Franchise agreements often require a percentage of gross revenue to be paid as royalties or advertising fund contributions. Most franchise agreements also require personal guarantees of the owners of corporate or LLC franchisees.

A prospective franchisee considering the worst-case scenario must consider whether, in the event the franchise is unsuccessful and goes out of business, the franchise and its owners remain liable for royalties and advertising contributions even though the business is defunct. The prospective franchisee may think that a formula based upon a percentage of gross revenue will result in zero obligation if the franchise is out of business. A recent 4th Circuit Court of Appeals case ruled to the contrary.

In the case of Meineke Car Care Centers, Inc. v RLB Holdings, LLC,¹ Meineke appealed from a federal district court judgment that Meineke could not recover lost future royalties and advertising fund contributions following the closure of four Meineke franchises in North Carolina, and the termination of their franchise agreements. The Fourth Circuit Court of Appeals reversed.

The district court held that future royalties and advertising fund contributions were not recoverable because the franchise agreement did not specifically allow such recovery, and therefore they were not recoverable under North Carolina common law. The appeals court disagreed.

The appeals court said that the parties to a contract may agree to a liquidated damages clause, specifying the amount of damages recoverable in the event of a breach, or to restrictions or limitations on the amount of damages recoverable, but absent such provisions a party to a contract was entitled to recover its damages. In this case, the franchise agreement contained no such restrictions, so upon the premature closure of the franchises (which was an admitted breach), Meineke was entitled to recover the damages it was able to prove, including lost profits based upon future royalties and advertising fund contributions. It was not necessary that the franchise agreement specifically authorize the recovery of future royalties and advertising fund contributions as long as it did not preclude their recovery.

Note that a franchisor may also have a duty to mitigate its damages. For example, if a franchise closes with 15 years left on its term, the franchisor may have a duty to try to find a new franchisee to replace the old one, so its damages may not simply be 15 years of royalties and advertising fund contributions.

An analysis of the worst-case scenario is an important step in purchasing a franchise, and may be an important issue to attempt to negotiate with the franchisor in light of the Meineke case.

For further information on franchise law issues, contact Bruce W. Haffey at (248) 457-7140; bhaffey@gmhlaw.com.