The Anatomy of Lost-Profits Claims in Franchise Cases

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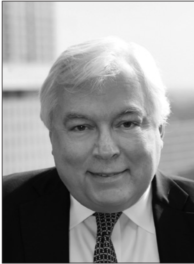
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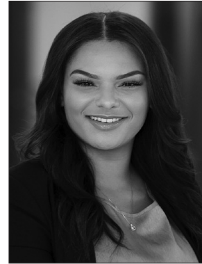
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I. Introduction

Claims seeking the recovery of lost profits are becoming increasingly more common in franchise litigation, particularly after franchise termination. Because both the franchisor and the franchisee enter into the relationship with the expectation of profit, a termination frustrates both sides' expectations and the economic rationale for entering the relationship in the first place. Although historically franchisees were more likely to assert these claims in reaction to terminations, more recently franchisors have also pursued such claims when franchisees leave the relationship before the end of the contract term. This article provides a brief history of the law governing claims for lost profits, outlines selected issues facing litigants under the current law, and concludes by offering some opinions about best practices for litigants relating to lost profits, particularly in the franchise context.

II. Overview of the Development of Lost-Profits Claims

In the early to mid-nineteenth century, American courts were reluctant to award monetary damages in general, especially lost profit. The reluctance to award lost profits stemmed from the inherent uncertainties in the

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underlying business venture and the desire to apply an objective formula to every damage calculation.[1]

Then, in 1845, the New York High Court announced that lost profits were available in breach of contract cases.[2] In *Masterton v. Brooklyn*, the court rejected an award of lost profits, but not because of a general rule prohibiting their recovery, but instead because the parties did not contemplate them at the time of contract formation.[3] The Chief Justice noted that the rule against the recovery of lost profits did not apply when the damages sought were "the direct and immediate fruits of the contract . . . between the parties."[4]

Throughout the next decade, other courts began to follow *Masterton* and allow plaintiffs to recover lost profits as direct damages in contract cases.[5] For example, in 1854, the English Court of Exchequer decided the famous case of *Hadley v. Baxendale*.[6] In *Hadley*, the court held that consequential damages were recoverable only if, at the time the parties formed the contract, the breaching party had reason to foresee that consequential damages would be the probable result of the breach.[7]

Just a few years later, in *Griffin v. Colver*, the New York Court of Appeals set the tone for the more modern rule of lost profits damages, stating:

> It is a well-established rule of the common law that the damages to be recovered for a breach of contract must be shown with certainty, and not left to speculation or conjecture; and it is under this rule that profits are excluded from the estimate of damages in such cases, and not because there is anything in their nature which should per se prevent their allowance. Profits which would certainly have been realized but for the defendant's default are recoverable; those which are speculative or contingent are not.[8]

Griffin thus concluded that lost profits are recoverable in contract cases, but only if the aggrieved party proved them with certainty. *Griffin* quickly became the "leading American case on recovery of lost profits."[9]

Since *Griffin*, it has been relatively clear that lost profits are available where the parties' contract clearly anticipated them and the party seeking them could prove the amount with relative certainty. Lost-profit damages

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1. Robert M. Lloyd & Nicholas J. Chase, *Recovery of Damages for Lost Profits: The Historical Development*, 18 U. Pa. J. Bus. L. 315 (2016).

2. Masterton v. Brooklyn, 7 Hill 61 (N.Y. 1845).

3. *Id.*

4. *Id.* at 69.

5. *See, e.g.*, Chi. & Rock Island R.R. Co. v. Ward, 16 Ill. 522, 530–31 (1855) (finding that farmer could recover lost profits where railroad breached covenant to maintain fence); Bridges v. Stickney, 38 Me. 361, 368 (1854) (allowing recovery of direct damages but not consequential damages); Simmons v. Brown, 5 R.I. 299, 302–03 (1858) (relying on *Masterton* to allow a mill owner to recover lost profits where defendant's damn reduced water flow at the mill); Hoy v. Gronoble, 34 Pa. 9, 10–11 (1859) (enabling sharecropper to recover profits lost when landowner breached oral contract); Hinckley v. Beckwith, 13 Wis. 31, 35 (1860) (holding that the lost profits of sawmill were recoverable).

6. Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. Ch. 1854).

7. *Id.* at 151.

8. Griffin v. Colver, 16 N.Y. 489, 491 (1858).

9. Lloyd & Chase, *supra* note 1.

are now available in a variety of civil contexts—tort actions (both personal and business), breach of contract actions, antitrust suits, and claims for trademark and patent infringement.[10] Nonetheless, courts continue to face the often difficult questions of how to assess whether the parties contemplated lost-profit damages, whether a party actually suffered them, and if so, how to measure those lost profits.[11] The remainder of this article will focus on the following common issues confronting franchise litigants when determining if lost profits damages are available, and if so, in what amount:

> (1) how a franchisee can prove lost profits, including the types and amounts of evidence necessary, and how a franchisor can challenge the factual basis of a claim for lost profits;
>
> (2) how new franchised businesses can prove lost profits without an available history of past profits;
>
> (3) the role of experts; and
>
> (4) whether a franchisor can contractually disclaim lost profit damages.

III. Quality and Quantum of Proof Required to Establish Lost Profit Damages

Perhaps the most important consideration in any lost-profits case is how much and what type of evidence a party needs to prove the alleged lost profits. To understand the necessary quantum of evidence, it is helpful first to understand the definition of *lost-profits damages*. Typically, *lost-profits damages* refer to the loss of net profits, rather than gross profits or revenue.[12] "Lost profits are damages for the loss of net income to a business and, broadly speaking, reflect income from lost business activity, less expenses that would have been attributable to that activity."[13] However, courts may award gross profits when operating expenses are fixed.[14]

After calculating net lost profits, the plaintiff (typically, but not always, the franchisee) must show

> (1) that the conduct upon which the claim is based caused the lost profit damages; (2) that the parties contemplated the possibility of lost profit damages or that the lost profit damages were a foreseeable consequence of the conduct; and (3) that the lost profit damages are capable of proof with reasonable certainty.[15]

These three elements of the claim are commonly known as proximate cause, foreseeability, and reasonable certainty.[16]

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10. Erwin v. Mendenhall, 433 P.3d 1090, 1095 (Alaska 2018).

11. Todd R. Smyth, *Recovery of Anticipated Lost Profits of New Business: Post-1965 cases*, 55 A.L.R.4th 507 (1987).

12. Hunter Bldgs. & Mfg., LP v. MBI Glob., LLC, 436 S.W.3d 9, 18 (Tex. App. 2014).

13. *Id.*; Ginn v. Stonecreek Dental Care, 30 N.E.3d 1034, 1043 (Ohio Ct. App. 2015).

14. 22 Am. Jur. 2d *Damages* § 57 (2019).

15. Jonathan Dunitz & Nancy Fannon, The Comprehensive Guide to Economic Damages (5th ed, 2018); Bona Fide Conglomerate, Inc. v. SourceAmerica, 2017 U.S. Dist. LEXIS 116329, at *13 (S.D. Cal. July 24, 2017).

16. Dunitz & Fannon, *supra* note 15.

A. *Causation*

Except where the defendant does not dispute liability, this first element of a claim for lost profits (proximate cause) typically requires an in-depth analysis of both the applicable law and the facts. The parties will likely dispute both what actually happened and the effect of the defendant's alleged actions. To resolve these conflicts, the showing of causation requires "comparison between the breach and non-breach worlds."[17] Specifically, the plaintiff must show, by a preponderance of the evidence, that the plaintiff's alleged loss was the proximate result of the breach, the so-called "but-for test" (i.e., but for the breaching conduct, the plaintiff would have earned profit). A "proximate" cause is a cause that (1) produces a result in a natural and continuous sequence and (2) without which the result would not have occurred.[18]

For example, in *National Controls Corp. v. National Semiconductor Corp.*,[19] the Third Circuit considered in detail the type and quantum of evidence needed to demonstrate proximate causation for purposes of lost-profits damages. The Third Circuit described the required proof as follows:

> The damages sought must be "a proximate consequence of the breach, not merely remote or possible . . . . The element of causation defines the range of socially and economically desirable recovery and requires not only 'but-for' causation in fact but also that the conduct be a substantial factor in bringing about the harm." Where the losses cannot be allocated between those caused by the defendant's breach and those not, an entire claim may be rejected. [Plaintiff] thus had to prove that any lost profits were proximately caused by [defendant's] breach, and not through some other cause. In essence, the proximate causation requirement demands that the plaintiff prove that the defendant's breach was a substantial factor in causing some harm.[20]

Notably, although causation is a required element in lost-profit cases, some courts only require the plaintiff to prove that the defendant was a cause of the lost-profit damages, rather than the sole cause. In *HSS Enterprises, LLC v. Amco Ins. Co.*, for example, the court stated that, in terms of proving causation for lost profit damages, Washington law does not mandate a "direct result" test or require that certain of defendants' acts of bad faith caused a certain specific amount of monetary damages.[21] Such an approach, the court concluded, would not comport with the long-held view that a defendant should not profit from the difficulty in proving exact damages, particularly if his breach contributes to that difficulty.[22] The court held that, to survive summary judgment, the insured must simply establish a genuine

17. Nycal Offshore Dev. Corp. v. United States, 743 F.3d 837, 843 (Fed. Cir. 2014) (citations omitted).

18. Racicky v. Farmland Indus., Inc., 328 F.3d 389, 396 (8th Cir. 2003).

19. Nat'l Controls Corp. v. Nat'l Semiconductor Corp., 833 F.2d 491, 496 (3d Cir. 1987).

20. *Id.* at 496.

21. HSS Enters., LLC v. Amco Ins. Co., 2008 WL 1787127, at *13 (W.D. Wash. Apr. 16, 2008).

22. *Id.*; Milgard Tempering, Inc. v. Selas Corp., 902 F.2d 703, 710 (9th Cir. 1990); Butcher v. Garrett-Enumclaw Co., 20 Wash. App. 361, 374, 581 P.2d 1352, 1361 (1978).

issue of material fact concerning whether the insurer's conduct was one of the causes of its lost profits.[23]

A common causation issue that arises in the franchise context is whether a franchisor can claim future lost royalties after it has terminated a franchisee for failing to timely pay royalties. In 1996, the California Court of Appeal first confronted this issue in *Postal Instant Press, Inc. v. Sealy*.[24] In *Sealy*, franchisor Postal Instant Press, Inc. (PIP) entered into a twenty-year franchise agreement with the Sealys whereby PIP would provide its trademark and certain services to the Sealys in exchange for royalty and advertising fees.[25] When the Sealys failed to make timely royalty and advertising payments, PIP terminated the franchise agreement and sued the Sealys for unpaid past royalties and future royalties remaining under the franchise agreement.[26] After a bench trial, the trial court awarded damages for lost royalties, including lost future royalties.[27] The Court of Appeal reversed the judgment, finding that the Sealys' breach in failing to pay *past* royalties was not a "proximate" or "natural and direct" cause of PIP's loss of future royalties.[28] Instead, it was the franchisor's own decision to terminate the franchise agreement that deprived it of lost future royalties.[29]

While some courts have followed *Sealy* and have taken a similar pro-franchisee approach to the issue of future lost royalties,[30] other courts have taken a pro-franchisor approach. In *Legacy Academy, Inc. v. JLK, Inc.*, for example, Legacy Academy, a franchisor of childcare centers, sued one of its franchisees, JLK, Inc., alleging breach of contract.[31] Similar to *Sealy*, the franchisee defaulted, which allowed the franchisor to terminate the agreement.[32] However, unlike *Sealy*, the Georgia Court of Appeal held that the franchisor was entitled to lost future royalties because the franchisor would have received the royalties had the franchisee not defaulted and therefore prompted the termination.[33] Thus, that the franchisor terminated the contract was not a *per se* bar on recovering future royalties.[34]

23. *HSS Enterprises*, 2008 WL 1787127, at *13; *see, e.g.*, Alpine Indus., Inc. v. Gohl, 30 Wash. App. 750, 755 (1981) ("If the plaintiff proves that the defendant's fault was a cause of lost profits, the plaintiff is not required to prove the entire loss was due to the defendant's fault.").

24. Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, 1706 (1996).

25. *Id.* at 1706–07.

26. *Id.* at 1707–08.

27. *Id.* at 1708.

28. *Id.* at 1713.

29. *Id.* at 1711. The Court went on to note that even if the Sealys' breach caused PIP to lose future royalties, the award was inappropriate because it would result in damages that were unreasonable, oppressive, and unconscionable. *Id.* at 1713–17.

30. *See, e.g.*, Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002); Kissinger, Inc. v. Singh, 304 F. Supp. 2d 944, 950–51 (W.D. Mich. 2003); I Can't Believe It's Yogurt v. Gunn, 1997 WL 599391 (D. Colo. Apr. 15, 1997).

31. Legacy Acad., Inc. v. JLK, Inc., 765 S.E.2d 472, 473 (Ga. Ct. App. 2014).

32. *Id.* at 476.

33. *Id.* However, the court went on to find that the franchisor failed to prove lost future royalties with reasonable certainty. *Id.* at 478.

34. *See, e.g.*, Leisure Sys., Inc. v. Roundup, 2013 WL 12178132, at *5 (S.D. Ohio Jan. 23, 2013); Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc., 488 F. Supp. 2d 953, 963 (C.D. Cal.

In sum, based on differences in the causation standard across jurisdictions, it is important to understand the controlling law in the jurisdiction when determining whether sufficient causation exists to establish lost-profits damages.[35]

B. *Foreseeability*

The second element of a lost-profits claim is foreseeability, which is essentially a determination if the parties contemplated such damages or should have reasonably foreseen that they would arise.[36] In the franchise context, the parties' relationship is typically governed by a contract, usually with a specific term. The language in the franchise contract usually determines whether lost profits were foreseeable.

1. The Parties' Contemplation

Determining whether contracting parties contemplated lost-profits damages typically involves two questions. First, does the contract allow lost profits at all? In a well-drafted contract, this first issue may be determinative, and the contract may expressly exclude any possibility of lost profits (see discussion in Section V regarding disclaimers of lost profits). Where a contract is not clear, however, this issue can be problematic.

Absent controlling contractual terms, lost profits are legally foreseeable if, at the time of contracting, (1) the loss was natural and inevitable upon the breach so that the defaulting party may be presumed from all the circumstances to have foreseen it; or (2) if the breach resulted in lost profits because of a special circumstance, a circumstance that must have been known to the defaulting party at the time of the contracting.[37] Importantly, the rule requires only a reasonable reason to foresee, not actual foresight.[38]

To meet this standard, courts require significant contractual evidence of the reasonable contemplation of lost profits.[39] Nonetheless, that does not mean the contract must expressly state that lost profits are available. In *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, for example, the Fourth Circuit found that the district court erred in rejecting a claim for lost profits based solely on whether the terms of the franchise and trademark agreement

2007); Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc., 2008 WL 4831339, at *5 (Tex. Civ. App. Nov. 6, 2008).

35. HSS Enters., LLC v. Amco Ins. Co., 2008 WL 1787127, at *13 (W.D. Wash. Apr. 16, 2008).

36. *Id.*

37. Precision Pine & Timber, Inc. v. United States, 63 Fed. Cl. 122, 130 (2004); Restatement (Second) of Contracts § 351(2).

38. *Precision Pine & Timber*, 63 Fed. Cl. at 130; *see* Am. Sav. Bank, F.A. v. United States, 98 Fed. Cl. 291, 298 (2011) ("[W]hat is required is merely that the injury actually suffered must be one of a kind that the defendant had reason to foresee and of an amount that is not beyond the bounds of reasonable prediction.") (citation omitted); Franconia Assocs. v. United States, 61 Fed. Cl. 718, 751 (2004) (plaintiff need not show that a particular type of breach is foreseeable, but must prove that both the general magnitude and type of damages were foreseeable).

39. Ashland Mgmt. Inc. v. Janien, 82 N.Y.2d 395, 405 (1993).

explicitly provided for such prospective damages.[40] The court held that "[d]emanding such express evidence of contemplation requires more than proof that lost profits were 'reasonably supposed to have been' within the parties contemplation, and instead requires absolute certainty that the parties considered such terms by including them in their written agreement."[41] Reversing, the Fourth Circuit instead held that although the absence of an express lost-profits provision in the contract is one factor that the court may consider in determining whether the parties reasonably contemplated future damages, it is not the *only* evidence relevant to the determination.[42] In fact, the court found that several relevant factors supported that the parties contemplated future lost profits—including the contract's fifteen-year term and the grant of an exclusive territorial right.[43] The court also found that the entire purpose of the contract was to establish a binding agreement whereby the defendant paid the plaintiff royalties and advertising-fund contributions in exchange for being permitted to operate under its names and marks.[44]

Indeed, courts may even reject the need to perform an express "foreseeability" analysis at all if the parties' contract is amenable to interpreting lost profits as a "direct" damage, rather than merely a consequential one. For example, in a somewhat uncommon twist, a franchisor was able to obtain lost profits from the franchisee in *Stern Oil Co. v. Brown* without proving the damages were "foreseeable" to the franchisee.[45] In that case, the franchisee (Brown) stopped purchasing ExxonMobil-branded motor fuel from the franchisor (Stern Oil) only a year and a half in to a ten-year franchise relationship.[46] Stern Oil sued and sought lost profits damages, and the South Dakota Supreme Court ultimately determined that, because the lost profits damages flowed directly from the motor fuel supply agreements that created the franchise relationship, Stern Oil did not have an obligation to demonstrate foreseeability.[47] The court instead determined that the damages were direct because, by their very nature, they were foreseeable.[48] Specifically, it was foreseeable to Brown that Stern Oil expected to earn a profit from the fuel supplied.[49] The agreement required Brown to use good faith and best efforts to maximize sales and required him to purchase a specified amount of fuel.[50] Because the court ruled that the damages were direct, it held that "direct damages for breach of contract do not have an element of

40. Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 F. App'x 274, 287 (4th Cir. 2011).
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 288.
45. Stern Oil Co. v. Brown, 908 N.W.2d 144, 153 (S.D. 2018).
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*

foreseeability because they are, by their very nature, foreseeable by the parties at the time of contracting."

2. The Loss Period

If the plaintiff is able to demonstrate that lost profits are actually available under the contract, it will typically then have to establish the applicable duration for which lost profits are recoverable. Parties often refer to this period for calculating lost profits as the "damage period" or the "loss period."

Calculating the loss period is typically fact-specific. Contract terms, statutory requirements, prior custom and practice, and industry standards can, and typically will, influence the extent of the loss period.[51] The loss period may be relatively short and in the past, or may be ongoing into the future, particularly when a franchisee continues to operate its business while pursuing litigation.[52]

For many franchise-based lost-profits cases under a breach of contract theory, the loss begins at the date of the breach and ends when the injured party is returned to the position it would have been in "but for" the alleged breach of the defendant.[53] However, not every lost-profits matter is a straightforward breach-of-contract matter where beginning and ending dates are apparent.[54] When dates are not definite to determine a loss period, experts often calculate losses, including future losses, by examining the facts in combination with the market and economic environment.[55]

In sum, there is no one way to determine a loss period for lost profits ahead of time.[56] Courts have provided little overall guidance on loss periods, other than indicating that the plaintiff must support its alleged loss period with sufficient evidence, and the loss period cannot be arbitrary.[57] Of course, the calculation will always depend on the type of case, the facts of the

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51. 35 U.S.C. § 284 (notes of decision); 15 U.S.C. § 15.

52. Norman A. Kur, Economic Damages in Commercial Litigation (Oct. 2016), https://www.hhcpa.com/wp-content/uploads/2016/10/Economic-Damages-in-Commercial-Litigation_Kur.pdf (last visited Sept. 24, 2019).

53. ABA Section of Antitrust Law, Proving Antitrust Damages: Legal and Economic Issues at 36 (1996).

54. *Id.*

55. Nancy Fannon & Jonathan Dunitz, The Comprehensive Guide to Lost Profits and Other Commercial Damages 500 (3d ed. 2014) ("Projecting lost revenues can be straightforward if the disrupted revenue stream occurs immediately following the bad act and the firm recovers relatively quickly. More complex cases can arise if the effect is delayed or the recovery is slow, intermittent, or nonexistent. . . . The projection of the revenue stream is likely to be the most controversial part of any damages estimate in a business case because it requires so many assumptions on the part of both experts with respect to the other players in the market and customer demand.").

56. LeMond Cycling, Inc. v. PTI Holding, Inc., 2005 U.S. Dist. LEXIS 742, at *16 (D. Minn. Jan. 14, 2005) (finding that lost profits depend on the circumstances of each case).

57. In *IC Mfg & Assocs. v. Bare Bd. Grp., Inc.*, 602 B.R. 780, 796 (Bankr. M.D. Fla. 2018), the court found that an arbitrary loss period that can be extended at the expert's whim is not a reasonable yardstick for adequately determining lost profits. In *Transverse, LLC v. Iowa Wireless Services, LLC*, 617 F. App'x 272, 278 (5th Cir. 2015), the court found that lost profit damages may not be based on evidence that is "speculative, uncertain, contingent, or hypothetical."

case, and applicable law.[58] A few of the more "certain" rules are that the loss period will typically start no earlier than the date of the damaging event, but the duration of the loss period can vary substantially.[59] In cases involving a breach of contract, the loss period is generally measured through the date on which the business returns to normal customary levels or the end of the term of the contract.[60] The longer the foreseeable period, the greater the risk that the damage claims will not meet the certainty and foreseeability tests and, consequently, that the courts will be reluctant to award those damages.[61]

3. Two Common Franchise Foreseeability Disputes: Renewals and Terminations

Foreseeability disputes in franchise cases most often arise in disputes concerning franchise agreement renewal or termination. In the case of a franchisee suing a franchisor, the franchisee can typically only seek lost profits during the term of the parties' contract. However, where a contract contains an option for renewal, the franchisee will often seek to project losses for a future period that includes the renewal.[62] Conversely, the franchisor likely will seek to limit losses to the initial term of the contract, under the theory that no future lost profits should arise following the date on which the agreement would have expired.[63]

For example, in *Comerica v. Smith (*In re *Magna Cum Latte*, *Inc.)*, a case arising from the purchase of three coffee franchises, the parties disputed whether the franchisee was entitled to lost profits for the ten-year franchise renewal period.[64] The court held that the franchisee was not entitled to lost

58. There is no set minimum or maximum loss period and there is no established way for determining a loss period via case or state law. Damages experts provide evidence to a judge to establish a loss period and the judge decides whether that evidence is sufficient to support that damages were incurred over that particular period. In *USM Corp. v. Marson Fastener Corp.*, 467 N.E.2d 1271, 1285 (Mass. 1984), the court found a damage period spanning fifteen years to be sufficiently supported by evidence of the defendant's profits from use of the trade secret that was at issue. In *Kenford Co. v. Erie County*, 108 A.D.2d 132, 489 N.Y.S.2d 939 (N.Y. App. Div. 1985), the Fourth Department of the New York Appellate Division held that although no rule in New York automatically precludes a new business from recovering lost profits, plaintiff's evidence contained too many variables and was too uncertain to support an award of lost profits. In *Lexington Insurance Co. v. Newbern Fabricating*, *Inc.*, 2016 U.S. Dist. LEXIS 171004, at *16–17 (N.D. Okla. Nov. 15, 2016), the court found that a loss period of nine months provided by the plaintiff's expert witness was reasonable but that such expert must establish a foundational basis for his opinion at trial. The Federal Circuit has implied that at least a two-year period of lost profits is acceptable if the lost profits are proved with the requisite evidence and precision. Dahl v. United States, 695 F.2d 1373, 1382 (Fed. Cir. 1982). And finally, in *Packgen v. Berry Plastics Corp.*, 847 F.3d 80, 87 (1st Cir. 2017), the court found evidence of conversations with the company president, expert analysis, and no competitors entering into the market sufficient to support a ten-year loss period.

59. 1 Patrick A. Gaughan & Michael L. Brookshire, *Economic Framework for the Lost Profits Estimation Process*, Commercial Damages: Remedies in Business Litig. § 22.04 (2019).

60. *Id.*; Matt Connors & Robert P.K. Mooney, Business Valuation Applications to Economic Damages for Lost Profits, Utah Bus. J. at 25–26 (Jan./Feb. 2011).

61. Gaughan & Brookshire, *supra* note 59.

62. *Id.*

63. *Id.*

64. Comerica v. Smith, 2008 Bankr. LEXIS 3736, at *40 (Bankr. S.D. Tex. May 9, 2008).

profits for the ten-year renewal period because the franchisor's obligation to renew the franchise agreement was contingent upon conditions not satisfied by the franchise. Moreover, the court found that even if the franchisee had not failed to satisfy the conditions for renewal, it would not be entitled to lost profits for the renewal period because a plaintiff must establish with "reasonable certainty both the occurrence and extent of alleged lost profits," and the franchisee offered insufficient evidence that it would be able to extend the store's operations for an additional ten years.[65] The franchisee's inability to negotiate its own lease and find a replacement location, rent, royalty, and product payment defaults, and inability to comply with the ADA's building requirements, all diminished the franchisee's likelihood of a successful renewal.[66] Based on those factors, the court determined that the franchisee did not meet its burden with respect to lost profits for the ten-year renewal period.[67]

Another important element of future lost profits claims in the renewal context turns on the actual history of the parties and the franchise system. Courts appear to be more likely to award future lost profits for renewal periods when the plaintiff shows a history of renewals and extensions.[68]

Another issue arises where a contract contains a termination notice provision. In such instances, most courts hold that the non-breaching party's damages are limited to the notice period in the contract.[69] The courts have held that neither party could reasonably anticipate that damages would result from a breach that could exceed the notice period.[70] However, a contract

65. *Id.* at 43–44.
66. *Id.*
67. *Id.*
68. Mariner Capital Advisors, The Basics of Lost Profits Calculations, http://marinercapitaladvisors.com/resources/the-basics-of-lost-profits-calculations (last visited Sept. 24, 2019).
69. *See, e.g.*, Reliable Tire Distrib., Inc. v. Kelly Springfield Tire Co., 607 F. Supp. 361, 369 (E.D. Pa. 1985) (concluding that plaintiff was only entitled to lost profits through the time that a manufacturing contract would have otherwise terminated pursuant to a ninety-day notice provision); Mach. Maint. & Equip. Co. v. Cooper Indus., Inc., 634 F. Supp. 367, 371 (E.D. Mo. 1986) (finding plaintiff's lost-profit damages were limited to the ninety–day termination period for a machinery distribution agreement); Martin v. U-Haul Co., 204 Cal. App. 3d 396 (1988) (finding damages should be limited to the damages attributable to the thirty days following the breach because the contract contained a thirty-day notice provision); Hentze v. Unverfehrt, 237 Ill. App. 3d 606 (1992) (finding lost profit damages for termination of an animal health store's dealership should be limited to a sixty-day period because either party could terminate the dealership at will with sixty days' notice); Trimed, Inc. v. Sherwood Med. Co., 977 F.2d 885, 893 (4th Cir. 1992) (concluding that lost profits would be limited to those incurred during the six months following the breach of a product-supply contract's termination provision requiring six months' notice); Smalley Transp. Co. v. Bay Dray, Inc., 612 So.2d 1182, 1186–91 (Ala. 1992) (holding the trial court should have awarded damages for ten days instead of seven years because the notice-of-cancellation period provided in a transportation-agency contract was ten days). *But see* Keystone Floor Prods. Co. v. Beattie Mfg. Co., 432 F. Supp. 869, 879–80 (E.D. Pa. 1977) (noting the notice period does not set the parameters for provable damages), Mercury Marine Div. of Brunswick Corp. v. Boat Town U.S.A., Inc., 444 So. 2d 88, 89 (Fla. Dist. Ct. App. 1984) (lost profit damages were not limited to the notice period).
70. *Martin*, 204 Cal. App. 3d 396.

that is terminable upon "reasonable notice" is not as clear. The court will have to determine, based on the circumstances, what is reasonable.[71]

C. *Reasonable Certainty*

The third element the plaintiff must prove is that lost profit damages are "reasonably certain and not speculative."[72] Generally, the certainty of damages is sufficient if the evidence enables the court to make a fair and reasonable approximation of damages.[73] Almost every jurisdiction has adopted "reasonable certainty" as the standard of proof for lost profits.[74] But whether lost profits are "reasonably certain" is a fact-intensive determination.[75] The basis of lost profits should be "objective facts, figures, or data from which the amount of lost profits can be ascertained."[76]

Courts generally recognize two ways to prove lost profits: the so-called "before and after" comparison and the "yardstick" approach. The "before and after" approach compares the profitability of the plaintiff before the breach to the post-breach profitability, or lack thereof, of the plaintiff to arrive at lost profits.[77] The yardstick approach is used when the "before and after" method is not available and uses some other entity or benchmark (industry standard) to set profitability.[78] Under either framework, courts examine whether the evidence of lost profits is supported by verifiable and relevant data.

For example, In *UST Corp. v. General Road Trucking Corp.*, the court found that "one of the best ways of establishing reasonably certain future lost profits . . . is to use the operational history of the enterprise for which future lost profits are being sought, or a representative portion thereof, as a basis for predicting lost profits" (the "before and after" test).[79] The court determined that lost-profit damages were not proved with reasonable certainty where the joint venture had only been in business for approximately three months when the breach of contract occurred and the plaintiff's damage expert's projections of future lost profits were based on only one week of available operating data.[80] Further, the court found that the damage expert relied on unsupported and speculative assumptions.[81]

In franchise cases, reasonable certainty can sometimes be established even when the franchised business does not have a substantial operational history. In *Pauline's Chicken Villa, Inc. v. KFC Corp.*, 701 S.W.2d 399, 401 (Ky.

71. *See* Sierra Wine & Liquor Co. v. Heublein, Inc., 626 F.2d 129, 130 (9th Cir. 1980) (finding six months reasonable).
72. Rubin Res., Inc. v. Morris, 237 W. Va. 370, 379 (2016); Stern Oil Co. v. Brown, 908 N.W.2d 144, 151 (S.D. 2018)
73. Precision Pine & Timber, Inc. v. United States, 63 Fed. Cl. 122, 131 (2004).
74. Robert L. Dunn, Recovery of Damages for Lost Profits § 1.6 (6th ed. 2005).
75. Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992).
76. *Id.*
77. Lehrman v. Gulf Oil Corp., 500 F.2d 659, 667 (5th Cir. 1974).
78. *Id.*
79. UST Corp. v. Gen. Rd. Trucking Corp., 783 A.2d 931, 942 (R.I. 2001).
80. *Id.*
81. *Id.*

1985), the court noted that certain characteristics of franchise outlets eliminate significant amounts of uncertainty that might exist in other contexts. The court held that when the franchisor is a national or regional franchisor with uniform advertising and quality control, and when there is available data on earnings and expenses and on failure and success ratios from similar locations, the franchisee can usually show lost profits with "reasonable certainty."[82] The court further noted that if, in addition, the franchisee is experienced in the particular business or has a past record of success in that industry (the yardstick approach), the case for awarding lost profits becomes even stronger.[83]

D. *Case Analysis:* Maaco Franchisor SPV, LLC v. Cruce

In *Maaco Franchisor SPV, LLC v. Cruce*, a federal district court recently applied the three-prong test and determined that the plaintiff franchisor was entitled to future lost-profit damages.[84] The parties entered into franchise agreements in 2013 and 2014 for the franchisees to run Maaco automotive maintenance and repair centers for fifteen-year terms.[85] Under the franchise agreements, the franchisees were required to continue the operation of the centers and pay certain royalties and advertising contributions for the term of the agreements.[86] In April 2017, the franchisees ceased operations with no intention of reopening.[87] The franchisor sued, alleging breach of the franchise agreements, and sought damages, including lost future royalties and lost future advertising contributions.[88] The franchisees failed to respond, so the franchisor filed a motion for default judgment.[89]

Applying North Carolina law, the court found that the franchisor had demonstrated that the closure of the centers before the end of the term of the franchise agreements proximately caused it to suffer damages because the closure stopped the potential for generating any revenue.[90] Further, the franchisor provided sufficient evidence, in the form of historical data concerning the franchisees' centers before closure (the "before and after" test), to establish the amount of its lost profits with reasonable certainty.[91] The court also found that the franchisor was entitled to future damages because it was reasonable for the parties to contemplate lost profits given the duration of the agreements with rights to renew.[92] Finally, the court found that

82. Pauline's Chicken Villa, Inc. v. KFC Corp., 701 S.W.2d 399, 401 (Ky. 1985).
83. *Id.* at 401–02.
84. Maaco Franchisor SPV, LLC v. Cruce, 2019 WL 5295702, at *7 (W.D.N.C. Oct. 18, 2019).
85. *Id.* at *1–2.
86. *Id.* at *2.
87. *Id.*
88. *Id.* at *3.
89. *Id.* at *1.
90. *Id.* at *5.
91. *Id.*
92. *Id.* at *6.

limiting damages to three years was a reasonable period because that is the average time that it takes to replace a franchisee's operations.[93]

Cruce offers valuable lessons regarding the sort of evidence that a franchise party can use to establish lost profits based on a potential renewal period, including the value of historical operating data and the relevance of a reasonable "replacement period" to determine the loss period. Of course, future plaintiffs should take *Cruce* with a grain of salt, because it is unclear how successful Maaco would have been if the franchisees had responded to the complaint and defended the litigation with experts and legal arguments aimed at contradicting the franchisor's evidence of foreseeability and reasonableness of lost profits.

IV. The Role of the Expert

Expert-opinion evidence is central to establishing the amount of lost-profits damages in franchise cases. Generally, an expert will determine what amount of profits that the plaintiff would have earned, but for the actions of the defendant.

Under Federal Rule 702 and analogous state law, an expert's opinion testimony regarding lost profits must be the "product of reliable principles and methods."[94] Most often, the financial expert is a certified public accountant (CPA). The American Institute of Certified Public Accountants (AICPA) governs CPAs. The AICPA issues standards and practice aids for CPAs relating to damages, and specifically the calculation of lost profit damages. Litigation engagements performed by a CPA that include an estimation of value are subject to the following AICPA standards: (1) Practice Aid 06-4, "Calculating Lost Profits," which discusses the "reasonably foreseeable" and "reasonable certainty," elements; and, (2) Forensic and Valuation Services Practice Aid, "Discount Rates Risk, and Uncertainty in Economic Damages Calculations." [95] Courts typically recognize that testimony based on AICPA standards, if those standards are properly applied, is "the product of reliable principles and methods."[96]

Two common AICPA-approved methods exist to prove lost profits: (1) the "before and after" method; and (2) the "yardstick test."[97] The "yardstick test" is generally used when a business has not operated long enough to compile an earnings record that can be used to extrapolate lost future profits.[98] It compares the profits of businesses that are closely comparable to

93. *Id.*
94. Fed. R. Civ. P. 702.
95. Connors & Mooney, *supra* note 60, at 25–26.
96. *See* Leon v. Kelly, 2009 WL 1300936, at *13, 20 (D.N.M. Jan. 12, 2009) (admitting lost profit opinion testimony that utilized the guidance in the AICPA practice aid on calculating lost profits).
97. Devon Med., Inc. v. Ryvmed Med., Inc., 60 So. 3d 1125, 1128 (Fla. Dist. Ct. App. 2011).
98. G.M. Brod & Co., Inc. v. U.S. Home Corp., 759 F.2d 1526, 1538 (11th Cir.1985).

the plaintiff.[99] By necessity, the “yardstick” approach is commonly used when calculating lost profits damages sustained by a new business.[100]

The “before and after” method is used for an established business, and it compares the plaintiff’s profitability before the defendant’s wrongful conduct with the plaintiff’s profitability after the wrongful conduct.[101] Because it is based upon actual data specific to the plaintiff, the “before and after” method is the more preferred method for proving lost profits.[102] In using the “before and after” method, it is important that the expert takes into consideration and, where appropriate, adjusts for factors that were likely unrelated to the defendant’s actions because it will seldom be the case that the defendant’s conduct was the only reason that the plaintiff’s results varied between the two periods being compared.[103] Some courts have required that a party presenting a “before and after” analysis identify potential confounding factors and show that they did not affect the business. For example, in *Isaksen v. Vermont Castings, Inc.*, Judge Posner dismissed a “before and after” theory analysis that failed to account for factors other than the defendant’s conduct.[104] Judge Posner stated:

> Although [the plaintiff] may well have suffered losses during the period of [the defendant’s] unlawful activity, he made no effort to establish how much of the loss was due to that activity as distinct from unrelated business factors. . . . All [the plaintiff] did to prove damages was to compare his average profits for several years before and several years during the period of unlawful activity. *Post hoc ergo prompter hoc* is not a valid methodology of damages calculation, especially when it is apparent that other causal factors are at work.[105]

Similarly, in *Saks Fifth Ave., Inc. v. James, Ltd.*, the court rejected a claim for lost-profit damages where the claimant using the “before and after” method, failed to rule out other causes of its loss of customers.[106] Here, James, a high-end men’s clothing retailer, asserted claims against Saks Fifth Avenue and one of James’ former employees after the employee left James to work at a Saks Fifth Avenue store located in the same mall.[107] James’ calculation of damages focused solely on a but-for model to determine what James’ profits would have been had the employee remained employed, but the court found that, under that analysis, James’ damages were the same regardless of whether the employee left to work at Saks or simply retired.[108] The court concluded that James’ claims, in neglecting to prove that damages

99. *Id.*
100. *See infra* Section V.
101. *In re* ICMfg & Assocs., Inc., 602 B.R. 780, 795 (Bankr. M.D. Fla. 2018).
102. *Id.*
103. Robert M. Lloyd, *Proving Damages for Lost Profits: The Before-and-After Method*, Coll. Law Fac. Scholarship (2014), http://trace.tennessee.edu/cgi/viewcontent.cgi?article=1074&context=utk_lawpubl.
104. Isaksen v. Vt. Castings, Inc., 825 F.2d 1158, 1164–65 (7th Cir. 1987).
105. *Id.* at 1165.
106. Saks Fifth Ave., Inc. v. James, Ltd., 630 S.E.2d 304, 312 (Va. 2006).
107. *Id.* at 307.
108. *Id.*

corresponded to the defendants' wrongful conduct, that James failed to show proximate cause and thus did not carry the necessary burden of proof as to lost-profit damages.[109]

Lost profits also typically have historical and future loss components. For both components, it is important for the expert to calculate past and future losses in terms of their present value. One commonly used method for doing so is the discounted cash flow model. The expert discounts cash flow to the date of loss and then calculates prejudgment interest to a future date, commonly the date of the award.[110] To perform this calculation, the expert obviously needs to establish a discount rate. The discount rate usually makes a large difference in the amount that the court awards as damages, and, therefore, it can be an area of contention between the parties.

Regardless of what method the expert uses, it important that the expert make his or her calculations based on as much information as possible. The expert should use both internal information from the business and external data consistent with generally accepted approaches. Internal information includes profit-and-loss statements, cash-flow reports, income tax returns, and business plans. External data includes market constraints, competitors comparable to the plaintiff, the impact of technology, capacity, and market share constraints. "While an expert need not consider every possible factor to render a 'reliable' opinion, the expert still must consider enough factors to make his or her opinion sufficiently reliable in the eyes of the court."[111]

For example, in *Education Logistics, Inc. v. Laidlaw Transit, Inc*, the plaintiff alleged that the defendant breached their agreement by not using its best efforts to promote its bus-routing software.[112] The plaintiff claimed that, as a result of the breach, it lost profits.[113] The defendant challenged the plaintiff's expert's calculation, arguing that the expert relied on unsupported assumptions and failed to consider other plausible causes of a purposed decline in revenue growth from the software.[114] The court agreed, finding that, among other things, the plaintiff's expert did not consider any other factors, other than the defendant's alleged misconduct, that might have caused the decline in sales.[115] As evidenced in *Education Logistics, Inc.*, one way to attack a lost-profits calculation is to argue that the expert ignored relevant factors, such as the condition of the overall economy.

The defendant—often the franchisor—can challenge the plaintiff's quality or quantum of proof by filing a pre-trial motion to exclude the expert's testimony. Federal courts and most state courts follow the *Daubert* standard. In *Daubert* and *Kuhmo Tire Co.*, the Supreme Court expanded the federal

109. *Id.*

110. Connors & Mooney, *supra* note 60 at 25, 27.

111. MicroStrategy Inc. v. Bus. Objects, S.A., 429 F.3d 1344, 1355 (Fed. Cir. 2005).

112. Educ. Logistics, Inc. v. Laidlaw Transit, Inc., 2012 WL 761950, at *1 (D. Mont. Mar. 8, 2012).

113. *Id.* at *5.

114. *Id.*

115. *Id.* at *7.

courts' obligation to act as a gatekeeper and exclude speculative, unreliable expert testimony.[116] As the Supreme Court stated in *Daubert*, the starting point for the court's analysis of a motion to exclude expert testimony is Rule 702 of the Federal Rules of Evidence:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.[117]

Courts have excluded expert witnesses for multiple reasons, including insufficient expertise, unsound methodology, and unfounded assumptions.[118] For example, in *Chemipal Ltd. v. Slim-Fast Nutritional Foods International, Inc.*, the court excluded an expert because he did not understand the methodology on which he relied.[119] In *Fail-Safe, LLC v. A.O. Smith Corp.*, the court found the expert's methodology was "utterly unreliable" where he "cherry picked" evidence about market share for pool pump motors.[120] In *Capital Metropolitan Transportation Authority/Central of Tennessee Railway & Navigation Co. v. Central of Tennessee Railway & Navigation Co.*, the court excluded expert testimony because the expert's lost-profit calculations were premised upon unfounded assumptions.[121] Countless other examples exist, all of which demonstrate that proving "reasonable certainty" is a difficult endeavor that often requires significant brainpower and expense. The party that allows its expert to consider and explain all of the possible relevant information will likely be much more successful than the party that tries to ignore the potential problems with its calculations.

V. New Businesses and Lost Profits—the New Business Rule

As noted earlier, measuring lost profits can be particularly tricky in cases where the plaintiff is a relatively new business venture without historical data regarding its profitability.[122] Many courts have traditionally refused to award lost-profits damages in this context, often because such profits are too remote, contingent, and speculative to meet the legal standard of reasonable certainty.[123]

116. Kumho Tire Co., Ltd. v. Carmichael, 526 U.S. 137 (1999); Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579 (1993).

117. Fed. R. Civ. P. 702; *Daubert*, 509 U.S. 579.

118. Stewart I. Edelstein, Daubert *and Lost-Profits Testimony When Lost Profits Are an Issue, Both Parties' Experts Will Face the Judicial 'Gatekeeper.' Study the Case Law to Understand Who Will Be Admitted and Who Will Be Stranded Outside*, Trial, Sept. 2005, at 31.

119. Chemipal Ltd. v. Slim-Fast Nutritional Foods Int'l, Inc., 350 F. Supp. 2d 582, 592 (D. Del. 2004).

120. Fail-Safe, LLC v. A.O. Smith Corp., 744 F. Supp. 2d 870, 891 (E.D. Wis. 2010).

121. Capital Metro. Transp. Auth./Cent. of Tenn. Ry. & Navigation Co. v. Cent. of Tennessee Ry. & Navigation Co., 114 S.W.3d 573, 582 (Tex. App. 2003).

122. *Id.*

123. *Id.*

Under this "new business rule," courts considered claims for lost profits of a newly established business inherently speculative and, therefore, unrecoverable.[124] In other words, if a business does not have a history of profitable operations, lost-profit damages have been generally unavailable.[125]

In recent years, however, many courts have moved away from or even abandoned this general rule and instead have considered the quality of the evidence presented to determine whether the plaintiff has demonstrated a supported basis for a reasonable estimate of its damages.[126] The majority of jurisdictions have now rejected the new business rule as a *per se* rule of exclusion of all lost-profits damages when the lost profits can be proven with reasonable certainty, regardless of whether the claimant is a new business.[127] Instead, the majority of jurisdictions follow a rule whereby a new business can recover damages for lost profits when they are proven with reasonable certainty. In those situations, the age of the business is only one relevant factor in assessing the certainty of the proof.[128] Many courts have also started to characterize this issue as a factual, not legal, issue.[129] These shifts appear to

124. Jim Kern, *4 Common Misperceptions About Lost Profits Claims*, Gross Mendelsohn, https://www.gma-cpa.com/blog/4-common-misperceptions-about-lost-profits-claims (last visited Sept. 24, 2019); Dunn, *supra* note 74; Hickman v. Coshocton Real Est. Co., 58 Ohio App. 38 (1936) (absent a history of past profits, future profits seemed too "uncertain and speculative," particularly in the progress-oriented atmosphere of the late 1800s when rules defining damages were first developed).

125. Victor P. Goldberg, *The New Business Rule and Compensation for Lost Profits*, CLS Blue Sky Blog (Mar. 28, 2019), http://clsbluesky.law.columbia.edu/2019/03/28/the-new-business-rule-and-compensation-for-lost-profits; Cal. Press Mfg. Co. v. Stafford Packing Co., 192 Cal. 479, 485 (1923) ("Where . . . damages by way of profits are sought for . . . interruption or prevention [of a new business or enterprise] the rule is that they will be denied, for the reason that such business is an adventure as distinguished from an established business, and its profits are speculative and remote, existing only in anticipation. The rule is one of necessity. Damages must be certain of ascertainment. If one engages in a new industry, there are no provable data of past business from which the fact can be legally deduced that anticipated profits would have been realized.").

126. Kern, *supra* note 124; Carmen D. Caruso & Bruce S. Schaeffer, *Damages for Lost Future Profits in Franchise Disputes—Overcoming the New Business Rule and Establishing Reasonable Certainty*, 36 Franchise L.J. 1, 6 (2016); *see also* W.W. Gay Mech. Contractor, Inc. v. Wharfside Two, Ltd., 545 So. 2d 1348 (Fla. 1989); AGF, Inc. v. Great Lakes Heat Treating Co., 555 N.E.2d 634 (Ohio 1990); Iron Steamer, Ltd. v. Trinity Rest., Inc., 110 N.C. App. 843 (1993); Given v. Field, 484 S.E.2d 647 (W.Va. 1997); Beverly Hills Concepts v. Schatz & Schatz, 247 Conn. 48 (1998); Neb. Nutrients, Inc. v. Shepherd, 261 Neb. 723 (2001); Kids' Universe v. In2Labs, 95 Cal. App. 4th 870 (2002); BMK Corp. v. Clayton Corp., 226 S.W.3d 179 (Mo. Ct. App. 2007) (rejecting the new business rule as an absolute); Va. Code Ann. § 8.01-221.1 ("Damages for lost profits of a new or unestablished business may be recoverable upon proper proof. A party shall not be deemed to have failed to prove lost profits because the new or unestablished business has no history of profits. Such damages for a new or unestablished business shall not be recoverable in wrongful death or personal injury actions other than actions for defamation.").

127. Goldberg, *supra* note 125.

128. Schonfeld v. Hilliard, 218 F.3d 164 (2d Cir. 2000); Hog Slat, Inc. v. Ebert, 104 F. Supp. 2d 1112 (N.D. Iowa 2000); KW Plastics v. U.S. Can Co., 131 F. Supp. 2d 1265 (M.D. Ala. 2001).

129. Bernadette J. Bollas, *New Business Rule and the Denial of Lost Profits*, 48 Ohio State L.J. 855 (1987); Everett Gee Warner & Mark Adam Nelson, *Recovering Lost Profits for an Unestablished Business Under Georgia Law: The New Business Rule Bows to MECCA*, 39 Mercer L. Rev. 977 (1988).

be a result of changing attitudes towards jurors and a focus on the inherent injustice to new businesses under the new business rule.[130]

Courts have recognized that a successful franchise model may supply sufficient evidence to achieve reasonable certainty with respect to lost-profits claims in cases that might previously have been subject to the new business rule.[131] For example, the U.S. District Court for the Northern District of Illinois stated that "[c]ourts are willing to entertain lost profit calculations based upon historical data from franchise operations, even when those calculations also included the business owner's assumptions, and sometimes, when the business had not yet begun operation."[132] Indeed, a leading treatise on damages law has argued that a franchise in a proven brand is not a new business, at all:

> The supposed rule that lost profit damages of an unestablished business were not recoverable would seem to be least justifiable when the business to be established is a location for a national franchise. Each store is cast from the same mold. The locations are rigidly controlled by the national franchisor. Projections are readily available based on extensive experience in other stores from which sales and profits can be derived with a high degree of certainty. These projections are the basis for the franchisor's selection of the new location and the franchisee's investment in it. If the figures are good enough for the parties to invest their money, it would seem that they should be good enough for the court.[133]

This argument is premised on "the theory that one franchise unit is a 'yardstick' for anticipating results at a new unit to be opened in the same system."[134] Applying this theory, the Kentucky Supreme Court allowed a KFC franchisee to recover lost profits for units that were never built after finding consumer acceptance of the brand, national advertising, uniform quality control, earnings and expense figures on nearby, comparable locations, and an available history concerning success and failure ratios as persuasive in showing potential profits.[135]

Similarly, in *Super Valu Stores, Inc. v. Peterson*, the Alabama Supreme Court reversed a summary judgment for a defendant based on the new business rule. There, the court determined that a nationwide franchise system provided sufficient data to support the recovery of lost profits and expressly held that it would be inequitable to deny the franchisee lost profits where the franchisee produced "the best evidence available," which was a reasonable basis for estimating the claimed losses.[136]

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130. *Id.*

131. Caruso & Schaeffer, *supra* note 126, at 7.

132. FMS, Inc. v. Volvo Constr. Equip. N. Am., Inc., 2007 U.S. Dist. LEXIS 19517, at *31 (N.D. Ill. Mar. 20, 2007).

133. Dunn, *supra* note 74, § 4.7 (citing Smith Dev. Corp. v. Bilow Enters., 308 A.2d 477, 483 (R.I. 1973)) (allowing a McDonald's franchisee who was blocked from opening his unit to recover lost profits).

134. Caruso & Schaeffer, *supra* note 126, at 7.

135. Pauline's Chicken Villa, Inc. v. KFC Corp., 701 S.W.2d 399, 401–02 (Ky. 1985).

136. Super Valu Stores, Inc. v. Peterson, 506 So. 2d 317, 330 (Ala. 1987) (cited with approval by the Seventh Circuit in Mid-Am. Tablewares v. Mogi Trading Co., 100 F.3d 1353, 1365 (7th Cir. 1996)).

Importantly, however, while successful franchise systems may afford a franchisee the opportunity to rely on the success of the overall brand to avoid application of the new business rule,[137] unsuccessful franchise systems may not. For example, in *Otis v. Doctor's Associates, Inc.*, the U.S. District Court for the Northern District of Illinois rejected a lost-profits claim based on an unbuilt franchised restaurant.[138] The court described the unbuilt units as potentially being a part of a "failed fast food franchise known as Cajun Joe's Chicken."[139] When determining whether a new or unbuilt franchisee is considered a new business under the new business rule, "[t]he critical dispositive factor appears to be . . . whether the performance of the brand, as a whole, provides sufficient data to overcome new business concerns. The brand as a whole, not the particular units that were never built, is the alleged new business being evaluated."[140] Based upon the court's evaluation of the Cajun Joe's brand, it declined to permit the franchisee to collect lost future profits because the brand was a brand new fast-food franchise without a history of losses or profits and, thus, subject to the new business rule. The court further found that, even if the new business rule had not precluded the plaintiff's theory of lost profits, the plaintiff failed to offer sufficient evidence to establish the reasonable degree of certainty necessary to obtain future lost profits.

Many states have taken a middle-ground approach. States taking the middle-ground approach to lost-profit damages often follow the new business rule but do not determine it as absolute. These states will apply the new business rule where the case involves a new business but will not automatically bar the new business from recovering lost-profit damages. New businesses in middle-ground states are given a chance to present evidence to prove their lost profits.[141] Other middle-ground states have not wholly abrogated the new business rule, but have either limited its effect through implementation of various exceptions to the rule or have used creatively used ways to avoid using it.[142]

137. Smith Dev. Corp. v. Bilow Enters., 112 R.I. 203, 214 (1973) (holding that a McDonald's marketing research manager testifying to the uniformity of procedures utilized at all McDonald's restaurants, its training and national advertising programs, the efforts made to maintain standards and quality and that the number of restaurants almost doubled by the time of trial and none of them failed was sufficient to establish reasonable certainty as to lost profits); *Pauline's Chicken Villa*, 701 S.W.2d at 401 (finding a franchise is sufficiently similar to other franchise outlets to negate nearly all uncertainty of lost profits).

138. Otis v. Doctor's Assocs., Inc., 1998 U.S. Dist. LEXIS 15414 (N.D. Ill. Sept. 10, 1998).

139. *Id.* at *1.

140. Caruso & Schaeffer, *supra* note 126, at 8.

141. Harsha v. State Sav. Bank, 346 N.W.2d 791, 797, 798 (Iowa 1984) (finding that the new business rule is not absolute and that if "factual data are presented which furnish a basis for compilation of probable loss of profits, evidence of future profits should be admitted and its weight, if any, should be left to the jury"); *No Ka Oi Corp. v. Nat'l 60 Minute Tune*, 71 Wash. App. 844, 849 (1993) (allowing recovery where "a reasonable estimation of damages can be made based on an analysis of the profits of identical or similar businesses operating under substantially the same market conditions").

142. Malatesta v. Leichter, 186 Ill. App. 3d 602 (1989) (applying an exception where the new business was prevented from acquiring the operations from an existing business); Milex Prods.,

Although there is not a uniform decision among courts regarding abandoning or maintaining the new business rule, there most certainly is a common trend in courts moving away from applying the new business rule, whether that is in the form of carving out exceptions or wholly abandoning the rule. With the trend moving in this direction, new businesses may have a chance at successful lost-profits claims as long as they have sufficient evidence to prove lost profits. This even holds true for new locations of established franchise chains. Franchisees have been successful in lost-profits claims for unbuilt or unopened locations of successful franchise chains.

Expert testimony may also avoid applications of the new business rule.[143] In all circumstances, the plaintiff must present sufficient evidence to demonstrate with reasonable certainty that it would have made a profit.[144] "Damages may be established with reasonable certainty through economic and financial data, market surveys and analyses, business records and experience of similar businesses, experience of the business owner, and through expert testimony."[145] When faced with quantifying lost profits for new businesses with little or no history of earnings prior to the breach, quantification of lost profits becomes more of a challenge. Fortunately, the widespread application of the "reasonable certainty" standard allows several methods of quantifying damages without the requirement of complete and absolute certainty as to amount.[146]

In sum, the new business rule traditionally made it very difficult, and many times impossible, for new businesses to be awarded lost-profit damages. But many courts have moved away from a strict reading of the rule, thereby permitting, new businesses, including new franchisees, to be awarded lost-profit damages if their evidence is sufficient to meet the "reasonable certainty" standard.

Inc. v. Alra Labs., Inc., 237 Ill. App. 3d 177 (1992) (applying exceptions to the rule where the new business planned to sell a product that is indistinct from an existing product); Lockheed Info. Mgmt. Sys. Co. v. Maximus, Inc., 259 Va. 92, 109–10 (2000) (finding that because the claimant was engaged in the relevant industry in other jurisdictions, its thwarted entry into the Virginia market did not constitute a new business); Jamsports & Entm't, LLC v. Paradama Prods., Inc., 336 F. Supp. 2d 824 (N.D. Ill. 2004) (applying exceptions where the new business lost profits were actually quantifiable); Amco Ukrservice v. Am. Meter Co., 312 F. Supp. 2d 681, 694 (E.D. Pa. 2004) (citing Delahanty v. First Pa. Bank, NA, 464 A.2d 1243 (Pa. 1983)) (recognizing an exception for "a new business that can show a 'significant interest' in its product or service"); RSB Lab. Serv., Inc. v. BSI, Corp., 847 A.2d 599, 613 (N.J. App. Div. 2004) (holding that, for purposes of the new business rule, a center that drew blood to be tested by third-party laboratories was not establishing a new business in attempting to in-source blood-testing services to a newly formed related entity); Holland Loader Co. LLC v. FLSmidth A/S, 769 F. App'x 40, 43 (2d Cir. 2019) (stating that it "is not a per se rule forbidding the award of lost profits damages to new businesses, but rather an evidentiary rule that creates a higher 'level of proof needed to achieve reasonable certainty as to the amount of damages'").

143. Kern, *supra* note 124.

144. *Id.*

145. *Id.*

146. Antrim Pharm. LLC v. Bio-Pharm, Inc., 310 F. Supp. 3d 934, 945 (N.D. Ill. 2018) (finding that expert testimony was sufficient to overcome the new business rule in a motion for summary judgment).

VI. Disclaiming Lost-Profits Damages

Because lost-profits awards are so often difficult to calculate or even estimate ahead of time, and because such awards can potentially be very large, many parties, including franchisors, seek to limit them prospectively in their contracts. Such lost-profits-damages disclaimers can serve as an important tool to allocate risk.

Contractual lost-profits-damages disclaimers are generally enforceable.[147] When constructing a lost-profits disclaimer, it is important to understand that lost profits can be considered as either direct or consequential damages. Consequential damages represent loss or injury that does not flow directly and immediately from the wrongful act of a party, but are the consequence or result of such act.[148] Lost profits are consequential damages when, because of the breach, the non-breaching party suffers loss of profits on collateral business arrangements.[149] Direct damages (or general damages) are those that are caused directly by the wrongful conduct.[150]

For example, in *Stern Oil v. Brown*, the Supreme Court of South Dakota found that a fuel distributor's alleged lost profits arising from the convenience store operator's failure to pay for fuel under the parties' fuel agreement were direct damages.[151] The court explained that the agreements granted defendant the right to use ExxonMobil proprietary marketing material and sell ExxonMobil-branded fuel, and defendant acknowledged that Stern Oil had a relationship with ExxonMobil which allowed it to purchase ExxonMobil fuel and sell it to Brown.[152] Importantly, all Stern Oil's profits arose from the sale of fuel by Stern Oil to Brown.[153] Conversely, in *Atlantech Inc. v. American Panel Corp.*, the Court of Appeals for the First Circuit found lost sales of LCD displays to third parties arising from a breach of the parties' agreement were consequential damages because they were not "necessarily inherent in the contract."[154] Thus, when determining whether lost profits are direct or consequential, the necessary question is whether the damages flow from the contract itself, or from a separate agreement with a nonparty.

The characterization of lost profits as either direct or consequential may be dispositive based on the language of the contractual disclaimer. For example, in *Westlake Financial Group, Inc. v. CDH-Delnor Health System*, the Court considered the following disclaimer:

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147. *See*, *e.g*., Quicksilver Res., Inc. v. Eagle Drilling, LLC, 2009 WL 1312598, at *7 (S.D. Tex. May 9, 2009); Fish Net, Inc. v. ProfitCenter Software, Inc., 2013 WL 5635992, at *10–11 (E.D. Pa. Oct. 15, 2013).

148. Hartford Acc. & Indem. Co. v. Case Found. Co., 10 Ill. App. 3d 115, 124 (1973).

149. Unilever United States, Inc. v. Johnson Controls, Inc., 2017 WL 622209, at *4 (N.D. Ill. Feb. 15, 2017) (applying New York law).

150. Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).

151. Stern Oil Co. v. Brown, 908 N.W.2d 144, 153 (S.D. 2018).

152. *Id.*

153. *Id.*

154. Atlantech Inc. v. Am. Panel Corp., 743 F.3d 287, 294 (1st Cir. 2014).

> *Limitation of Liability*. Except with respect to the indemnification and confidentiality obligations contained in this Agreement or any Exhibit hereunder, without limitation to the foregoing, under no circumstances shall either party be liable to the other party for any *indirect*, *incidental*, *consequential*, *special*, *punitive or exemplary damages*, even if either party has been advised of the possibility of such damages, arising from this Agreement, *such as*, *but not limited to*, *loss of revenue or anticipated profits or lost business.*[155]

This case considered whether the disclaimer prevented an award of *any* lost profits, or just incidental or consequential lost profits.[156] The Court ultimately agreed with the plaintiff and found that the plain reading of the clause disclaimed only indirect, consequential damages from lost profits, but not direct lost profits.[157] Similarly, in *Penncro Associates, Inc. v. Sprint Spectrum, LP*, the court found that a provision excluding consequential damages "includ[ing], but . . . not limited to, lost profits" only limited consequential lost-profit damages.[158] Lost profits as a whole were not singled out as a distinct type of damage and, therefore, not precluded from recovery in their entirety.[159]

Conversely, in *Quicksilver Resources, Inc. v. Eagle Drilling, LLC*, the provision stated that the "parties [have] agreed that special, indirect or consequential damages shall be deemed to include, *without limitation*, . . . loss of profit or revenue; . . . [and] cost of loss of use of property, equipment, materials and services, including without limitation those provided by contractors and subcontractors of every tier or by third parties."[160] The court held that this provision manifested a clear intent by the parties to modify the legal meaning and breadth of the term *consequential damages*.[161] The court found that the wording in *Penncro* implied that other unlisted damages could also be considered consequential damages and, as a result, where the provision at issue stated that the listed damages were to be considered special, indirect, or consequential, "without limitation," only those specifically enumerated damages categories were barred from recovery.[162]

In *Biotronik A.G. v. Conor Medsystems Ireland, Ltd.*, the provision excluding consequential damages precluded only consequential lost profits, not direct lost profits because it neither specifically precluded recovery for lost profits, nor did it explicitly define *lost profits* as consequential damages.[163] The issue, then, was whether the lost profits were consequential damages.[164] The plaintiff, the manufacturer and distributor of medical devices, had an agreement

155. Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).
156. *Id.* at 1175.
157. *Id.* at 1177.
158. Penncro Assocs., Inc. v. Sprint Spectrum, LP, 499 F.3d 1151, 1155 (10th Cir. 2007).
159. *Id.* at 1157–58.
160. Quicksilver Res., Inc. v. Eagle Drilling, LLC, 2009 WL 1312598, at *5 (S.D. Tex. May 9, 2009).
161. *Id.* at *7.
162. *Id.*
163. Biotronik A.G. v. Conor Medsystems Ireland, Ltd., 22 N.Y.3d 799, 805 (2014).
164. *Id.*

with Conor Medsystems Ireland, Ltd., the developer and manufacturer of CoStar, a drug-eluting coronary stent, whereby the plaintiff was the exclusive distributor of CoStar for a defined territory.[165] The defendant ultimately recalled CoStar, and the plaintiff sued the defendant for breach of the agreement,[166] seeking, *inter alia*, lost profits related to the resale of the stents.[167] The court analyzed other cases and found that "the distinction at the heart of these cases is whether the lost profits flowed directly from the contract itself or were, instead, the result of a separate agreement with a nonparty."[168] The court ruled that the agreement clearly contemplated that the plaintiff would resell the stents.[169] Thus, plaintiff was entitled to recover because lost profits resulting from a breach constituted general damages.[170]

Lost-profit disclaimers can be a valuable tool for franchisors. But it is important to consider the specific language of the disclaimer in regard to whether the franchisor is limiting only consequential lost-profit damages. One way to do this analysis is to define specifically the categories of excluded damages. Because lost profits may reflect either general or consequential damages, contracting parties should specifically define lost profits as one or the other, and the parties should consider analogously defining *anticipated savings* and other damages normally thought to be consequential in nature.

VII. Lessons Learned

In most jurisdictions, the recovery of well-grounded lost profits damages is available, especially for so-called direct damages (i.e., those flowing directly from the breach of contract). Absent contractual disclaimers, lost profits (either direct or consequential), are available if they were a foreseeable consequence of the conduct. Although doctrinal limitations still apply in some jurisdictions to claims for new enterprises, these limitations are fading. A prudent franchisor should anticipate such claims when drafting franchise agreements and assessing litigation and risk.

For a franchisee, proving lost profits will likely depend on having detailed and sufficient past financial information. Franchisees must be prepared to explain any trends in their financials or outlying financial information. Many times, a plaintiff's inability to produce financial information impairs the ability to prove its damages. The plaintiff's experts should be diligent in applying lost-profits calculations, consistent with AICPA standards, to prevent a successful *Daubert* attack on the methodology. Plaintiffs will also need to be ready to prove causation—that but-for the defendant's wrongful conduct, they would have earned a profit. In the situation where the plaintiff is the

165. *Id.* at 804.
166. *Id.*
167. *Id.*
168. *Id.* at 806.
169. *Id.* at 808.
170. *Id.*

franchisor, depending on the jurisdiction, the franchisor may not be able to prove causation for future profits if it terminated the franchise agreement.

For the franchisor defending such claims, it is helpful to obtain all information and documents relating to the plaintiff's finances for a broad time period and potential future revenue. This may include requesting documents from third parties, such as banks, accountants, and/or auditors. The franchisor should consider a pre-trial *Daubert* motion to exclude evidence of lost profits. One way for a franchisor to attack lost profits is to show that the lost profits were not proximately caused by the alleged wrongful conduct. In other words, because of some external impediment, the franchisee would not have made a profit irrespective of the breach.

For both parties, it is important to hire an expert. Plaintiffs need an expert to help them meet the standards for proving lost profits, and defendants should have an expert to rebut the plaintiff's expert. Most often, the defense expert will merely present flaws in the plaintiff's expert's testimony, rather than offering a calculation of his own. The defense expert will help lay the groundwork for filing a pretrial motion to exclude the plaintiff's expert.