC ("It's Just Lunch") alleged that the franchisee, which had been open for 3 months, gave written notice of its intention to abandon the franchise and to terminate the franchise agreement. Thereafter, the franchisee confirmed by e-mail that the franchised business "has been closed" and that the franchisee has "terminated the franchise agreement". Upon receipt of the e-mail, It's Just Lunch terminated the franchisee for abandonment. The franchisee moved to dismiss IJL's complaint arguing that because IJL terminated the franchise agreement, it could not recover lost future royalties under PIP, and therefore the amount in controversy was under the jurisdictional minimum of $75,000 for diversity cases.

In PIP, the California Court of Appeals reversed an award of future lost profits to a franchisor that terminated a franchise agreement based on non-payment. The specific question before the PIP court was whether a franchisee's failure to timely pay some past royalties entitled a franchisor to both terminate the franchise agreement and recover over 7 years worth of future lost royalties.

The PIP court concluded that given the particular facts of the case, the franchisee's breach was not the "proximate" or "natural and direct" cause of the franchisor's loss of future royalties, and determined that the lower court's award of these damages was "excessive", "oppressive" and "disproportionate" to the loss. The court held that the franchisor's election to terminate the franchise agreement rather than pursue an in-term action for breach was the proximate cause of the lost profits it sought to recover from the franchisees. The PIP court, however, expressly stated that it was not holding that a franchisor could never collect lost future royalties for a franchisee's breach of a franchise agreement, but rather found that the issue depended on the nature of the breach and whether the breach itself prevents the franchisor from earning those future royalties.

Despite these reservations, the franchisee bar contended that PIP effectively meant that lost future royalties were not recoverable as a matter of law if the franchisor terminated the franchise agreement. However, a federal court in Pennsylvania, applying California law in RemedyTemp, Inc. v. Taylor, No. 96-6778, 1998 WL 111806 (E.D.Pa. Feb. 5, 1998), denied a franchisee's motion for summary judgment on the issue of lost future royalties where each side, as in IJL, contended that the other terminated the franchise agreement. The

RemedyTemp court held that there was nothing in PIP that precluded a claim for lost future royalties if the franchisee terminated the franchise agreement.

Later that year, Judge Moore of the U.S. District Court for the Southern District of Florida decided two cases brought by Burger King Corporation ("BKC") for lost future royalties. In Burger King Corp. v. Barnes, 1 F.Supp.2d 1367 (S.D.Fla. 1998), Judge Moore awarded BKC lost future royalties where the franchisee provided BKC with written notice of its intent to close its franchised restaurant and to stop performing under the franchise agreement. Four years later, in Burger King Corp. v. Hinton, 203 F.Supp.2d 1357 (S.D.Fla. 2002), Judge Moore refused to award lost future royalties where BKC terminated the franchise agreement for failure to pay royalties. While specifically stating that the franchisee's reliance on PIP was misplaced, Judge Moore nevertheless engaged in a PIP-like analysis and found that BKC's termination, rather than the franchisee's breach itself, proximately caused the loss of future royalties, rendering them unrecoverable as a matter of Florida law. The court distinguished a franchisee who voluntarily abandons the franchise from one who the franchisor terminates as a result of the franchisee's breach. The result of such an analysis is that a franchisee who breaches the franchise agreement and continues to use the franchisor's marks without paying royalties is in a better position to defeat a lost future royalties claim than one who abandons the marks altogether.

IJL brought the issue back to California, and presented a case where both sides alleged that the franchise agreement was terminated by the other. The court refused to dismiss the complaint and held that PIP does not preclude the recovery of lost future royalties where the franchisee was the first to terminate the franchise agreement. The court further held that even if the franchisor terminated the contract, nothing in PIP precludes the recovery of lost future profits if the franchisee's conduct proximately caused the damages. IJL therefore supports the conclusion that a franchisee's abandonment of the franchised business will permit the recovery of lost future profits even where the franchisor later terminates the franchise agreement. By finding that lost future royalties may be recoverable under California law if the franchisee terminates the franchise agreement and more significantly, if the franchisor terminates, so long as the franchisor can demonstrate that the franchisee's conduct proximately causes the damages, and the award is neither excessive, oppressive nor disproportionate, the decision narrows the application of PIP closer to the specific facts of that case.

However, the question remains as to what will constitute "proximate cause" and what range of damages will be awarded. Hinton demonstrates the ambiguity surrounding the "proximate cause" issue and the latitude afforded the fact finder to defeat future royalty claims by finding a lack of proximate cause. Moreover, the PIP court clearly considered the density of the franchisor's neighboring outlets, which could absorb the terminated franchisee's gross sales, material to the determination of whether the franchisor suffered a compensable loss. In addition, while IJL did not find over 9 years of lost future royalties (on a 10 year term) to be excessive, oppressive or disproportionate on its face, the PIP court found that 7 years of future royalties (of a 20 year term) was unconscionable. In short, these decisions illustrate that while PIP may have curtailed a franchisor's ability to recover lost future profits in a termination case, the door is not shut altogether.