Operation Of Competing Brands Upheld Again

By James C. Rubinger

James C. Rubinger

In this era of mergers and acquisitions, it should not be surprising that many franchise companies own and operate multiple brands. In some cases, these brands do not compete directly with one another, but are considered complementary, operate in different geographic markets, or are completely unrelated. In many cases, however, franchise companies have acquired brands that operate in the same market segment as an existing brand, and the two brands compete directly in at least some geographic markets.

When franchise companies operate directly competing brands, franchisees of one or both brands frequently object that they are being forced into head-to-head competition with their own franchisor. Franchisees contend that they are placed at a competitive disadvantage when their franchisor is, or controls, a competitor. Franchisees also often believe that their brand is the disfavored "stepchild" of the franchisor; that advertising, product development, or other aspects of the business are skewed to the other brand; or that they are restrained in some manner from competing as they would like.

Relatively few lawsuits, however, have arisen out of the operation of competing franchise brands under common ownership. The reported decisions provide fairly clear and seemingly obvious guidance: when the language of the franchise agreements authorizes the franchisor to operate a competing brand, the franchisor may do so; when the franchise agreements prohibit the franchisor from competing with the franchisee, the franchisor may not. The importance of drafting and of thorough pre-acquisition due diligence are underscored by these cases.

The most recent of these cases is *Hanson Hams, Inc. v. The HBH Franchise Company, LLC,* Bus. Franchise Guide (CCH)¶ 13,093 (S.D. FL 2004). Hanson, a franchisee of the HEAVENLY HAMS system, asserted a claim under the Florida Little FTC Act arising out of the acquisition of that system by a subsidiary of the franchisor of the HONEYBAKED HAM system. Hanson sued only the franchisor of the HONEYBAKED HAM system, not its own franchisor. Hanson alleged that the common ownership of the two systems "'pits franchise siblings against one another while placing the parent [Defendant] … in a position where it can favor (and has favored) one franchise system over the other by way of promotion, development and support'."

Hanson argued that it was entitled to the same purchasing, advertising, shipping, and other benefits afforded HONEYBAKED HAM franchisees. The court held that it was not a violation of the Little FTC Act to treat two different brands differently, where there was a business justification for the disparate treatment. The court held that it was not "immoral, unethical, oppressive, or unscrupulous" for a franchisor to treat two related, but competing, entities differently, particularly when the "favored" entity was larger and generated higher average sales. The court concluded:

> Carried to its logical conclusion, [Hanson's] argument would entitle every acquired entity to enjoy the same benefits as the acquiring entity, lest the [Little FTC Act] be violated, regardless of the comparative size, revenue, and purchasing power of the respective entities. As applied to the facts of this case, such an entitlement "would be tantamount to subsidizing the Heavenly Ham system with money generated by the HoneyBaked Ham System. There exists no support, legal or otherwise, for such an entitlement."

The court rejected Hanson's premise that the franchisor intended to destroy the HEAVENLY HAM system as implausible and unsupported by the facts. The court observed that in none of the areas in which the HEAVENLY HAM franchisees allegedly received worse treatment than HONEYBAKED HAM franchisees had the policy in either system changed since the acquisition. The court held: "The Court perceives no reason why Defendant's pre-acquisition conduct, which was wholly unrelated to the Heavenly Ham system and which [Hanson] has nowhere suggested was improper, could suddenly be rendered unlawful by virtue of the Defendant's acquisition of [Hanson's] franchisor."

The *Hanson* court also emphasized that there was no breach of the franchise agreement. In rejecting Hanson's argument that *Gossard v. Adia Services,* 723 So. 2d 182 (Fla. 1998) (discussed below) was controlling, the Court held that, unlike Gossard, Hanson had neither alleged nor proven a breach of its franchise agreement. To the contrary, the franchise agreement expressly authorized the franchisor to "merge, acquire, joint venture or affiliate with any existing franchise business, whether competitive or not."

The Court also rejected Hanson's contention that it had been damaged by the franchisor's decision to suspend the sale of HEAVENLY HAM franchises. Hanson argued that this decision rendered it unable to sell its business. But, as the Court observed, Hanson never enjoyed a contractual right to open additional franchises, but had only a single store franchise agreement. Hanson, therefore, never had the ability to sell expansion rights to a buyer because it had none.

The result in *Hanson* is consistent with earlier cases involving parallel operation of competing systems. The merger in 1989 between the POPEYES and CHURCH'S chicken chains led to several lawsuits. In each case, the franchisor's right to own and operate franchise systems that compete in the same market segment was upheld. The only one to reach the appellate level, *Clark v. America's Favorite Chicken Company,* 916 F. Supp. 586 (E.D. La. 1996), *aff'd*, 110 F.3d 3d 295 (5th Cir. 1997), provides useful analysis.

(continued on page 6)

Operation Of Competing Brands Upheld Again *(continued from page 5)*

In *Clark*, POPEYES franchisees in Detroit complained that the common ownership of the two systems placed them in direct competition with the franchisor's company-owned CHURCH's units. The franchisees contended that the franchisor "repositioned" the two systems to prevent their POPEYES restaurants from competing for the "low-end" market. The franchisees asserted claims for breach of the express and implied provisions of the franchise agreement and unfair trade practices under the Louisiana Little FTC Act.

The district court granted the franchisor's motion for summary judgment, and the Fifth Circuit affirmed. The *Clark* courts focused on the language of the franchise agreement that expressly reserved to the franchisor the right to operate "other franchise systems for the same, similar, or different products or services" using proprietary marks not licensed to the franchisee. The courts held that this language unambiguously gave the franchisor the right to operate a competing franchise system.

The *Clark* courts further held that the "positioning" of the two brands did not constitute a breach of contract because the franchise agreement gave the franchisor broad discretion over advertising and menu selection. The Court of Appeals emphasized the absence of any bad faith or ill motive on the franchisor's part, stating that there was no evidence that the franchisor had treated the Detroit market differently from any other, intended to injure the POPEYES system (or what motive it would have to do so), or had in fact "manipulated" the two systems. This evidence (or lack thereof) also compelled the courts to conclude that there was no unfair trade practice in violation of the Little FTC Act.

The only case holding that a franchisor's acquisition and operation of a competing franchise system could be improper is also instructive. In *Gossard v. Adia Services, Inc.*, 723 So. 2d 182 (Fla. 1998), the United States Court of Appeals for the Eleventh Circuit certified the following question to the Florida Supreme Court:

> Whether Florida Law recognizes a claim for tortious interference against a corporation which purchases as a subsidiary corporation which has a preexisting obligation not to compete against its franchisee, plaintiff herein, and subsequently purchases another subsidiary which is in direct competition with the franchisee?

Gossard was a NURSEFINDERS franchisee, whose franchise agreement provided that "neither Nursefinders nor any person or firm authorized or licensed by it shall establish an office for the purposes of providing competing services within the franchise territory." The parties orally agreed that "neither Nursefinders, nor its parent or affiliates, would provide similar services within the franchise territory." Several months after Gossard executed his franchise agreement, Nursefinders was acquired by Adia. Subsequently, Adia acquired Star-Med, a direct competitor of Nursefinders, which had locations within Gossard's territory.

Gossard sued, alleging that by purchasing Star-Med, Adia had caused Nursefinders to breach its agreement not to compete with Gossard. The Florida Supreme Court concluded that, by acquiring Star-Med, Adia had "knowingly caused Nursesfinders to be in breach of its 'promise' to Gossard that neither a parent nor affiliate would provide similar health care services within Gossard's territory." The Court held that those allegations established a prima facie case of tortious interference. After the Florida Supreme Court's decision, the Eleventh Circuit reversed the trial court's entry of judgment as a matter of law for Adia.

The reasoning of each of these cases demonstrates the importance of the terms of the franchise agreements. In *Hanson* and *Clark*, the language of the franchise agreements was critical to the decision upholding the franchisor's acquisition and operation of a competing brand. In *Gossard*, the language of the franchise agreement, coupled with the parties' undisputed oral extension of it, left the franchisor (or, more accurately, its acquirer) subject to liability. Cases distinguishing *Gossard* (which include *Hanson* as well as two distributorship cases, *Auto-Chlor System of Minnesota, Inc. v. Johnson Diversey,* 328 F. Supp. 2d 980, 1015 (D. Minn. 2004) and *Voice-Tel Enterps., Inc. v. JOBA, Inc.*, 258 F. Supp. 2d 1353, 1369 (N.D. Ga. 2003) have done so on the basis that, unlike *Gossard*, there was no contractual prohibition on the operation of a competing brand.

The implications for the drafting of franchise agreements are obvious. But, by the time a franchise company gets to the point of acquiring a competing brand, it is too late to solve any drafting issues. Due diligence in the acquisition process therefore becomes critical. When the franchise agreements of either the acquiring or the acquired brand do not contain language authorizing the operation of competing brands, the acquiring company must take business steps to alleviate the legal problem, prepare to accept potential liability, or abandon the acquisition. A franchisor that does its legal homework before committing itself will be able to manage this problem successfully.

James C. Rubinger is a partner in the Washington, DC firm of Wiley Rein & Fielding LLP. The author was lead counsel for the franchisors in the Hanson and Clark cases discussed in this article.