PILLOW TALK:

Can Spouses Own Competing Franchise Businesses?

by Justin Klein

"Pillow talk" is loosely explained by one source as the "relaxed, intimate conversation that often occurs between two sexual partners after sexual activity, usually accompanied by cuddling, caresses and other physical intimacy. It is associated with honesty, sexual afterglow and bonding […]." The sharing of one's business trade secrets does not seem to fit squarely into the mood and setting elicited by this definition. However, Dunkin' (formerly, Dunkin' Donuts), one of the world's largest coffee and baked goods chains, seems to have a different opinion. In fact, Dunkin' advanced this argument in a fascinating legal case – although the court didn't quite bite on this legal theory.

Covenants not to compete are standard in franchise agreements. Indeed, most any franchisor – small or big, new or established – would argue that non-compete agreements go to the very core of protecting the brand. Notwithstanding this belief and the franchisor's fervent attempt to stop competing franchisees, there are numerous court decisions around the United States where courts have refused for various reasons to enforce covenants not to compete in the franchise context. Many of these cases share virtually identical facts: 1) franchisee is failing or is terminated, 2) franchisee then begins operating a business that sells goods or services that are the same or similar to those offered by the franchisor, 3) franchisor sues and seeks damages and/or to enjoin the franchisee from competing. What happens next is highly

fact-sensitive and varies considerably depending on which state's law is being applied.

Notably, although many of the cases share these similar facts, there are, of course, cases that buck the trend. Dunkin' Donuts Franchising, LLC, et al. v. C3WAIN INC., et al., is one such case. In C3WAIN, Dunkin' filed suit against a New Jersey-based multi-unit franchisee alleging that the franchisee had violated the non-compete of one of his franchise agreements on the theory that his wife owned and operated a competitive business. The theory, at least initially, relied solely on the fact that the husband violated his franchise agreement simply by being married to a woman who happened to own a business that offered products for sale similar to those that the husband offered in his business. The reasoning behind the theory was that, because they were intimately involved, it was assumed that they must share sensitive business information with one another.

The C3WAIN is an important reminder to any franchisee of any system of the broad-reaching impact a non-compete provision in their franchise agreement can have. Indeed, it highlights that a non-compete can not only hinder a franchisee's ability to diversify their franchise portfolio, but it can also hinder their family members from even getting engaged in another franchised or independent business that might be the same or similar in certain respects.

Facts and Circumstances

The facts are as follows: Franchisee husband (Husband) owned several Dunkin' stores in Monmouth County, New Jersey, for over a decade, including one in the Freehold Raceway Mall. Each of Husband's franchise agreements contained a clause prohibiting franchisee from "own[ing] maintain[ing], engag[ing] in, be[ing] employed by, or hav[ing] any interest in any business which sells or offers to sell the same or substantially similar products to the type" offered by Dunkin'. In or around 2011, the franchisee's wife (Wife) independently began exploring the idea of opening a Red Mango franchise, which sells, among other things, frozen yogurt treats and frozen yogurt smoothies and, ultimately, signed a franchise agreement to operate such a Red Mango store. Unbeknownst to Dunkin', Wife decided to open her Red Mango store in the Freehold Raceway Mall in a spot adjacent to where Husband had planned on opening his newly purchased Dunkin' franchise (which would also include offerings from Baskin-Robbins, a Dunkin'-affiliated brand). Dunkin' argued that Husband's failure to advise them of his or his Wife's ownership interest in the Red Mango was fraudulent. And, in the words of the Hon. Peter J. Sheridan, who presided over the bench trial in his Memorandum and Final Judgment, Dunkin' "coyly" argued in the case that the "no-fraud provision" of Dunkin's franchise agreement triggered a cross-default and a right of termination of each of the franchisee's other franchise agreements. However, the court noted that while Dunkin's argument was "interesting," the cross-default provision of the franchise agreement was "limited to fraud."

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The Non-Compete

The Dunkin' non-compete provision at issue is as follows:

> *10.1 During the term of this Agreement, neither you nor any shareholder, member, partner, officer, director of guarantor of yours, or any person or entity who is in active concert or participation with you or who has a direct or indirect beneficial interest in the franchised business, may have a direct or indirect interest in, perform any activities for, provide any assistance to, sell any approved products to, or receive any financial or other benefit from any business or venture that sells products that are the same or substantially similar to those sold in Dunkin' Donuts or Baskin-Robbins restaurants . . .*

Dunkin's main argument in support of the franchise termination was that Husband violated the Freehold Mall franchise agreement since he had an interest in Wife's Red Mango. Dunkin' alleged that Red Mango sells similar products to that of Baskin-Robbins, which was sold in Husband's Dunkin'. According to Dunkin', both Red Mango and Baskin-Robbins are in the "frozen dessert" business and offer frozen yogurt – thus, they contended that the two sell the same or substantially similar products. Notably, under the "Terms and Conditions" for a Baskin-Robbins franchise, the franchise agreement defines "Baskin-Robbins Products" as:

> [I]ce cream, ice milk, sherbets, water ices, yogurts, frozen desserts, syrups, toppings, confections, novelties, food, beverages and fountain ingredients, all of a variety of kinds of flavors, made in accordance with the formulas or specifications designated by BASKIN-ROBBINS and identified by the Baskin-Robbins Proprietary Marks.

The court was intrigued to learn, according to testimony from a Dunkin' in-house lawyer, that Dunkin' had a written "internal policy" in place that identified what products are considered the "same or substantially similar," but that it did not distribute this policy to franchisees – rather, it kept the policy internal for management purposes. The internal policy states, "Baskin-Robbins is an ice cream and frozen treats chain, and we do not permit into the Baskin-Robbins System someone who has an interest in any ice cream or frozen treats retail business." The policy includes examples of what is deemed to be a competitor: Ice Cream Concepts (hard or soft), including Ben & Jerry's, Haagen Daz, Friendly's, Brigham's, Carvel, Dairy Queen, Swenson's; Yogurt Concepts, including TCBY Treats; and Smoothie concepts, including Planet Smoothie.

Critically, and perhaps most guiding for other franchisees in the system, was that the policy also included exceptions to the enforcement of the same or substantially similar products prohibition. Strikingly, Dunkin's internal policy even declared that some franchisees may, in fact, sell the same or similar products and not be in violation of a franchise agreement. The policy states:

> It is not our intention to preclude an operator of another restaurant or concept simply because it competes for the same day-part dollars as one or more Dunkin' Brands franchises. In a multi-brand world this would preclude the vast majority of existing operators. Accordingly, our policy does not preclude, for example, a BURGER KING® franchisee from purchasing a Dunkin' Donuts franchise simply because BURGER KING competes in the morning and sells coffee and breakfast sandwiches.

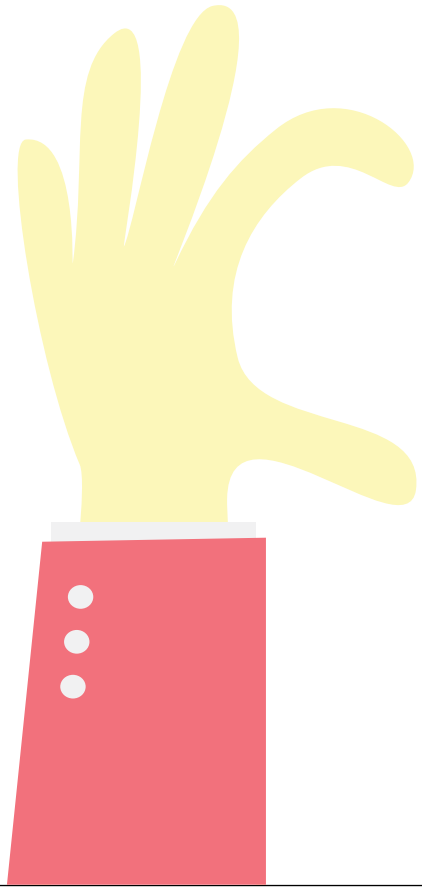
Ultimately, despite Husband and Wife's best arguments, the court found that, because both locations offered frozen yogurt for sale, the franchise agreement had been breached. Interestingly, the decision is not reconciled by the exceptions to the internal policy, which makes you wonder when it is acceptable for a franchisor to selectively enforce (or not enforce) its own internal policies on specific, contemplated matters such as this.

No Fraud, Cross-Default Provisions and a Judge With Compassion

As mentioned above, Dunkin' sought not only to terminate the Freehold Mall franchise agreement, but also each of Husband's remaining franchise agreements – the primary basis for such argument being that Husband committed a fraud on Dunkin'. Remarkably, the court decided that Husband's concealment of his ownership (which was disputed throughout) did amount to fraud in the inducement of the Freehold Mall franchise agreement. However, the court refused to cross-terminate Husband's other franchise agreements. And, in doing so, the court gave some positive real-world considerations.

First, Judge Sheridan made short shrift of Dunkin's "pillow talk" argument – noting that Dunkin's testimony on that theory was "unimpressive." Dunkin's entire "pillow talk" theory boiled down to: "Pillow talk is pillow talk, and we don't know it's not happening." Perhaps the ambiguity (as the judge called it) in that statement alone undercut their argument – but, more likely, because the court determined Husband had an interest in the Red Mango, the court did not have to analyze whether spouses with competing businesses can per se violate a non-compete simply by virtue of sharing a bedroom (which analysis would have been perhaps the most intellectually appealing part of the case). From this writer's perspective, had that theory been better developed it may have gained more traction. However, standing alone, and absent more facts, it does not appear the court was inclined to agree that spouses cannot own competing businesses as a bright line rule. Yet, it is clear that sensitive facts will likely guide any analysis in that regard.

Second, notwithstanding the termination of the competing franchise, the judge refused to enforce the cross-default



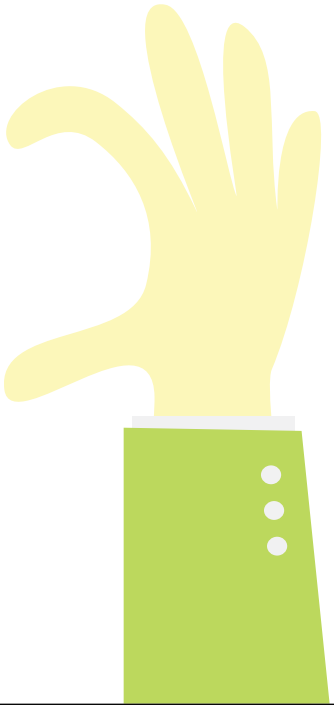
provision and terminate all of Husband's franchises because he could find no evidence of harm or injury to Dunkin' in those locations. The judge held, "[t]o enforce the franchise provisions against all the franchises when there is no proof of financial harm or injury to Dunkin' is an untenable outcome."

Third, and perhaps the most confusing aspect of the judge's decision, the judge found there to be no evidence or justification why the non-compete was being strictly enforced against Husband, but could be waived against others. As such, it is hard to reconcile the termination of any of the franchises considering that finding. Moreover, it seems likely that Dunkin', and franchisors like it, will face this argument in court again one day, as more and more families enter the franchise world and diversify their networks into multiple brands that arguably compete against one another in some form or fashion.

Lastly, and what some might see as the silver lining, Judge Sheridan was swayed by the fact that Husband and Wife were "minority-owned franchisees who have succeeded on [their] hard work[,]" and "[i]t seem[ed] unreasonable to crush the two successful small-business franchises […]." Hmmm. On that comment alone, it seems the results-oriented decision was the judge's attempt to be fair and give each party a piece of the pie (or donut as it may be).

Conclusion

In sum, while "pillow talk" may not have been the basis of the court's ultimate decision in C3WAIN, it was, quite frankly, the driving force behind this article. Knowing and understanding a non-compete in your franchise agreement, including its breadth and its scope, is critical when considering expansion outside your franchise network. It is equally important, if not more so, to also know about the business holdings of others in your family, as C3WAIN emphasizes, and to consider that in the face of any non-compete agreement. Academically, can a franchisee breach a franchise agreement by virtue of an intimate relationship? The answer is seemingly … maybe.



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