The Impact of the New Jersey Franchise Practices Act on Contracts

by Jeremy I. Silberman

Transactions between manufacturers, distributors, wholesalers, retailers, licensors, and licensees are generally at will, governed only by the contract terms negotiated by the parties. However, where the parties intentionally or unwittingly create a franchise relationship, those contract terms may be supplemented or even trumped by the protections of the New Jersey Franchise Practices Act (NJFPA). Most significantly, the NJFPA restricts the grounds for terminating or refusing to renew the relationship, thereby extending the term of the relationship beyond the period specified in the contract. These protections cannot be waived or contravened by contractual provisions; the act makes it unlawful for a franchisor to impose contract terms that violate the act or that relieve any party from liability for violating the act. Therefore, it is critical for a practitioner looking at any business relationship involving the sale of goods or services, whether in a litigation or transactional setting, to consider whether the relationship is a franchise under New Jersey law and how the NJFPA will affect the parties' agreements.

The NJFPA protects a wide range of businesses in New Jersey, far broader than the fast-food restaurants one might typically think of as franchises. Any type of business involved in the sale of goods or services can be a franchise protected by the act, as long as the relationship meets the six elements discussed below. Courts will look beyond the terminology used in the contract and apply the statutory criteria to determine whether a franchise exists, even where the contract does not mention the word franchise or where it expressly disclaims the establishment of a franchise. Parties may unintentionally establish a franchise relationship, a so-called accidental franchise. Often, it is not until one party tries to terminate the relationship that the other party discovers and asserts that it is a franchise protected under the act.

The Legislature enacted the NJFPA in 1971 to protect New Jersey businesses from overreaching by franchisors who could deprive the local business person of the benefits of his or her efforts by arbitrarily terminating the relationship or imposing onerous requirements. This purpose was reiterated by the Legislature in 2009, in the amended “Legislative Findings” portion of the statute:

The Legislature finds and declares that distribution and sales through franchise arrangements in the State of New Jersey vitally affects the general economy of the State, the public interest and the public welfare. It is therefore necessary in the public interest to define the relationship and responsibilities of franchisors and franchisees in connection with franchise arrangements and to protect franchisees from unreasonable termination by franchisors that may result from a disparity of bargaining power between national and regional franchisors and small franchisees.

Not all businesses are entitled to this protection. Rather, the act protects franchises that “are sufficiently local to merit regulation and sufficiently consequential to merit protection.”

Six Requirements to be a Protected Franchise Under the NJFPA

The NJFPA requires a two-stage analysis to determine first, whether a business relationship is a franchise as defined by the act, and second, whether it is a franchise protected by the act. A franchise exists where three elements are met: 1) there is a “written arrangement for a definite or indefinite period,” 2) “in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics,” 3) “and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.” To be protected by the act, the franchise must meet three additional requirements; the act applies only “to a franchise (1) the performance of which contemplates or requires the franchisee to establish or maintain a place of business within the State of New Jersey, (2) where
gross sales of products or services between the franchisor and franchisee...shall have exceeded $35,000.00 for the 12 months next preceding the institution of suit pursuant to this act, and (3) where more than 20% of the franchisee's gross sales are intended to be or are derived from such franchise.”

A considerable body of case law exists interpreting each of these six elements. The courts' application of even the seemingly straightforward statutory requirements reveal considerable nuances. For example, while the statute requires “a written arrangement for a definite or indefinite period in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics,” the writing itself is not required to expressly provide the license; a franchise can exist even where the written agreement is silent on the right to use the trade name. Indeed, the meaning of the term “license” in the NJFPA is different from the ordinary use of the term. Even the facially unambiguous requirement that sales between franchisor and franchisee exceed $35,000 “in the 12 months next preceding the institution of suit” was held not to bar claims brought more than 12 months after the last sale between the franchisor and franchisee, so long as sales exceeded the $35,000 annual threshold prior to termination.

Other requirements, which are less clearly spelled out in the act, provide additional room for interpretation by the courts. For example, the act requires a “community of interest in the marketing of goods or services,” yet does not define the term “community of interest.” A franchisee can meet the community of interest requirement by demonstrating it has made franchise-specific investments that will have little or no value if the franchise is lost.

Notwithstanding the complexities of determining whether a client’s proposed or existing business relationship is a protected franchise under the NJFPA, the analysis must be conducted because of the NJFPA’s effect on the parties’ agreements.

**The Effect of the NJFPA on the Term of the Relationship**

If the business arrangement is a franchise protected by the NJFPA, the act regulates important aspects of the relationship, the most significant of which are the length of the term and the grounds for termination. The act makes it unlawful for the franchisor to cancel, terminate or refuse to renew the franchise “without good cause,” and good cause is statutorily limited to the “failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.”

Because the good cause requirement applies to refusals to renew an agreement as well as terminations, the relationship is effectively automatically renewed regardless of the term specified in the contract, unless the franchisor has good cause to terminate under the statute. As stated by the New Jersey Supreme Court, “With the advent of the New Jersey Franchise Practices Act, once a franchise relationship begins, all that a franchisee must do is comply substantially with the terms of the agreement, in return for which he receives the benefit of an ‘infinite’ franchise—he cannot be terminated or refused renewal.”

Good cause to terminate a New Jersey franchisee is limited to the franchisee's wrongdoing. Thus, what might otherwise be viewed as a manufacturer’s legitimate, good faith reason to terminate a distributor, such as an overhaul of its national distribution system, is not lawful grounds to terminate its New Jersey franchisee.

The NJFPA also protects franchisees from “constructive termination,” where the franchisor does not expressly terminate the franchise, but unilaterally and substantially changes the terms of the relationship or other business conditions. “A franchisor is not permitted to accomplish a termination by indirect means that it would not be permitted to accomplish by direct means.” A franchisee can pursue an action for constructive termination under the NJFPA even though it remains in operation and the franchisor is continuing to sell its product. A franchisor also cannot circumvent the protections of the act by terminating an ancillary agreement, such as a real estate lease, which would effectively terminate the franchise.

Although the NJFPA is designed to protect franchisees from arbitrary terminations, it does not give franchisees carte blanche to disregard their obligations. The act expressly provides the franchisor with the defense that the franchisee substantially failed to comply with the requirements of the franchise and its related agreements. Courts have not hesitated to allow the termination of franchisees who substantially violated material requirements of their franchises.

A franchisor planning to terminate or decline to renew a franchise must give written notice setting forth the reasons for the termination or non-renewal at least 60 days prior to the effective date of the termination. A franchisee threatened with termination or other violation of the act can seek damages and injunctive relief from the court. The statute also includes a mandatory fee-shifting provision awarding reasonable attorneys’ fees to the successful franchisee.

**Other Practices Regulated by the NJFPA**

In addition to limiting the grounds for termination and non-renewal, the...
NJFPA injects other terms into the parties’ agreements and practices. It is a violation of the act for the franchisor “to impose unreasonable standards of performance upon a franchisee.” The statute does not define what constitutes an unreasonable standard of performance, and the courts have provided little guidance on this issue. At a minimum, a franchisor cannot deliberately create such adverse conditions that the franchisee has little choice but to terminate the relationship. Beyond such egregious circumstances, it is not always clear where the court will draw the line in determining that a standard of performance violates the act. For example, on an application for a preliminary injunction, where the distributor demonstrated the manufacturer’s new marketing program would cause the distributor to operate at a substantial financial loss, the district court found the distributor likely to succeed on the merits of a claim that the manufacturer had imposed an unreasonable standard of performance. However, in another district court case, where the franchisees argued that provisions of a new agreement substantially increased their costs, the court stated “the NJFPA does not provide for judicial review of the parties’ economic relationship.” The franchisee’s “mere disagreement with the franchisor’s standards and requirements” do not render them unreasonable.

The act also regulates the franchisee’s ability to sell, assign, or transfer its business, and the grounds for the franchisor to prevent such a transfer. The franchisee must give the franchisor written notice of the proposed transfer and provide the franchisor with the proposed transferee’s name and address, and a statement of the transferee’s financial qualification and business experience. The franchisor has 60 days to either approve or disapprove the transfer, or the transfer is deemed approved. The act limits the basis for the franchisor to withhold approval of the transfer to “material reasons relating to the character, financial ability or business experience of the proposed transferee.” The burden is on the franchisor to present credible reasons, supported by substantial evidence, for denying the transfer.

The NJFPA also bars a franchisor from: 1) prohibiting the free association among franchisees, such as the formation of a franchisee association; 2) requiring or prohibiting a change in management of the franchisee without good cause stated in writing; and 3) restricting the franchisee from transferring equity interests in the franchise to employees and certain family members, so long as there is no transfer of the controlling interest.


A franchisor cannot avoid the effect of New Jersey’s franchise act by inserting a choice-of-law provision designating another state’s laws. Because of New Jersey’s strong public policy in favor of protecting its franchisees, the NJFPA will apply regardless of the contractual choice-of-law provision. However, the choice-of-law provision will likely be enforced with regard to other claims in the case.

A choice-of-forum provision requiring a New Jersey franchisee to litigate in a court outside of New Jersey is presumed to be invalid. The New Jersey Supreme Court held:

We are persuaded that enforcement of forum selection clauses in contracts subject to the Franchise Act would substantially undermine the protections that the Legislature intended to afford to all New Jersey franchisees. We hold that such clauses are presumptively invalid because they fundamentally conflict with the basic legislative objectives of protecting franchisees from the superior bargaining power of franchisors and providing swift and effective judicial relief against franchisors that violate the Act.

A franchisor can overcome that presumption by demonstrating the forum selection clause was specifically negotiated by the parties and included in the contract in exchange for specific concessions to the franchisee, or by other persuasive proof that the clause was not imposed on the franchisee. Note, however, that the federal court, sitting in diversity, applies federal law, not state law, on a motion to transfer. If a franchisee files suit in New Jersey despite a forum selection clause specifying a court in another state, and the franchisor moves to transfer venue, the district court must apply the factors set forth in 28 U.S.C. § 1404(a). However, the district court will weigh, as part of that consideration, New Jersey’s strong public policy that franchisees in the state have a New Jersey forum in which to litigate claims under the NJFPA.

Where the forum selection clause designates an arbitral forum, New Jersey’s presumption of the invalidity of the forum-selection clause is preempted by the Federal Arbitration Act. “Under Supremacy Clause principles, the New Jersey Franchise Practices Act...cannot preclude enforcement of this [arbitral] forum selection clause provision.” Thus, an arbitration clause designating a non-New Jersey forum will be enforced, unless it can be demonstrated that the clause is invalid under general principles of contract interpretation. Even an arbitration clause requiring a New Jersey franchisee to arbitrate in a foreign country is not per se unconscionable, and will likely be upheld.

Conclusion

The NJFPA helps level the playing field between qualifying New Jersey businesses and their suppliers and licensors by providing protections beyond...
the contractual terms. If a business arrangement meets the requirements of the NJFPA, the act affects critical aspects of the parties’ relationship, potentially re-writing the terms of their agreement. The act’s requirements and effects must be considered by counsel when advising clients on structuring certain transactions; negotiating sales, distribution, and licensing agreements; and addressing the termination or non-renewal of those agreements.

Endnotes
1. N.J.S.A. 56:10-1, et seq.
3. N.J.S.A. 56:10-7(a) and 7(f). Note that 56:10-7(a) prohibits the franchisor from requiring a release from liability for violation of the act “at the time of entering into a franchise arrangement,” and thus does not bar a release as part of a settlement. However, it appears to apply where a franchisor includes a release as part of a franchise renewal agreement.
4. This article is limited to the general application provisions of the NJFPA. There are also sections of the act that apply specifically to gas stations and motor vehicle franchises: N.J.S.A. 56:10-7.1 thru 7.3 and 56:10-13 thru 56:10-31. There are also other state and federal laws regulating franchises in specific businesses, particularly in the motor vehicle, motor fuel, and alcoholic beverage distribution industries.
10. N.J.S.A. 56:10-3 and 4(a). The definition of a franchise under the NJFPA differs from the definition of a franchise under the Federal Trade Commission rule. 16 C.F.R. 436.1(h). While there is substantial overlap between the definitions, a business can be a ‘franchise’ under the FTC’s definition yet not the NJFPA’s definition and vice-versa.
14. In Cooper Distributing Co., supra, there was no explicit contractual grant of a license in the distribution agreement. The Third Circuit held that a reasonable jury could have inferred the existence of a license based on various aspects of the parties’ lengthy relationship. See also Beilowitz, 233 F. Supp. 2d at 642 (“For purposes of the NJFPA, a license may be found to exist based on a longstanding business relationship, even absent an explicit contractual grant of authority”).
15. See Instructional Systems, Inc., 130 N.J. at 351-55, for the Supreme Court’s explanation of the NJFPA’s license requirement.
17. Instructional Systems, Inc., 130 N.J. at 357; Atlantic City Coin, 14 F. Supp. 2d at 644. In determining whether there is a community of interest, courts have also considered the degree of control the manufacturer exercised over the distributor’s business operations. Colt Industries, Inc. v. Fidelco Pump & Compressor Corp., 844 F.2d 117, 120 (3rd Cir. 1988). However, the district court in Atlantic City Coin observed that the New Jersey Supreme Court only applied a “franchise investment” test, and not a “control” test in Instructional Systems, and interpreted this to mean that the New Jersey Court had implicitly rejected the control test. Atlantic City Coin, 14 F. Supp. 2d at 661.
18. An analysis of the courts’ interpretation and analyses of each of the six elements is beyond the scope of this article. For a more detailed discussion of the six requirements, see Jeremy I. Silberman, An Overview of the New Jersey Franchise Practices Act, in 2011 Business Law Symposium Seminar Material (New Jersey Institute for
Continuing Legal Education 2011).

19. N.J.S.A. 56:10-5. The statute specifies shortened notice requirements for terminations due to the franchisee’s voluntary abandonment of the franchise or the franchisee’s conviction of an offense directly related to operation of the franchise, indicating that these are additional permissible grounds for termination, or at least presumed to meet the good cause requirement of substantial failure by the franchisee to comply with the requirements of the franchise. N.J.S.A. 56:10-5.

20. General Motors Corp. v. New A.C. Chevrolet, Inc., 263 F.3d 296, 319 (3d Cir. 2001) (“Even if the terms of a private franchise agreement permit termination at will, §56:10-5’s good cause requirement will supersede that arrangement and impose a good cause requirement on the franchisor’s decision.”).


22. Maintainco, 408 N.J. Super. at 476 (“In the absence of substantial failure of franchisee compliance, the statutory requirement of ‘good cause’ prohibits a franchisor from terminating for other reasons, even if they reflect a sound and nondiscriminatory business strategy”).

23. Maintainco, 408 N.J. Super. at 479-80; See also, Beilowitz, supra.


25. Maintainco, supra. In contrast, the United States Supreme Court held that gas station franchisees cannot claim constructive termination under a federal franchise statute, the Petroleum Marketing Practices Act, while still operating their service stations. Mac’s Shell Service, Inc., et al. v. Shell Oil Products, et al., 130 S. Ct. 1251 (2010).


29. N.J.S.A. 56:10-5. Shorter notice is permitted where the grounds for termination is the franchisee’s abandonment of the franchise or conviction of an indictable offense directly related to the operation of the franchise. Id.


32. N.J.S.A. 56:10-7(e).

33. Carlo C. Gelardi, 502 F. Supp. at 653 (D.N.J.1980) (denying franchisor summary judgment on NJFPA claims); Dunkin’ Donuts Inc. v. Dough Boy Mgmt. Inc., 2006 WL 20521 at *11 (D.N.J. 2006). (“Defendants provide a litany of examples as to how Plaintiffs set them up for failure so that the Franchise Agreements could be terminated... [U]nder this set of facts, whether the standards that Dunkin’ imposed on Defendants constituted an ‘unreasonable standard of performance’ are questions for a jury”).

34. Beilowitz, 233 F. Supp. 2d at 643-44.

35. Sarwari v. BP Products N.A., Inc., 2007 WL 1118344 at *3 (D.N.J. 2007). The Sarwari opinion must be considered in the context of its unique facts and procedural posture, where the court found that the plaintiffs were essentially asking the court to issue an advisory opinion on provisions that were not yet affecting them. Id. at *5. See also Liberty Lincoln-Mercury Inc. v. Ford Motor Co., 2006 WL 1098178 at *5 (D.N.J. 2006) aff’d in part and rev’d in part on other grounds 676 F.3d 318 (2012) (imposition of a $157 surcharge on wholesale price of vehicles did not constitute an unreasonable standard of performance); Central Jersey Freightliner, Inc. v. Freightliner Corp., 987 F. Supp. 289, 295 (D.N.J. 1997) (plaintiff denied preliminary injunction pending arbitration where it failed to demonstrate that requirements to remain open 24 hours a day, seven days a week, and to maintain specific inventory levels, sales quotas, and financing were unreasonable within the meaning of the NJFPA).


The federal courts have applied the NJFPA to franchise claims and then the contractually selected state law to other claims. See, e.g., General Motors Corp. v. New A.C. Chevrolet, 263 F.3d at 330-37; Goldwell of NJ v. KPSS, Inc., 622 F. Supp. 2d at 193; Stadium Chrysler Jeep, LLC v. Daimler-Chrysler Motors Co., 324 F. Supp. 2d 587 at n.1 (D.N.J. 2004).


Kubis, 146 N.J. at 195.


Id. at 488.


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