Recent Franchise Non-Compete Cases Show Unpredictability of Enforcement

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Summary: Recent cases involving attempted enforcement of covenants not to compete by franchisors show the unpredictability of the results in such cases. However, careful reading of the factual circumstances of the cases also supports the adage that "bad facts make bad law." So it behooves franchisors to check whether they have a sympathetic case on the facts when trying to enforce their non-competes.

In July 2013, in the case of Golden Crust Patties, Inc. v. Bullock, Case No. 13-CV-2241, the U.S. District Court for the Eastern District of New York "threw the book" at a recently terminated Golden Krust Caribbean Bakery & Grill Restaurant franchisee. The franchise was terminated because the franchisee was "not only selling the competitor's products (i.e., frozen Caribbean-style patties), but were selling those products using Golden Krust packaging." Thus, the franchisee was engaging in a classic form of trademark piracy, likely to cause harm to the brand. Despite receiving an immediate termination notice, the franchisee only stopped using the trademarks after Golden Krust filed suit. Even then, rather than adopting a new name it put up a sign reading, "Come in. We are Open. Nothing has Changed Only Our Name"; and another sign that read: "Open. Same Great Food, Same Great Service. Thanks for Your Support!!! Come Again."

Under those circumstances, the court enjoined the former franchisee and her son, who had managed the restaurant, from continued operation of a Caribbean-style restaurant. In its order the court, acting under New York law, enjoined such operations at the former franchised location and within 4 miles of it (rather than 10 miles, as written in the contract), or within 2.5 miles of any other Golden Krust restaurant (rather than 5 miles, as written in the contract). While giving them a bit of a break on the geographic extent of the non-compete, the court overall had no sympathy for the franchisee's arguments of harm to their livelihood, including the possibility that their landlord would not allow them to operate a different type of restaurant at the leased premises; rather, the court found that to be a harm of the former franchisee's own making.

In September of this year, in the case of Steak 'N Shake Enterprises, Inc. v. Globex Company, LLC, the U.S. District Court for the District of Colorado found that the franchisor had good cause to terminate and force its Denver franchisee to cease use of the trademarks, but did not find cause to enjoin the former franchisee from violating the covenant not to compete. The cause for termination was that the franchisee refused to comply with the franchisor's demand that it offer a "$4 value menu" and instead insisted on charging higher prices. The court held that Steak 'N Shake had good cause to terminate the franchise and enjoined continued use of the Steak 'N Shake trademarks, trade dress and menu item names.

However, the court did not order the former franchisee to refrain from operating a similar restaurant, finding that, because the next closest Steak 'N Shake restaurant was in Colorado Springs (about 100 miles away) and the franchisor had no prospects to open up any Denver area locations in the near future, it could not prove irreparable harm if the former franchisee continued to operate. This decision does not preclude the franchisor from seeking damages due to violation of the covenant not to compete later in this case. While not expressly stated in the opinion, it is quite possible that the court may have been swayed by the fact that Steak 'N Shake was requiring that an enormous number of meals be offered for $3.99, which likely would mean little or no profit to the franchisee on those sales. In other words, Steak 'N Shake had a right to insist that restaurants using its name follow its pricing demands, but if it chose to terminate on those grounds it would have to suffer repercussions.

Finally, on August 6, 2013, in the case of Outdoor Lighting Perspectives Franchising, Inc. v. Patrick Harders, the North Carolina Court of Appeals affirmed a state trial court ruling denying enforcement of a post-expiration covenant not to compete by a North Carolina based franchisor against its former franchisee in northern Virginia. In so doing, the court wrote, "During the time in which Mr. Harders operated as an OLP franchisee, entities holding OLP franchises encountered numerous problems with OLP suppliers. Since [Outdoor Living Brands] purchased [the franchisor] in 2008, numerous franchises have closed and the OLP business model has been devalued. Among other things, [the franchisor] failed to provide its franchisees with adequate support, feedback, and product innovation. Although the information provided to Mr. Harders and OLP-NVA by [the franchisor] was alleged to be proprietary, much of it was publicly available and common knowledge in the industry.

Similarly, the training that Mr. Harders had received from [the franchisor] was readily available without charge in many national home improvement stores.

Once the court laid out the facts in this manner, it was obvious that it would rule against the franchisor. It did so in a fairly creative manner, seizing on the fact that the non-compete prohibited the non-renewing franchisee from engaging in a "competitive business" within any "Affiliate's territory." At the time of the franchise agreement, the franchisor was only involved in Outdoor Lighting Perspectives, but during the term the franchisor was purchased by OUtdoor Living Brands, which also owned the Mosquito Squad® and Achadeck® franchise systems. While the likely purpose of restricting competition with "affiliates" was to protect Outdoor Lighting Perspective businesses owned by the Franchisor's corporate siblings, and the franchisor was not seeking to enjoin the former franchisee from competing with later-acquired affiliates in unrelated fields, the literal language of the non-compete supported an argument that it was overbroad in its geographic scope.

The court also found that the definition of a prohibited "Competitive Business" under this non-compete was overly broad. It prohibited involvement in "any business operating in competition with an outdoor lighting business" or "any business similar to the Business." The provision's scope could prohibit the former franchisee from operating an indoor lighting business or "obtaining employment at a major home improvement store that sold outdoor lighting supplies, equipment tor services as a small part of its business even if he had no direct involvement" in that part of the operation. The appeals court affirmed the trial court's decision to read the provision literally and therefore refuse to enforce it in any manner, rather than entering a more limited injunction prohibiting the former franchisee from operating or managing an outdoor lighting business.

Conclusion

These court rulings demonstrate the "bad facts make bad law" truism. The Golden Krust franchisor had a sympathetic case and a franchisee acting badly; in the Steak 'N Shake case, the parties clearly needed to go their separate ways, but the franchisor's inflexibility persuaded the court to allow the franchisee to operate independently, at least pending a full trial; and the Outdoor Lighting franchisor, despite litigating in its "home court," apparently had such an unimpressive franchise system that the court was unwilling to fashion an equitable remedy when confronting an overly broad non-compete. These cases should make franchisors think carefully about the situations in which they seek to enjoin competition by their former franchisees.