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Getting Maximum Value for Franchisee and Franchisor During Condemnation Proceedings

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A recent Georgia trial illustrates certain challenges for franchisees and franchisors forced to close a location because of a transportation project. One of the most important and challenging damages to recover is the lost value of the business. While the standard of "just and adequate compensation" applies almost universally to real property damages, most jurisdictions do not allow recovery for the destruction of business value. Georgia is a minority jurisdiction because it clearly recognizes that permanent destruction of business value is a separate compensable interest. Businesses with operations in multiple states should check with counsel to determine whether their jurisdiction allows recovery of lost profits if a location is destroyed or damaged due to condemnation.

A loss of a franchised unit location damages both the franchisee and the franchisor. Though the damages may be reflected in a loss of brand strength, market penetration and customer base, legal damages are measured by lost business value. For franchisors and franchisees, the damages are two-fold. The franchisors lose the value of the franchise fee income stream and the franchisees lose the value of the business primarily created by net income. The nature of the relationship between the franchisor and franchisee creates a series of challenges in recovering such lost value.

Baker Donelson attorneys recently tried a case to a jury where the Georgia Department of Transportation condemned the leasehold interest of a nationally franchised restaurant and forced the closure and demolition of the franchised unit at that location. After the condemnation, the franchisor assigned its rights to any recovery to the franchisee-condemnee. The landlord settled the real estate value claim with the DOT and the only issue at trial concerned lost value of the business. To recover lost business value, Georgia requires that any party meet three criteria. First, did each entity operate a business at the location? Second, could the location be replaced in the immediate vicinity? Third, was the evidence sufficiently grounded in fact so as not to be remote and speculative?

Franchisors are often challenged regarding the "operates a business" test. Even though the business interests of the franchisor and franchisee are directly related with regards to gross revenues, service and product quality, and public perception of the brand as offered by the franchisee at the franchised unit, the franchisor does not operate the business literally. This hurdle is especially challenging because franchisors draft their franchise agreements, operating manuals and internal publications with a view toward avoiding the imposition of tort liability for acts and omissions of the franchisee. Fortunately, the degree of control needed for eminent domain purposes is a limited and less stringent notion than the literal meaning. A court may interpret the test to impose a degree of control significantly less extensive than what is thought to be necessary for a franchisor to be held liable for torts committed by the franchisee.

However, these competing policy goals allow condemning authorities to attack the "operates a business" assertion with any language from franchise agreements, manuals, handbooks and internal publications that may give the franchisee "wink and nod" flexibility to ignore instructions of the franchisor. Because the success of any single location is so intertwined for the franchisee and the franchisor, all internal guidance by the franchisor for the benefit of the franchisee is most helpful in the condemnation realm if it is drafted to reflect the actual degree of control the franchisor intends to assert over the operations of the franchised unit. Clear and mandatory guidance from a franchisor setting forth the revocation of a franchise for failure of a franchisee to comply with the franchisor's directives makes it difficult for a condemnor to argue that the franchisor does not "operate a business" on the site for condemnation purposes. Such clear and plain documentation effectively communicates to the court that the franchisor's system, products and trademarks are equally necessary for the affected business to operate and that the financial performance of the location is the result of the efforts of both franchisor and franchisee. The documents must communicate, without qualification, that without the franchisor, the franchisee would have no business to operate and without the franchisee, the franchisor would be unable to participate in the stream of revenue derived from percentage franchise fees related to the location.

Documenting the responsibilities of the franchisor and franchisee also assists with the determination of whether or not the business can be replaced in the immediate area. The most concrete evidence of what defines the immediate area is the trade area of the franchise defined by the franchise agreement. If a particular franchise location depends on specific population density, interstate visibility, traffic patterns and other typical site evaluation criteria, these factors help limit the trade area if they are incorporated in the franchise agreement or an ancillary document such as a site approval addendum. The better tailored to the circumstances the specific geographic trade area is for each location, the more difficult it will be for the condemnor to argue that a location could be replaced within the trade area. If the franchise agreement is silent or allows for a very large or generic trade area, it will more difficult for management and experts to testify that the business cannot be relocated within the immediate area.

The ban on remote and speculative damages is easily overcome if the business is profitable and the business records meet commercial standards for properly maintained accounting records, which are typically required by the franchise agreement. Expert valuation testimony rooted in pro forma estimates and projections make this requirement difficult to satisfy. Again, consistency in the franchisor/franchisee relationship is critical. So long as the reality of the relationship conforms to the legal documents and practical experience does not disconnect from contractual mandates, so as to undermine the credibility of the financial records, experts can formulate loss estimates based on actual information reliably created in the ordinary course of business.

Our jury trial proved it is possible to recover business value losses for both a franchisor and a franchisee when a condemnation totally destroys a business. If a jurisdiction allows recovery for these value losses, the key to a successful recovery is proving the intertwined relationship between the franchisee and franchisor. The tools of proof lie within the conventional documentation and operation of the franchise, ready to be exploited for the benefit of both franchisee and franchisor.

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