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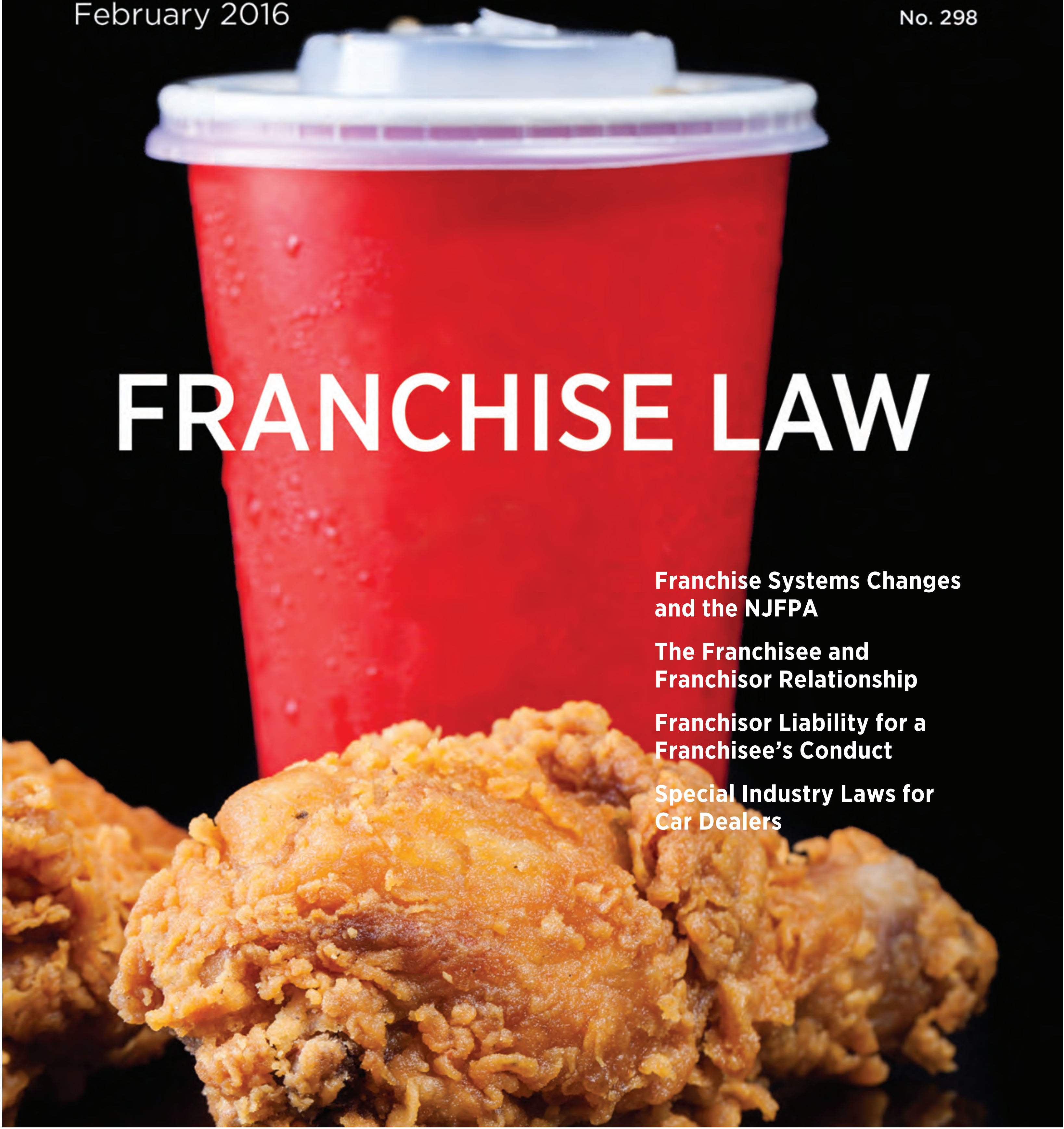


FRANCHISE LAW

Franchise Systems Changes and the NJFPA

The Franchisee and Franchisor Relationship

Franchisor Liability for a Franchisee's Conduct

Special Industry Laws for Car Dealers

"Forget the cake, I go for the lime

almost every time."

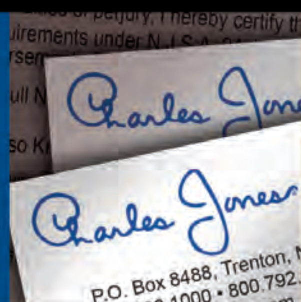
"It's just a tiny boo-boo. Let mommy put a

on it, and it'll be fine."

"Sparky loves it when we throw his

around the park."

"This search has to be thorough. Better get a



to be absolutely sure."

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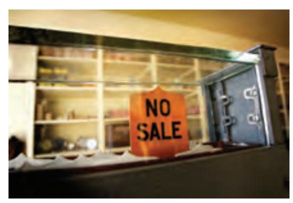

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NJSBA Spearheads Efforts to Improve Community and Profession

While we may be headed into the depths of winter, it is my honor to share with you important news about New Jersey State Bar Association initiatives that are heating up.

Lawyers Feeding New Jersey 2016

Though we may all be waking up to outside temperatures well below freezing, I have something to warm your hearts.

It's called Lawyers Feeding New Jersey 2016.

As lawyers we do a host of good things for the communities where we live and work—for the vast majority of those efforts, we do not receive payment. Yet, our profession still receives an enormous amount of criticism from the public.

Lawyers Feeding New Jersey 2016 is a swift, sweeping event that will do a great deal of good for the communities in which we live, as well as show the world we care and that we are doing something for which we get no recompense.

We are feeding the hungry of our great state.

Did you know that 1.1 million people in our state of 9 million are food insecure?

Of these, 1.1 million, 400,000 are our children.

That's enough children confronting food insecurity to nearly populate both Newark and Jersey City.

To make this event more impactful for all of us, we have established a competition where you can create or be on a team—and winners of the competition will be honored at a ceremony this spring.

The event began on Jan. 4 and continues until Feb. 26.

Please donate today at njsba.com.

Diversity and Inclusion

As an association, we are making progress to become more diverse and inclusive.

Our Leadership Academy is progressing and we will hold graduation and introduce of a new class by the Annual Meeting and Convention in May.

Moreover, the Board of Trustees updated a statement supporting diversity and inclusion last year. That statement will guide this organization for years to come. More recently, the trustees approved a Diversity and Inclusion Action Plan for the association and a checklist our leaders can use to track and share the work they perform in their offices, communities and personal lives to promote diversity and inclusion.

Further, this month—on Feb. 10—the NJSBA will hold the annual Diversity Summit, which was originated by President Rick Steen, a half a decade ago.

The summit brings together our leaders and members with those of the state's diversity bar associations. The goal is to provide an opportunity for an open discussion of how the NJSBA and profession can become more diverse and inclusive and how we can help our members do the same.

Sign up today and attend. It will be worth your time.

As always, thanks for your continuing support and if you see me in a courthouse, at the New Jersey Law Center or on the street, please stop and introduce yourself and tell me what you are up to. ⚖

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Message From the Special Editors


Philip W. Lamparello


James J. Ferrelli

Over the last 20 years or more, we have seen a noteworthy expansion in franchise businesses as a substantial component of our economy. Franchises, it seems, are everywhere you turn—full-service restaurants, fast food, convenience stores, food retailers, automobile dealers, auto parts dealers, business services, hotels/ accommodations, and real estate firms are just a few of the businesses where franchising has become a commonplace business model. According to the 2015 mid-year forecast of the International Franchise Association Educational Foundation and HIS Economics, franchise businesses were projected in 2015 to continue to grow at a faster pace than the rest of the United States economy, and franchising was on track in 2015 to outperform the United States economy for the fifth consecutive year, with gross domestic product of the franchise sector anticipated to increase by 5.2 percent to $521 billion in 2015.[1]

We are pleased to devote this issue of *New Jersey Lawyer* to an examination of a number of unique topics relating to the franchisor/franchisee relationship.

Franchises fall into three general categories: business-format franchises, product franchises and manufacturing franchises. In a business-format franchise, the franchisor provides the franchisee with a structured business format, establishing everything from name and trademark to accounting and inventory functions, and typically stipulating details as specific as the size of coffee cups and the design of napkins. A fast food chain is the archetype of such a franchise. The franchisor provides the look and feel of the 'brand,' so the franchisee has a ready-made and established business to step into and run in accordance with the standards and directives established by the franchisor.

Product franchises similarly rely upon the established brand of the franchisor, but typically involve relationships in which a manufacturer/franchisor contracts with various retailers to distribute and/or service the manufacturer's products and use the product names and trademarks in connection with the retailer's business. An example of such a franchise is a tire dealer licensed to sell a particular tire brand and to use the name of the tire in their own business name.

A manufacturing franchise, in comparison, is a franchise relationship in which the franchisor allows a manufacturer/franchisee to produce and sell products using the franchisor's specifications, name and trademark. For example, the Coca Cola Company produces Coca-Cola syrup concentrate, which is then sold to bottlers around the world who are licensed to complete the manufacturing process and package and distribute the finished product to retail stores, restaurants, and food services.

These various franchise models have proved beneficial to franchisors, franchisees and consumers by establishing that products and/or services that meet the quality standards established by the franchisor are widely available on a consistent basis. For example, a McDonald's hamburger purchased in

New Jersey tastes the same as one purchased in California.

As one might expect, the world of franchise relationships gave rise to a host of unique legal issues and problems specific to the franchisor/franchisee relationship. As our Supreme Court explained, "in common law, freedom of contract was the rule applicable to franchise agreements," and the franchisor/franchisee relationship was no different from that of any other parties to a contract.[2] The common law respected the franchisor's right to use its often-superior bargaining power to negotiate favorable terms as essential elements of its franchise offering, including the right to terminate the franchise relationship upon expiration of the franchise agreement or upon any breach of the agreement by the franchisee.[3] The effect of such a termination frequently resulted in a particularly harsh impact upon the franchisee, who, upon being ousted from the franchise, essentially forfeited his or her entire investment in the enterprise but for equipment, supplies and inventory that had previously been purchased.[4] Following such a termination, the franchisor would regain full control of the terminated business and was free to commence a new franchisee relationship.[5]

Over time, state legislators became concerned with the seemingly unfair and disproportionate situation faced by terminated franchisees, many of whom had invested substantial time and money in building their franchise businesses only to lose them upon termination by the franchisor. As a result, many states passed legislation to provide franchisees protection against unfair terminations and unfair treatment by franchisors. In New Jersey, the New Jersey Franchise Practices Act (NJFPA), enacted in 1971, is among the strongest statutory protections for franchisees in the country.[6]

Based upon its statutory elements, the NJFPA applies to business relationships that one would ordinarily describe as a franchise (such as a McDonald's or Dunkin' Donuts), but also provides protection to certain distributor relationships that are characterized by the NJFPA's statutory elements, irrespective of whether the parties call their relationship a franchise. Indeed, lawyers involved in business disputes involving distributor relationships frequently find the NJFPA may be applicable, notwithstanding that the parties never called or thought of their relationship as a franchise. Paul J. Halasz's article reviews the pertinent law applicable to determine when a dealership or distributorship is a franchise under the NJFPA. Salvatore A. Giampiccolo, Nicole DiBello and Jennifer M. Lahm drill into the case law applying the elusive community of interest element under the NJFPA.

Uniformity across the franchise is a critical component of the franchise relationship, not only from the perspective of franchisor and franchisee, but also from the perspective of their customers, who expect a franchised product or service will be of the same nature and quality irrespective of where it is purchased. Sometimes, however, franchisors determine that changes in the franchise requirements are necessary for the good of the brand and the franchise. These changes can give rise to issues and/or disputes with franchisees. Thomas J. Goodwin's article explores the issues that may arise when a franchisor wants to revise its franchise requirements, and its impact on franchisees.

For lawyers involved in representing franchisors or franchisees, numerous legal issues unique to the franchise relationship arise when one side or the other fails to comply with the parties' agreement, or desires to terminate the relationship. This issue contains four articles addressing various aspects of such situations. First, Harris J. Chernow analyzes the considerations and issues from the franchisor's perspective relating to the contemplated termination of a franchisee. Sheila Raftery Wiggins, Susan V. Metcalfe and Allison S.

Khaskelis provide an overview of preliminary injunction issues in contested franchise termination lawsuits. Edward T. Kole and James E. Tonrey Jr. examine the franchise termination situation from the perspective of the franchisee seeking to fend off the termination. And Bryan Couch discusses recent case law addressing the problem of so-called 'holdover usage' of a franchisor's trademarks following termination of the franchise relationship. Irrespective of whether you represent franchisors or franchisees, each of these articles provides a unique insight into the multifaceted issues confronted by attorneys in this context.

Besides the foregoing, we present three articles addressing other aspects of the franchise relationship. Justin M. Klein discusses the issue of vicarious liability of a franchisor for the conduct of its franchisees. Besides vicarious liability issues, a cutting-edge issue of concern to franchisors and franchisees alike is the application of the doctrine of joint employer status in franchise relationships—in which a court deems a franchisor as the employer of its franchisee's employees. Robert C. Brady, Philip W. Lamparello and Michael Poreda review recent cases and the impact they may have on franchisor relationships as courts wrestle with the issue of joint employer status. Finally, in New Jersey, as in a number of other states, franchise automobile dealers and their franchisors have specific statutory provisions addressing the automobile dealer franchise relationship. Eric L. Chase reviews these special industry laws for car dealers and points out pitfalls for counsel in this area.

Irrespective of their practice area, we hope our readers find this issue interesting and informative. We thank all of our authors for their outstanding work on this issue, and for taking the time to share their expertise. ⚖

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James J. Ferrelli, *a partner in the trial department of Duane Morris LLP, is resident in its Cherry Hill office and concentrates his practice primarily in the areas of complex business and commercial litigation, products liability and class actions. He is a member and past chair of the* New Jersey Lawyer *Editorial Board and a past trustee of the New Jersey State Bar Association.*

ENDNOTES

1. Franchise Businesses Continue to Grow Faster Than Rest of U.S. Economy, published at franchise.org/franchise-businesses-continue-to-grow-faster-than-rest-of-us-economy. Final figures for 2015 were not available as of the editorial deadline for this issue.
2. *Dunkin' Donuts of America v. Middletown Donut Corp.*, 100 N.J. 166, 176-78 (1985).
3. *Id.*
4. *Id.*
5. *Id.*
6. N.J.S.A. 56:10-1 *et seq.*

Ascertaining When a Dealership or Distributorship is Subject to the NJFPA

by Paul J. Halasz

While the variety of ways in which businesses distribute products and services are seemingly limitless, few rely upon a completely vertically integrated model in which a single enterprise designs, manufactures, markets and sells directly to consumers. Instead, suppliers typically forge relationships with middlemen at the wholesale or retail level (or both) in order to take advantage of local expertise and market share, or simply to avoid the cost of building the infrastructure needed to deliver the product or service to the ultimate consumer themselves. These relationships are typically governed by contractual terms freely negotiated by the parties dictating, among other things, how to terminate their association.

Some arrangements—even if never intended to be franchises when they were formed—can be subject to additional regulation imposed by franchise relationship statutes such as the New Jersey Franchise Practices Act (NJFPA).[1] The consequences of coming within the ambit of the act can be enormous. Perhaps most notable are the restrictions against termination and non-renewal of a franchise without good cause, and the notice requirements mandated before a termination or non-renewal is effective. These, and other provisions in the act, typically trump the parties' own negotiated terms, resulting in a relationship that is different—and possibly of significantly longer duration—than was originally intended.

Identifying the conditions under which the NJFPA will be applicable to a given distribution or dealer agreement can be laden with complexity. The labels attached to the relationship by the parties themselves are often not determinative. Rather, a two-step analysis is employed to determine: 1) whether the relationship meets the act's definition of a franchise, and 2) whether, if a franchise exists, it falls within the scope of the NJFPA, which not all do. Moreover, even when these statutory requirements are met, other legal bases may exist to exempt the relationship from the scope of the act.

This article addresses the statutory framework and judicial pronouncements that have been developed to resolve what is often a high-stakes threshold question when a dispute arises between a supplier and a dealer over termination or non-renewal of their relationship.

Rationale for Regulation of Private Agreements

In order to address the question of *when* the NJFPA applies, it is first useful to consider *why* the act was initially deemed necessary. Judicial consideration of the legislative policy behind the NJFPA can tip the resolution of this issue one way or another.

Statutory regulation of the franchisee/franchisor relationship in New Jersey began in 1971, and "was aimed at curbing the tendency of franchisors to unduly profit from their superior economic and bargaining positions when negotiating agreements with potential franchisees."[2] Such disparity of bargaining power granted franchisors the ability to terminate the relationship, often at the expense of the franchisee's investment in the business.[3] The power to end the relationship, combined with the economic dependence of the franchisee on the franchisor's business model, prompted the creation of a statutory "exception to the general rule that two businesses are free to terminate their business relationship according to the terms of their contract."[4]

The need for such protection is more evident when the putative franchisee's investment in the business is specific to the supplier/franchisor's brand. For example, if a supplier required a distributor to purchase franchise-specific signage (think golden arches) or to remodel a business location to meet the supplier's specifications for marketing the brand, the investment would be useless if the franchisee lost the right to continue the business under the supplier's brand. "The Act's concern is that once a business has made a substantial franchise-specific investment it loses all or virtually all of its original bargaining power regarding continuation of the franchise."[5]

These legislative concerns all tie into how a franchise is defined under the act:

> "Franchise" means 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, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.[6]

Accordingly, it is not all distribution or dealership arrangements with which the act is concerned. Rather, the hallmark of a franchise relationship is the existence of a community of interest, centered around a license to use the supplier's brand marks.

Similarly, the scope of the NJFPA is limited to franchise arrangements based in New Jersey and of a substantial nature. For example, a department store that sells a supplier's product among many other goods, even with the benefit of specific branded advertising support, is unlikely to give rise to the sort of legislative protection that is warranted when the dealer's business is focused on just one, or relatively few, product lines. Thus, the NJPFA is expressly applicable only to business arrangements meeting certain monetary thresholds, discussed in further detail below.[7] And, where the business relationship pre-dates the act or is governed by another regulatory scheme, the act may be construed as inapplicable, even where the other hallmarks of a franchise are present.[8]

Does the Distribution Model Constitute a 'Franchise'?

Under the NJFPA definition set out above, a franchise exists where two basic elements are found: 1) a written agreement granting a license to use another's marks; and 2) a community of interest in marketing the goods and services. This provision, while outwardly clear and concise, has spawned a significant body of law simply by virtue of the innumerable variations in which businesses combine to distribute products and services. And, as discussed below, with no further legislative definition of 'community of interest,' the courts have developed a variety of additional factors when considering whether a franchise relationship exists.

The Written License Requirement

In order for a franchise to exist, there must be a written agreement granting a license to use the alleged franchisor's marks. Mere oral permission is not enough, nor will this requirement be satisfied simply by furnishing the dealer with a limited license to use trademarked marketing and advertising materials.[9]

In one recent case,[10] a New Jersey federal court rejected a watch dealer's effort to preclude the termination of its distributorship with a watch manufacturer. The manufacturer decided to end the relationship so it could open its own boutique in the same mall, selling the same line of watches. In support of its claim, the dealer, which sold other brands of watches as well, argued the written agreement requirement was satisfied by, among other things, written brand policies detailing how to handle, display and present the watches and a 'co-op commitment agreement' by which funds for advertising could be made available to the dealer. The court determined these and other written policies did not meet the statutory requirement of a written license agreement because no 'proprietary' right in the marks were granted in the written materials. That the manufacturer supplied branded advertising materials, such as window decals and counter displays, likewise did not confer a license.

As the court noted:

> The trademark, tradename reference [in the NJFPA] means and implies use of that name in the very business title of the franchise and a holding out or perhaps representation to the public of some special relationship or connection. Simply selling goods or distributing materials which bear the manufacturer's name or trademark does not license use of the trademark.[11]

While use of the supplier's name in the putative franchisee's business title may confirm the existence of a license to use the supplier's marks, it is not a mandatory element. The Third Circuit, in a case decided under the NJPFA,[12] refused to disturb a jury's verdict in favor of an appliance wholesale distributor that operated under its own name. In that case, the court found it was reasonable for the jury to presume a license was present where the distributor provided warranty service on the supplier's products, identified itself as an authorized parts and service provider, served as the exclusive distributor within the territory for 30 years, and its service persons wore uniforms with the supplier's name. Moreover, the distributor's customers—retail dealers—regarded the distributor and supplier as "one and the same."[13] Accordingly, courts may be more receptive to finding that a license exists where there is a longstanding relationship in which the putative franchisee's identity is intricately bound with that of its supplier.[14]

The Community of Interest Requirement

The second component of the statutory definition of a franchise involves the existence of a community of interest in the marketing of the supplier's goods and services. As the New Jersey Supreme Court noted in the *Instructional Systems* case, "[t]he community of interest requirement addresses the inequality of bargaining power between the parties and is critical in distinguishing franchises from other types of business relationships"[15] in which a license to use another's marks is granted.

Without any legislative guidance regarding what that term means, the courts addressing the community of interest issue have articulated a number of factors to analyze this "broad, elastic and elusive" concept.[16] These factors variously include the extent of the supplier's control over the dealer, the dealer's economic dependence upon the supplier, the relative disparity in bargaining power between the parties and whether a franchise-specific investment is required under the terms of the parties' agreement. These factors have all been distilled into the present controlling iteration of the standard:

> A community of interest exists when the terms of the agreement between the parties or the nature of the franchise business requires the licensee, in the interest of the licensed business's success, to make a substantial investments in goods or skill that will be of minimal utility outside of the franchise.[17]

The New Jersey Supreme Court's decision in *Instructional Systems* exemplifies how the community of interest concept serves to expand the scope of the NJFPA beyond the stereotypical notion of franchises as fast-food restaurants and automobile dealerships. In that case, plaintiff Instructional Systems, Inc., (ISI) served for many years as the exclusive distributor of defendant Computer Curriculum Corporation (CCC) for its computer-based learning system pursuant to a series of written contracts. ISI filed suit under the NJFPA seeking protection as a franchisee when CCC refused to renew the parties' existing agreement and only offered a much-reduced territory to ISI. CCC argued there was no community of interest because ISI was not required to make franchise-specific investments that would be valueless in the event of termination. Instead, ISI maintained an ordinary office building, did not stock CCC products in inventory, did not have CCC-branded signage and only invested in a minimal amount of CCC equipment and software for demonstrator purposes.

Despite the lack of such outwardly visible franchise-specific investments, the Court concluded that a community of interest—and thus a franchise relationship—did exist.[18] Pointing to the symbiotic nature of the parties' relationship, as well as ISI's long-term investment in promoting good will for CCC's products, the Court distinguished the facts before it from earlier authority in which the putative franchisee's investment was fully transferrable to the products of a different supplier. Rather, CCC had many 'sunk investments' in the promotion of CCC's products, the most critical of which was the installed base of clients who would be loathe to switch from one learning system to a competing brand. Thus, a community of interest may be found where the franchisee risks an "unconscionable loss of his tangible and intangible equities."[19] Such economic dependence has been cited more recently as the most important factor in determining whether a community of interest exists.[20]

Does the Franchise Fall Within the Scope of the Act?

Even if a party satisfies the license and community of interest tests to come within the statutory definition of a franchise, it may still fall outside the act's reach. N.J.S.A. 56:10-4 limits the reach of the NJFPA to franchises that: 1) contemplate or require the franchisee to maintain a place of business within the state of New Jersey; 2) generate gross sales that exceed $35,000 in the 12 months prior to suit; and 3) generate or are intended to generate at least 20 percent of the franchisee's gross sales. These requirements have served to limit the act's protections in a variety of contexts.

Place of Business

Disputes over the 'place of business' requirement can arise over the nature of the actual physical business location and the activity that occurs within it.

Exactly what constitutes a place of business is governed by the act's definitional provision. It includes a "fixed geographical location where the franchisee displays for sale and sells the franchisor's goods or offers for sale and sells the franchisor's services."[21] Maintaining a warehouse would not satisfy this requirement. Thus, where a franchisee distributed large bottles of water and water coolers to consumers, its warehouse distribution facility did not meet the place of business requirement.[22] Moreover, a sale or offer of sale by the franchisee must be involved; where a business merely solicits or brokers a sale between a franchisor and the customers, the requirement is not satisfied.[23] However, the act was amended in 2009 for the benefit of wholesale franchisees. For these franchises, the place of business requirement is satisfied by "an office or a warehouse from which franchisee personnel visit or call upon customers or from which the franchisor's goods are delivered to customers."[24] Finally, the parties' agreement need not explicitly state the franchise must be located in the state of New Jersey; what is required is that the parties at least *contemplated* that the franchise would be performed from a location within the state. This factor may be satisfied if the franchisee can show the parties "reasonably anticipated that the franchisee would establish a New Jersey place of business."[25]

Monetary Thresholds

The act is intended to protect *bona fide* franchises. The monetary thresholds set out under the statute are thus intended to remove from the act those business relationships generating a small amount of product or services sales (less than $35,000 within the prior

12 months) or that constitute only a fraction of the franchisee's overall business (less than 20 percent). These provisions are generally construed without much difficulty. In one case, however, the court clarified that the 20 percent threshold was not limited to the prior 12-month period; rather, the inquiry with respect to that factor is whether the parties intended that at least 20 percent of the franchisee's gross sales be derived from sales of the franchisor's products.[26] Accordingly, if at the time the parties entered into their relationship it was anticipated the dealer's sales of the supplier's products would be at least 20 percent of its overall business, this provision is satisfied, even if the sales levels are not, in fact, reached.

Are There Other Potential Bases for Exclusion from the NJFPA's Coverage?

In addition to ascertaining whether the relationship is a franchise and, if so, whether it meets the statutory place of business requirement and sales thresholds, other reasons may exist that result in exclusion from the act's coverage. These include arguments based on the effective date of the act, non-retroactivity of amendments to the act and preemption/conflict with other regulatory schemes.

Some distribution arrangements have been in place for a long time—decades even. In fact, some franchises (automotive dealerships come to mind) may even pre-date the 1971 effective date of the NJFPA. In such a case, assuming the contract itself has not been amended or renewed since then, the act by its own terms does not apply.[27] While that factual scenario is becoming less likely with each passing year, there may be grounds to exclude certain *portions* of the act that have been added more recently. For example, in 2011, the act was amended to provide for an automatic injunction against an automotive franchisor's termination in the event an automotive dealer commences an action challenging the termination.[28] Whether that amendment applies retroactively to all automotive franchises entered into before 2011 is seriously questionable, inasmuch as the Legislature has not declared the amendment should have retroactive effect, and it is neither curative nor its application consistent with the expectations of the parties.[29]

Another basis on which the NJFPA may be deemed inapplicable concerns business relationships that are already heavily regulated, and in which there is a real possibility of conflicting regulatory schemes. A recent example comes from the world of insurance agencies. In *De Luca v. Allstate,* a longtime insurance agent sought protection from termination under the NJFPA. The trial court, in a decision affirmed by the Appellate Division, held the act did not apply. Among its reasons, the court determined that regulation of the insurance industry by the state Department of Banking and Insurance was "primary and pervasive and that provisions of the NJFPA conflict with provisions of this regulatory framework."[30] Accordingly, dealerships that exist in heavily regulated industries may be exempt from the act where there are multiple regulations that work at cross purposes.

Conclusion

Whether a relationship is subject to the dictates of the NJFPA is not always an easy question, but it is one that could be critical to an enterprise facing major business challenges. A manufacturer seeking to restructure its distribution channels by eliminating longstanding distributors would be well served by analyzing the nature of the relationship to ascertain whether the notice and good cause requirements for termination under the act apply. Likewise, a small business that is economically dependent upon a primary supplier with whom it shares a community of interest could find the act protects it against termination, non-renewal or unreasonable standards of performance.[31] These and a multitude of other circumstances may call for an analysis of whether the distributorship or dealership is governed by more than just the private agreement between the participants. ⚖

Paul J. Halasz *is a member of Day Pitney LLP in Parsippany, where he serves as chair of the firm's franchise and distribution law practice group.*

ENDNOTES

1. N.J.S.A. 56:10-1, *et seq.*
2. *McPeak v. S-L Distribution Co.*, Civ. No. 12-348, 2014 U.S. Dist. LEXIS 10794, *9 (D.N.J. Jan. 29, 2014) (*citing Goldwell of New Jersey, Inc. v. KPSS, Inc.*, 622 F. Supp. 2d 168, 184 (D.N.J. 2009) and *Westfield Centre Serv., Inc. v. Cities Serv. Oil Co.*, 86 N.J. 453, 461-62 (1981)).
3. *See Instructional Sys., Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 338-39 (1992).
4. *McPeak*, 2014 U.S. Dist. LEXIS 107984, at *10 (*quoting New Jersey Am., Inc. v. Allied Corp.*, 875 F.2d 58, 61 (3d Cir. 1989)).
5. *Instructional Sys.*, 130 N.J. at 357.
6. N.J.S.A. 56:10-3(a).
7. N.J.S.A. 56:10-4.
8. *See DeLuca v. Allstate Ins. Co.*, Nos. C-185-11, C-291-11, C-299-11, 2011 N.J. Super. Unpub. LEXIS 1090, *3-4 (App. Div. April 30, 2014) (rejecting application of NJFPA to insurance agent because of conflicts with statutory insurance brokerage regulations).
9. *Finlay & Associates v. Borg-Warner Corp.*, 146 N.J. Super. 210, 219 (Law Div. 1976).
10. *Orologio of Short Hills, Inc. v. The Swatch Group (U.S.) Ltd.*, Civ. No. 11-6854, 2015 U.S. Dist. LEXIS 95977 (D.N.J. July 23, 2015).
11. *Id.* at *14 (*quoting Finlay*, 146 N.J. Super. at 219); *see also Colt Indus., Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117, 120 (3d Cir. 1988) (holding that limited agreement to display trademark and identify dealer as an authorized distributor did not meet statutory requirement

of a written license agreement).

12. *Cooper Distrib. Co., Inc. v. Amana Refrigeration, Inc.*, 63 F.3d 262 (3d Cir. 1995).

13. *Id.* at 273.

14. *See Instructional Sys., Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 354 (1991) (holding that NJFPA did not require franchisee to use franchisor's business name as evidenced by statutory requirement that act applied to franchises where as little as 20 percent of gross sales involves franchisor's product).

15. *Id.* at 356.

16. *Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prod.*, 190 N.J. Super. 153, 165 (App. Div. 1983).

17. *DeLuca v. Allstate Ins. Co.*, Nos. C-185-11, C-291-11, C-299-11, 2011 N.J. Super. Unpub. LEXIS 1090, *8-9 (App. Div. April 30, 2014) (*quoting Instructional Sys.*, 130 N.J. at 359). Despite the absence of any discussion of control or disparity in bargaining power in this definition of community of interest, some federal courts continue to include them in their recitation of the factors to be considered while others have expressly rejected the notion that they continue to be part of the required analysis. Compare, for example, *Orologio of Short Hills, Inc. v. The Swatch Group (U.S.) Ltd.*, Civ. No. 11-6854, 2015 U.S. Dist. LEXIS 95977, *15 (D.N.J. July 23, 2015), identifying control and disparity of bargaining power as factors, with *Atlantic City Coin & Slot Serv. Co. v. IGT*, 14 F. Supp. 2d 644, 661 (D.N.J. 1998), finding that the factor of control was absent from the New Jersey Supreme Court's definition of the standard in *Instructional Systems* and, therefore, did not include it in its own analysis.

18. *Instructional Sys.*, 130 N.J. at 366.

19. *Id.* at 359 (*quoting Neptune T.V.*, 190 N.J. Super. at 165).

20. *McPeak v. S-L Distribution Co.*, Civ. No. 12-348, 2014 U.S. Dist. LEXIS 10794, *19 (D.N.J. Jan. 29, 2014).

21. N.J.S.A. 56:10-3(f).

22. *Watchung Spring Water Co., Inc. v. Nestle Waters N. Am., Inc.*, Civ. No. 14-cv-04984, 2014 U.S. Dist. LEXIS 151178, *4-5 (D.N.J. Oct. 23, 2014), *aff'd*, 588 F. App'x 197 (3d Cir. 2014).

23. *DeLuca v. Allstate Ins. Co.*, Nos. BER-C-185-11, BER-C-291-11, BER-C-299-11, 2011 N.J. Super. Unpub. LEXIS 3140, *67-68 (Law Div. Dec. 28, 2011).

24. N.J.S.A. 56:10-3(f).

25. *Strassle v. Bimbo Foods Bakeries Distribution Inc.*, Civ. No. 12-3313, 2013 U.S. Dist. LEXIS 34560, *14 (D.N.J. March 13, 2013) (*quoting Instructional Sys., Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 346 (1992)).

26. *Harter Equip., Inc. v. Volvo Constr. Equip. N. Am., Inc.*, Civ. No. 3-01-CV-04040, 2003 U.S. Dist. LEXIS 27210, *11 (D.N.J. Sept. 24, 2003).

27. N.J.S.A. 56:10-8.

28. N.J.S.A. 56:10-30.

29. *Gibbons v. Gibbons*, 86 N.J. 515, 522-23 (1981).

30. *DeLuca v. Allstate Ins. Co.*, Nos. BER-C-185-11, BER-C-291-11, BER-C-299-11, 2011 N.J. Super. Unpub. LEXIS 3140, *79 (Law Div. Dec. 28, 2011).

31. N.J.S.A. 56:10-7 provides, among other things, that it is a violation of the act for a franchisor to impose unreasonable standards of performance upon a franchisee.

Your Distributor May be a Franchisee

If it Walks, Talks, and Sounds Like a Franchisee, it is a Franchisee

by Salvatore A. Giampiccolo, Nicole DiBello and Jennifer M. Lahm

The New Jersey Franchise Practices Act (NJFPA)[1] governs the relationship and responsibilities of franchisors and franchisees, and the agreements between them, not only in a traditional retail sense, but also with respect to wholesale distribution franchises.[2] Thus, a principal concern for attorneys with clients in distribution arrangements[3] should be whether the NJFPA applies to the parties. If the NJFPA applies, then the terms of the parties' agreement will be subject to and the conduct of the parties will be governed by the act. In addition, if a franchisor/manufacturer/supplier does not conduct itself in accordance with the act, then the franchisee/distributor may be entitled to compensatory damages, including the reasonable value of the 'franchise' or lost profits, and reasonable attorneys' fees.[4] The franchisee/distributor may also seek injunctive relief restraining the franchisor/manufacturer/supplier from violating the NJFPA.[5] Accordingly, practitioners must understand the application of the NJFPA and analyze whether their clients' distribution contracts are governed by it.

The New Jersey Franchise Practices Act

The NJFPA defines a franchise as:

> 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, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.[6]

A franchise exists under the act if: 1) the parties contemplate the franchisee will maintain a "place of business within the State of New Jersey," 2) the franchisor grants a "license" to the franchisee, 3) there is a "community of interest" between the franchisor and franchisee, 4) where gross sales of product or services between the franchisor and franchisee exceed $35,000 for the year preceding the institution of any lawsuit, and 5) where more than 20 percent of the franchisee's gross sales are intended to be or are derived from the relationship.[7]

A critical issue in determining whether the NJFPA applies to a business relationship is whether the community of interest element is satisfied. This article will focus on the requirement that the franchisee/distributor share a community of interest with the franchisor/manufacturer/supplier. As evident from the following discussion, the community of interest inquiry is a fact-sensitive inquiry that focuses upon the potential abuses sought to be remedied by the NJFPA.

Community of Interest

Community of interest is not expressly defined by the act, and has been described as a "broad, elastic, and elusive" concept.[8] The Legislature recognized that a hallmark of a franchise relationship is the existence of the parties' inequality.[9] Thus, the act itself sets forth protections for the franchisee that prevent the franchisor from imposing unreasonable standards of performance or improperly terminating the parties' relationship.[10] Community of interest is meant to "ensure that the [a]ct reaches only those licensing relationships which...are 'singularly susceptible' to the type of abuses intended to be remedied by the [a]ct."[11] In short, this element addresses whether the franchisee may face an unconscionable loss of its tangible and intangible assets if the franchise is terminated.[12]

Courts analyze several factors to determine whether the parties share a community of interest: 1) "disparity in bargaining power"; 2) "the presence of a franchise-specific investment by the licensee"; 3) "the licensee's economic dependence on the licensor"; and 4) the "licensor's control over the licensee."[13] Importantly, the courts have differed over which factors should be given greater weight or, in some cases, considered at all. Significant cases will be reviewed in turn.

Neptune T.V. & Appliance Service, Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc.

The Appellate Division, in *Neptune T.V. & Appliance Service, Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc.,* focused on the disparity in the parties' bargaining power and the licensee's economic dependence on the licensor. The court found the plaintiff, alleging its status as a franchisee, was not a franchisee because it did not have a "symbiotic" relationship with the defendant and was not vulnerable to suffering an unconscionable loss of equities by the termination of the parties' agreement.[14]

Plaintiff Neptune T.V., an appliance repair company, entered into a "service contract agreement" with defendant Litton, a microwave oven manufacturer, in which Neptune T.V. was designated as "an Authorized Litton service source" for a 50-mile radius. As an authorized service provider, Neptune repaired Litton's ovens at the request of the customer and the repairs were paid by Litton if within warranty. Neptune was obligated to comply with Litton's *Service Policy and Procedural Guide*, policies for performing and billing for warranty work, parts inventory requirements, and Litton training requirements.

The court found this relationship did not involve a community of interest as required by the NJFPA. In defining community of interest, the court emphasized the interplay between the dependence factor and the inequality factor, stating that franchise agreements have a "symbiotic character" resulting in the "consequent vulnerability of the alleged franchisee to an unconscionable loss of his tangible and intangible equities."[15] This vulnerability creates the potential for abuse by the franchisor if it were to arbitrarily, and without compensation to the franchisee, terminate the franchise.[16] The court cited the language of the act to support its finding that the potential for abuse, created by dependence and inequality, were hallmarks of the franchise relationship.[17]

Litton's only interest in Neptune's business was that Neptune T.V. perform its repairs in a satisfactory manner so Litton maintained its reputation of providing quality repairs. Beyond that, Litton had no interest in Neptune T.V.'s business; Litton had no interest in the volume of its business and, in fact, was best served if Neptune T.V. had fewer warranty repairs. Further, Litton did not profit from the repair operations, as Neptune T.V. was not the source of Litton's customer base; rather, Neptune T.V. received customers from Litton.[18] Accordingly, the court found "there was no requisite community of interest between the parties and consequently that their agreement did not create a franchise."[19]

Colt Industries Inc. v. Fidelco Pump & Compressor Corp.

The Third Circuit, in *Colt Industries Inc. v. Fidelco Pump & Compressor Corp.,* focused on the parties' disparity in bargaining power as well as the licensor's control over the licensee.[20] Ultimately, the court found the distributor did not share a community of interest with the manufacturer because it failed to provide "specific proof, focusing on certain indicia of control by the supposed franchisor over the supposed franchisee," and was not "subject to the whim, direction and control of a more powerful entity whose withdrawal from the relationship would shock a court's sense of equity."[21]

New Jersey American, Inc. v. Allied Corp.

In *New Jersey American, Inc. v. Allied Corp.*, the Third Circuit reviewed the holdings in *Neptune T.V.* and *Colt Industries* and focused on the disparity in bargaining power as evidenced by the licensee's franchise-specific investments.[22] Significantly, this is the first time franchise-specific investments were considered; the court in *Neptune T.V.* only recognized that a licensee's vulnerability to suffering an unconscionable loss of equities was a hallmark of a franchise relationship.[23]

The court held that New Jersey American (NJA) and Allied Corporation did not share a community of interest because "NJA simply was not in the type of vulnerable position that motivated the New Jersey legislature to pass the Franchise Practices Act."[24] NJA used Bendix brake linings manufactured by Allied to assemble and sell automobile brake disc pads. Allied was just one of several lining suppliers NJA used in its production. The parties' agreement allowed Allied to inspect NJA's facilities, review quality control, and review financial statements. The agreement expressly stated that NJA was an independent contractor and not a representative of Allied. NJA included Allied's Bendix brand name on brake pads containing Bendix linings, and Allied reimbursed NJA for certain advertising ventures.[25] NJA sued Allied for violation of the NJFPA when Allied terminated the parties' agreement as part of a comprehensive restructuring.[26]

The court found that NJA did not share a community of interest with Allied and, therefore, was not a franchisee for several reasons. First, only a portion of NJA's sales relied on Allied, and the other suppliers were capable of meeting NJA's needs. Thus, NJA's reliance on Allied was limited.[27] Next, NJA was not "required to undertake any substantial specific tangible or intangible investments in Allied's business."[28] NJA could continue to use its manufacturing equipment for non-Allied products and, therefore, would not suffer a loss of equities as a result of Allied's termination. The court concluded "any possible leverage that the putative franchisor may have over the putative franchisee must stem from the franchisee's status as licensee rather than the necessary fact that the two firms do business together."[29]

In *dicta*, and further demonstrating the abstract concept behind community of interest, the court criticized the act for its emphasis on inequality of bargaining power at the time of the agreement, when the true risk for abuse occurs after the franchisee has made franchise-specific investments.[30] To compensate for this discrepancy and effectuate the purpose of the act, the court considered whether the parties' agreement contemplated future investments.[31]

Cassidy Podell Lynch, Inc. v. SnyderGeneral Corp.

Just a few years later, the Third Circuit again discussed community of interest in deciding *Cassidy Podell Lynch, Inc. v. SnyderGeneral Corp.*[32] Cassidy Podell Lynch was the exclusive sales representative in the area, and Cassidy's vehicles and uniforms bore the SnyderGeneral Corporation logo. Most of Cassidy's income came from distributing SnyderGeneral's products, and SnyderGeneral's policies prohibited Cassidy from carrying directly competing products. However, Cassidy was able to sell non-competing products, managed its own sales force, made its own decisions about hiring and firing, and solicited its own new customers. Cassidy entered an agreement with a third party to supply it with SnyderGeneral products. Cassidy sued SnyderGeneral when SnyderGeneral terminated the parties' agreement and did not fulfill the order needed to supply the third party.

The court reasoned that "community of interest exists when the terms of the agreement between the parties or the nature of the franchise business requires the licensee, in the interest of the licensed business's success, to make a substantial investment in goods or skill that will be of minimal utility outside the franchise."[33] The court examined the then-existing New Jersey District Court and New Jersey Appellate Division decisions and, for the first time, set forth the four factors courts now examine: "(1) licensor's control over the licensee, (2) the licensee's economic dependence on the licensor; (3) disparity in bargaining power, and (4) the presence of a franchise-specific investment by the licensee." The court ultimately held that no community of interest existed between SnyderGeneral, a manufacturer of industrial air conditioning systems, and Cassidy, the distributor of SnyderGeneral's products in northern New Jersey and Rockland County, New York.[34]

Instructional Systems, Inc. v. Computer Curriculum Corp.

The New Jersey Supreme Court first examined community of interest in *Instructional Systems, Inc. v. Computer Curriculum Corp.*[35] As the Court explained: "The Act's concern is that once a business has made substantial franchise-specific investments it loses all or virtually all of its original bargaining power regarding the continuation of the franchise."[36] Further, the Court recognized that community of interest inherently addresses the inequality of bargaining power between parties.[37]

One guidepost illustrative of a community of interest is a "symbiotic" or "interdependent" relationship that "takes into account the extent of the licensor's control and the licensee's economic dependence."[38]

The investment factor evaluates whether the franchisee, in the interest of the licensed franchisor's success, is required "to make a substantial investment in goods or skills that will be of minimal utility outside the franchise."[39] For developing the goodwill of the manufacturer to qualify as an investment, the goodwill in question must be useful for the alleged franchisee only in the context of its relationship with the alleged franchisor.[40] Thus, a distributor that sells many manufacturers' products and creates some goodwill for all or many of them does not create goodwill sufficient to create a community of interest.[41]

Cooper Distrib. Co. Inc. v. Amanda Refrig. Inc.

A franchisee's investments support the existence of a shared community of interest when: 1) its investments are "substantially franchise-specific;" and 2) the franchisee was "required to make these investments by the parties' agreement or the nature of the business."[42] In describing the policy behind this, the Third Circuit quoted the New Jersey Supreme Court's analysis in *Instructional Systems*, stating:

> The [a]ct's concern is that once a business has made substantial franchise-specific investments it losses all or virtually all of its original bargaining power regarding the continuation of the franchise. Specifically, the franchisee cannot do anything that risks termination, because that would result in a loss of much or all of the value of its franchise-specific investments. Thus, the franchisee has no choice but to accede to the demands of the franchisor, no matter how unreasonable those demands may be.[43]

The given name of the parties' relationship is irrelevant; parties are governed by the NJFPA and/or the Federal Trade Commission (FTC) rule if their relationship meets the statutes' definitional criteria.[44] Franchise-specific investments can take the form of tangible and intangible assets. For instance, the investment may be in the form of purchasing software and products, a special building design, special equipment useful only to produce and sell the product, demonstration models, the cost of computer upgrades and hardware, and the cost of conducting market studies.[45]

The franchise-specific investment could also take the form of effort required to gain specialized skills or knowledge to market the manufacturer's licensed product efficiently[46] or developing the goodwill of the manufacturer by the distributor.[47]

Atlantic City Coin & Slot Serv. Co. v. IGT

In *Atlantic City Coin & Slot Service Company, Inc.*, the court, in addressing the distributor's motion for preliminary injunction, found that the distributor had established likelihood of success on the merits and that the distributor was a franchisee. The court went to great lengths to discuss the history and the development of the community of interest requirement and the lack of guidance from the New Jersey Supreme Court on the "control" factor in its standard in the *Instructional Systems* case and, therefore, did not include it as part of its analysis.[48] The court, however, did specifically identify certain criteria the New Jersey Supreme Court reviewed in the *Instructional Systems* case, and applied those criteria to the facts before it. It specifically identified the contractual obligations between the parties, including the requirements to use promotional materials; maintain adequate facilities; submit sales reports; require best efforts to develop demand for the manufacturer's products; training and education of customers; right to monitor financial performance; use of specific order and service forms; imposition of quality standards and standards for use of trademarks and logo; as well as requiring the number of sales representatives to be employed.[49] The court also reviewed the economic dependence of the distributor and the "interdependence" of the parties.

Finding that the manufacturer had imposed those criteria under its contractual terms, Atlantic City Coin & Slot Serv. Co. also was economically dependent on IGT since 76 percent of its revenue was "derived from the sale, lease and servicing of IGT products." The court also found interdependence where the parties worked jointly to resolve maintenance engineering problems and collaborated on sales, marketing, product demonstrations, training sessions and product development.[50]

Although control was not a defined factor within the standard established by the *Instructional Systems* case, the elements addressed by the Court and referenced in the *Instructional Systems* case were nonetheless elements of control imposed by the manufacturer on the distributor, and were followed by the court in *Atlantic City Coin & Slot Service Company, Inc*.

Orologio of Short Hills, Inc. v. The Swatch Group (U.S.) Ltd.

In *Orologio of Short Hills, Inc. v. The Swatch Group (U.S.) Ltd.*, the court held that a watch retailer and seller of The Swatch Group (U.S.) Ltd. brand watches did not share a community of interest with Swatch and, therefore, was not a franchisee.[51] Orologio of Short Hills, Inc., with a storefront located in the Garden State Mall in Paramus, sued Swatch alleging, among other things, a violation of the NJFPA after Swatch terminated Orologio as an authorized dealer and opened its own boutique in the same mall. Although the parties did not have a written franchise agreement, they executed several written distribution and partnership plans, enabling Orologio to obtain a flat fee percentage of sales above an agreed-upon threshold. Swatch provided free displays and training to its dealers, and Orologio was entitled to advertising support through a co-op agreement in which the parties equally shared the costs of advertising. The court applied the criteria in *Cassidy v. Snydergeneral Corp.*,[52] stating that "there was a lack of control and dependence" since Orologio had the freedom to choose whether to do business with Swatch and was not economically dependent on them. An important fact the court considered in its analysis was that after the termination as a dealer, Orologio's business actually increased.

Approach Distribution Agreements with Caution

In sum, practitioners must remember that neither manufacturers nor distributors are immune from the NJFPA. What the parties name their agreement (*e.g.*, a distribution agreement or a franchise agreement) is irrelevant. If a client's arrangement takes on the definitional characteristics of a franchise agreement under the NJFPA, including the community of interest component, then it is likely to have a franchise agreement. Thus, practitioners advising clients on these issues should make themselves familiar with the NJFPA, and should perform a careful and detailed factual analysis to determine whether their client's relationship satisfies the community of interest element of the NJFPA. ⚖

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ENDNOTES

1. N.J.S.A. 56:10-1 to -15.
2. N.J.S.A. 56:10-2.
3. More specifically, the Legislature states that the act is intended to apply to retail businesses and wholesale distribution franchisees "that, through their efforts, enhance the reputation and goodwill of franchisors in this State." *Id.*
4. N.J.S.A. 56:10-10.
5. This article is limited to a review of the NJFPA. A distributor must consider its obligations to file or register pursuant to any statutes regulating the sale of franchises or business opportunities. That process should be in conjunction with a licensed practitioner of its specific state. In addition, a manufacturer/supplier has to determine whether its business model is exempt by the Federal Trade Commission (FTC) pursuant to Section 18(g) of the Federal Trade Commission Act, 15 U.S.C.A. § 57a(g), or by the FTC's Trade Regulation Rule, Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. Part 436, also known as the Franchise Rule. The authors' review for this article is limited solely to the NJFPA.
6. N.J.S.A. 56:10-3(a).
7. *Id.*; N.J.S.A. 56:10-4(a).
8. *Neptune T.V.*, 190 N.J. Super. at 165; *Colt Indus. Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117, 124 (3d Cir. 1988); *see New Jersey American, Inc. v. Allied Corp.*, 875 F.2d 58, 63 (discussing the legislative history behind the act and lack of an express definition).
9. *New Jersey American, Inc.*, 875 F.2d at 64; *Neptune T.V.*, 190 N.J. Super. at 164.
10. N.J.S.A. 56:10-5, -7(e).
11. *New Jersey American, Inc.*, 875 F.2d at 62 (*quoting Neptune T.V.*, 190 N.J. Super. at 161).
12. *Instructional Sys.*, 130 N.J. at 356.
13. *Cassidy Podell Lynch, Inc. v. SnyderGeneral Corp.*, 944 F.2d 1131, 1140 (3d Cir. 1991); *accord Orologio of Short Hills, Inc. v. The Swatch Group (U.S.) Ltd*., Civ. No. 11-6854, 2015 WL 4496653, at *6 (D.N.J. July 23, 2015), *appeal filed* (3d. Cir. Aug. 25, 2015).
14. *Neptune T.V. v. & Appliance Service, Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc.*, 190 N.J. Super. 153, 167 (App. Div. 1983).
15. *Neptune T.V.*, 190 N.J. Super. at 165.
16. *Neptune T.V.*, 190 N.J. Super. at 164.
17. *Id*.
18. *Id.*
19. *Id.* at 168.
20. 844 F.2d 117, 120-21 (3d Cir. 1988).
21. *Id.*
22. *New Jersey American, Inc.*, 875 F.2d at 61-63.
23. *Id.* at 62-64.
24. *Id.* at 65.
25. *Id.* at 59-60.
26. *Id.* at 60.
27. *Id.* at 63.
28. *Id.* at 64.
29. *Id.*
30. *Id.* at 65.
31. *Id.* at 65.
32. 944 F.2d 1131 (3d Cir. 1991).
33. *Id.* at 1143.
34. *Id.* at 1134.
35. 130 N.J. 324 (1992).
36. *Instructional Sys.*, 130 N.J. at 357.
37. *Instructional Sys.*, 130 N.J. at 356 (*quoting Neptune T.V.*, 190 N.J. Super. at 165).
38. *Instructional Sys.*, 130 N.J. at 360 (*quoting Ziegler Co. v. Rexnord, Inc.*, 407 N.W.2d 873, 879 (Wis. 1987)).
39. *Id.* at 359 (*quoting Cassidy v. SnyderGen. Corp.*, 944 F.2d 1131, 1143 (3d Cir. 1991)); *accord DeLuca v. Allstate New Jersey Ins. Co.*, No. A-2724-11T4, 2014 WL 1884403, at *3 (App. Div. May 13, 2014).
40. *Cooper*, *supra,* 63 F.3d at 270.
41. *Instructional Sys.*, 130 N.J. at 356-57.
42. *Cooper Distributing Co.*, 63 F.3d at 269 (*quoting Instructional Sys.*, 130 N.J. at 141) (*citing* N.J.S.A. § 56:10–3(a)) (citations omitted); *see also Atlantic City Coin & Slot Serv. Co., Inc. v. IGT*, 14 F. Supp. 2d 644, 659 (D.N.J. 1998).
43. *Instructional Sys.*, 130 N.J. at 357.
44. *Instructional Sys.*, 130 N.J. at 324. The FTC additionally requires that the "franchisor exert[ ] or [have] authority to exert a significant degree of control over the franchisee's method of operation." 16 C.F.R. § 436.2(a).
45. *Id.* at 363; *accord DeLuca, No.* A-2724-11T4, 2014 WL 1884403, at *3. *See also Atlantic City*, 14 F. Supp. 2d at 663-64 (holding that franchise-specific investments included, among other things, expanding marketing facility to sell, service, and modify defendant's products, purchasing a computer system, show room models for demonstrations, service manuals and stationery, leasing additional warehouse space, and installing a base of clients).
46. *Cassidy*, 944 F.2d at 1144; *Cooper*, 63 F.3d at 270.
47. *New Jersey American*, 875 F.2d at 62; *Neptune T.V.*, 190 N.J. Super. at 164.
48. *Atlantic City Coin & Slot Serv. Co. v. IGT*, 14 F. Supp. 2d 644, 661 (D.N.J. 1998).
49. *Id.* at 663.
50. *Id.* at 664.
51. Civ. No. 11-6854, 2015 WL 4496653, at *6. The court also found that the parties did not have a licensing agreement and, therefore, could not be governed by the NJFPA. *Id.*
52. *Cassidy Podell Lynch, Inc. v. Snydergeneral Corp.*, 994 F.2d 1131, 1140 (3rd Cit. 1991).

Franchise Systems Changes and the New Jersey Franchise Practices Act

by Thomas J. Goodwin

Franchising is a business model in which uniformity plays a prominent part. Consumers like to know that a product purchased in one part of the country from one franchise is of the same nature and quality as one purchased in any other part of the country. Likewise, brand consistency is important to franchisors who want their trade dress and store identity to be uniform throughout the country (or the world for that matter) so consumers can instantly recognize the franchise. But what happens when a franchisor wants to revise its product offerings, pricing model, logo and signage, or upgrade facilities' appearance with concomitant impact on franchisees?

Express Provisions of the Franchise Agreement

It is common for a franchisor seeking to enforce system upgrades to point to express provisions of a franchise agreement permitting such conduct. In contrast, franchisees opposing a requirement to update systems frequently rely on the covenant of good faith and fair dealing.

As a general proposition, courts are reluctant to interfere with conduct expressly permitted by a franchise agreement. For example, in *La Quinta Corp. v. Heartland Properties LLC*,[1] a franchisor terminated a franchise agreement after its franchisee refused to implement changes to a computerized reservation system. The franchisee alleged the termination breached the implied covenant of good faith and fair dealing because the cost of implementing the changes was beyond that contemplated at the time it entered into the franchise agreement. The Sixth Circuit rejected the franchisee's claim, finding the terms of the franchise agreement were unambiguous with respect to the franchisor's right to require system changes. In its reasoning, the court adopted the general deference to the express terms of an agreement, noting, "where the contracting party complains of acts of the other party that are specifically authorized in their agreement, we cannot see how there can be any breach of good faith and fair dealing."[2]

Similarly, in *Layton v. AAMCO Transmissions, Inc.*,[3] a franchisee was unsuccessful in its claim for breach of the implied covenant of good faith and fair dealing where a franchisor unilaterally modified terms of the franchise agreement. The court granted the franchisor's motion for summary judgment, finding it had exercised its rights under the express terms of the agreement, which permitted unilateral changes, and had applied those modifications to all of its franchisees.

Likewise, in *Economou v. Physicians Weight Loss Ctrs. of Am.*,[4] franchisees that had operated a number of weight-loss facilities challenged the franchisor's system-wide implementation of a new diet program, which led to decreased sales and an inability to operate at a profit, resulting in their ceasing operations. The franchisor attempted to enforce a post-termination restrictive covenant and the franchisees objected, arguing the franchisor's program change was a breach of the franchise agreement, which excused them from complying with the restrictive covenant. The court rejected the franchisees' argument and enforced the covenant based, in part, on an express provision of the franchise agreement, which expressly permitted the franchisor to make changes in the diet program.

Absence of Specific Provisions

Even if a franchise agreement does not expressly recite which specific systems the franchisor may require be updated, it may refer to system upgrades in more general terms. Under such circumstances, the implied covenant of good faith and fair dealing may be implicated.

For example, in *Burger King Corp. v. E-Z Eating, 41 Corp.*,[5] the franchisee asserted the franchisor's failure to grant the franchisee an exception to a system-wide implementation of a "value menu" was a breach of the implied covenant of good faith and fair dealing. The franchise agreement provided the franchisee "agrees that changes in the standards, specifications and procedures may become necessary and desirable from time to time and agrees to accept and comply with such modifications, revisions and additions to the [Operating Manual] which [franchisor] in the good faith exercise of its judgment believes to be desirable and reasonably necessary."[6] The franchise agreement did not specifically mention the right to require a value menu. Nevertheless, the 11th Circuit affirmed summary judgment in favor of the franchisor, determining the franchisor had not acted in bad faith when it required system-wide compliance and was exercising rights generally reserved in the franchise agreement.

A different result was obtained in *Manhattan Motorcars, Inc. v. Automobili Lamborghini, S.p.A.*,[7] in which the contract between an automobile dealer and manufacturer was silent on the issues of exclusivity and territory. When the manufacturer granted dealership rights to a nearby competitor, the automobile dealer alleged a breach of the covenant of good faith and fair dealing. Although the contract did not expressly prohibit the manufacturer's conduct, the dealer alleged the manufacturer acted in bad faith, arguing the nearby competitor would usurp sales and the "loss of market share increases 'the risk of a termination by [manufacturer] under the dealer agreement, because each dealer must sell a specified minimum number of vehicles, and failure to meet the minimum is grounds for termination....'"[8] The court held that the dealer stated a claim for relief under the implied covenant of good faith and fair dealing, accepting the dealer's argument that "the unique nature of the market for Lamborghini automobiles carries with it an understanding that the manufacturer will not 'park a competitor in [an approved dealer's] backyard[,]' such that the exclusivity term could fairly be implied into the contract."[9]

It is well-settled in New Jersey that the "covenant of good faith and fair dealing is implied in every contract."[10] In *Wilson v. Amerada Hess Corp.*, a franchisee operated a gas station pursuant to an agreement that expressly permitted the franchisor to set gasoline prices. The franchisee alleged the franchisor's price increases prevented it from operating at a profit. In addition, the franchisee alleged the franchisor sold gasoline at reduced prices to certain other franchisees through its dealer assistance program. The Supreme Court of New Jersey remanded the case for discovery and stated the franchisor had to provide "an explanation for its pricing that is not arbitrary, capricious, or unreasonable"[11] in order to avoid a jury question for breach of the implied covenant of good faith and fair dealing.[12]

In New Jersey, parties must exercise good faith even if a contract explicitly permits a specific course of conduct. Nevertheless, New Jersey courts give deference to the terms of an agreement and a party asserting a breach of the implied covenant of good faith and fair dealing must prove an evil intent or bad motive.[13]

In *Pai v. DRX Urgent Care, LLC*,[14] a franchisee brought a claim for breach of the implied covenant of good faith and fair dealing as a consequence of the franchisor imposing new system standards. The franchisee alleged the franchisor "initiated material and system-wide changes, designating a vendor to provide required services as a mandatory contract, despite the fact that the contract increases...costs on an annual basis of at least $30,000."[15] The franchisee faced a difficult obstacle, however, since the franchise agreement provided "that the franchisor 'may modify the System Standards, and these modifications may obligate [the franchisee] to invest additional capital in the Franchised Business and/or incur higher operating costs.'"[16] The court noted that "[w]hile New Jersey does recognize a cause of action for breaching the covenant, the duty of good faith and fair dealing cannot be used to supersede the express terms of a valid contract."[17] The court found the franchisor's conduct was permitted by the express terms of the agreement and dismissed the franchisee's claim because it was unable to submit "proof of bad motive or intention."[18]

In *Anil Enterprises v. Getty Petroleum Mktg. Inc.*,[19] another gasoline retailer case, the franchise agreement permitted rebranding and reasonable price adjustments for gasoline by the franchisor. Shortly after the gas station was rebranded, the franchisor raised the price charged to the franchisee for gasoline. The franchisee commenced suit, alleging the franchisor was acting arbitrarily and denying it the benefit of its contracted-for bargain. The court granted the franchisor's motion for summary judgment because the franchisee did not prove a bad motive or an attempt by the franchisor to undermine the franchisee's full benefit of its bargain. The court suggested there might have been a different outcome had the franchisee been able to demonstrate the price increase was "an intentional sales strategy to gain profit"[20] at the expense of the franchisee.

As a general matter, therefore, the requirement of demonstrating proof of bad motive or intention can pose a significant hurdle to a New Jersey franchisee opposing a system-wide change in standards. While perhaps a franchisee might be able to demonstrate bad motive if a franchisor made an isolated (as opposed to system-wide) change in standards, the mere fact that a proposed change is to be implemented system wide can significantly diminish any implication of bad motive on the part of the franchisor.

The New Jersey Franchise Practices Act

The New Jersey Franchise Practices Act[21] may afford some solace to a franchisee faced with system-wide changes. One of the act's chief objectives was to address the perceived inequality of bargaining power between franchisors and franchisees. Among other things, the act provides protection for a franchisee by prohibiting a franchisor from imposing "unreasonable standards of performance."[22] The act does not define the term "unreasonable standard," but case law analyzing this provision provides some guidance.

In *Beilowitz v. General Motors Corp.*,[23] an automobile parts distributor attempted to impose territorial limitations upon its franchisee as part of a new business strategy after a 23-year relationship during which there were no territorial restrictions. The franchisee argued that such limitations would result in a loss of 40 percent of its sales. The court held that "[i]t is clearly an 'unreasonable standard of performance' within the meaning of the [Act] to require a franchisee to operate at a substantial financial loss while the franchisor attempts to implement a new and unproven marketing strategy."[24]

Similarly, in *Naik v. 7-Eleven, Inc.*,[25] franchisees alleged they were expected to assume all responsibilities with respect to maintenance of their facilities while the franchisor controlled the frequency and methods of repairs, leaving the franchisors unable to perform in accordance with their franchise agreement. The franchisees contended they were expected to purchase maintenance contracts from the franchisor, which left them at the mercy of the franchisor when repairs were needed since maintenance calls went unanswered and caused them to lose profits due to spoiled product. Accepting as true the factual allegations and inferences that could be drawn from them, the court denied the franchisor's motion to dismiss claims under the act, finding the allegations in the complaint were sufficient to demonstrate a violation of the act.

In *Cornerstone Inv. Partners, LLC v. Steak n Shake Enterprises, Inc.*,[26] a franchisee alleged it experienced significant operating losses stemming from unexpectedly high costs. When the franchisor refused the franchisee's request to change system requirements contributing to the high costs, the franchisee brought suit alleging, among other things, violations of the act. The court found the failure of the franchisor to change system-wide standards did not violate the act. Perhaps significantly, in contrast to *Beilowitz*, the franchisor in *Cornerstone* was not seeking to impose new standards. It merely refused to comply with the franchisee's request to amend existing, agreed-upon, standards.

The act is not a panacea permitting a franchisee to oppose system changes. In *King v. GNC Franchising, Inc.*, the court noted the "mere disagreement with the franchisor's standards and requirements does not...render them unreasonable.[27] Rather, "arbitrariness, bad intent or economic ruin…appear to be the hallmarks of an 'unreasonable standard of performance' under the [Act]."[28]

Conclusion

Franchising, by its nature, requires that franchisors and franchisees adapt to changing circumstances. Concepts or appearances that might have been wonderful 10 years ago may be outdated now. Thus, franchisors seek leeway in addressing the need to update operations, standards or facility appearance. Ideally, the best way to address those issues would be to have express and unequivocal language to that effect in the franchise agreement. But, even if these issues are specifically addressed in a contract, New Jersey limits a franchisor's ability to impose system-wide changes to agreements that are reasonable under the circumstances, and changes that are arbitrary or could lead to significant economic losses may be prohibited. ⚖

Thomas J. Goodwin *is a member of McCarter & English, LLP and chair of its franchising and distribution law group.* *The author acknowledges the assistance of Kyle A. Valente, Rutgers Law School, class of 2017, in the preparation of this article.*

ENDNOTES

1. 603 F.3d 327 (6th Cir. 2010).
2. *Id.* at 338.
3. 717 F. Supp. 368, 373 (D.Md. 1989).
4. 756 F. Supp. 1024 (N.D. Ohio 1991).
5. 572 F.3d 1306 (11th Cir. 2009).
6. *Id.* at 1308.
7. 244 F.R.D. 204 (S.D.N.Y. 2007).
8. *Id.* at 218.
9. *Id.*
10. *Wilson v. Amerada Hess Corp.,* 168 N.J. 236, 773 A.2d 1121, 1126 (2001) (*citing Sons of Thunder, Inc. v. Borden, Inc.,* 148 N.J. 396, 690 A.2d 575 (1997)).
11. *Id.* at 254.
12. *See also JOC, Inc. v. Exxonmobile Oil Corp.,* 2010 WL 1380750 (D.N.J. 2010) (Gasoline station franchisees' allegations that petroleum company franchisor acted arbitrarily, unreasonably, or capriciously, when it used its discretionary power to control gasoline prices and volume to such an extent as to imperil franchisees' profitability stated a claim for breach of covenant of good faith and fair dealing…).
13. *See Wilson,* 168 N.J. at 251 (*quoting JRT, Inc. v. TCBY Sys., Inc.*, 52 F.3d 734, 736 (8th Cir. 1995) ("[w]ithout bad motive or intention, discretionary decisions that happen to result in economic disadvantage to the other party are of no legal significance.").
14. 2014 WL 837158 (D.N.J. 2014).
15. *Id.* at 5.
16. *Id.* at 10.
17. *Id*.
18. *Id.* at 11.
19. 2009 WL 467844 (D.N.J. 2009).
20. *Id.* at 4.
21. N.J.S.A. 56:10-1, *et seq*.
22. N.J.S.A. 56:10-7(e). In addition, N.J.S.A. 56:10-7.4(a), applicable specifically to motor vehicle franchises, prohibits a franchisor from "impos[ing] unreasonable standards of performance or unreasonable facilities, financial, operating or other requirements upon a motor vehicle franchisee."
23. 233 F. Supp. 2d 631 (D.N.J. 2002).
24. *Id.* at 644.
25. 2014 WL 3844792 (D.N.J. 2014).
26. 2015 WL 4094630 (D.N.J. July 2, 2015).
27. 2006 WL 3019551 at 4 (D.N.J. 2006). *See also, Liberty Lincoln-Mercury, Inc. v. Ford Motor Co.*, 2006 WL 1098178 (D.N.J. 2006), *rev'd in part*, 676 F.3d 318 (N.J. 2012) (franchisor surcharge not unreasonable standard of performance because it did not constitute a penalty on the franchisee) and *Central Jersey Freightliner, Inc. v. Freightliner Corp.,* 987 F. Supp. 289 (D.N.J. 1997) (no evidence that franchisor's requirement that franchisee purchase specified number of vehicles, maintain specified number of vehicles in stock and maintain certain financing, was unreasonable).
28. *Id.* at 5.

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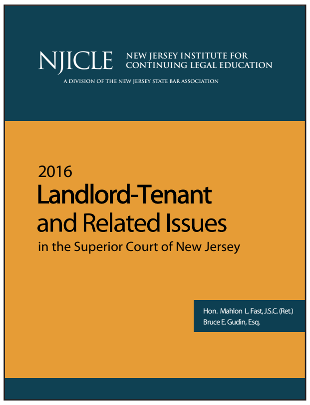

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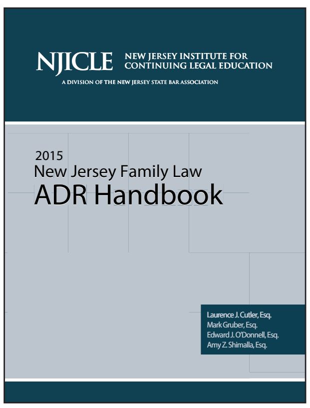

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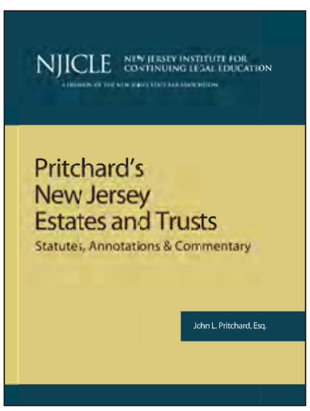

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The Franchisee and Franchisor Relationship

An Easy Exit (or Not)

by Harris J. Chernow

The franchise relationship begins once the franchisee (the person or entity receiving the rights to operate the franchised business) and the franchisor (the entity granting the rights to allow the franchisee to operate the franchised business system) have put pen to the franchise agreement, which is the cornerstone of the franchise relationship. The relationship term, at least initially, is usually between five and 10 years, although some run for 20 years or more, during which both parties hope to build a successful relationship. However, problems may, and do, arise during franchise relationships, some of which may require termination of the franchise agreement.

At first glance, it is easy to assume the termination of a franchise relationship is no different than any other contractual relationship. In fact, there are numerous franchise nuances that need to be taken into account, which do not make it easy to simply terminate the relationship from the franchisee or franchisor perspective.

The dynamics of the franchise relationship begin with the concept that there is a brand (the trademark/tradedress), an established system of how to operate the business, and a business relationship that 'hides' the true owner (the franchisee) of the franchised business behind the brand, since it is typically only the brand that is known to the general public. Many of the issues that can arise emanate from these questions: Did the franchisor approve an ideal candidate to be a franchisee? Did the franchisee really understand the franchise relationship and what they were getting into? Did the parties really understand the contractual relationship when signing a long-term franchise agreement? And, is the relationship meeting the expectations of one or both parties?

One of the primary reasons for issues with the franchise relationship is the failure of the prospective franchisee to fully understand what the franchise relationship is *really* all about. The issue begins with the prospect's failure to read and understand the franchise disclosure document (FDD), the required disclosure document pursuant to the Federal Trade Commission Franchise Rule,[1] and failure to engage a lawyer who concentrates in franchise law and a good accountant to analyze the financial aspects of the business *before* entering into the franchise relationship. Too often, prospective franchisees simply rely on their perception that a franchise is a 'guaranteed success.'

Franchisees often go into the relationship thinking they control all aspects of the business, and that—other than the brand and an operating manual—the franchise is no different than if they started their own independent business. The fact that there is more to the relationship often remains unrealized until *after* the franchise agreement is signed.

The franchise industry is, however, a vibrant and significant component of the U.S. economy, with over 760,000 units operating in 2014.[2] It provides many successful business models, but it does not guarantee success. Like all relationships, some may last and flourish, while others will need to be dissolved.

This article will describe, from the franchisor's prospective, issues that arise when contemplating a termination (other than a sale in the normal course, which in the franchise relationship also has its own nuances and unique issues).

Should You Terminate the Relationship?

If there is a valid reason to terminate the franchise relationship, the franchisor must decide whether to issue a default notice and/or terminate[3] the franchisee; or seek an alternative resolution. (While not all defaults result in termination, a franchisor should avoid sending default notices unless the franchisor is ready, willing and able to follow through with a termination should the need arise.) Although, at times, a termination may seem like the clear answer (*e.g.*, if the franchisee has failed to pay royalties or there are health and safety non-compliance issues) the decision can be difficult. Termination is an acknowledgement that the franchise relationship has failed in one form or another. Terminating a franchisee can do more harm than good, which is sometimes overlooked in the process. Prior to deciding whether to terminate the relationship, the parties should analyze the facts, the law and the intangibles surrounding the proposed termination and whether it really makes sense in that particular circumstance.

Benefits/Costs to Avoiding Termination

There are certain reasons for termination of the franchise agreement that one would think should not be tolerated, the most notable being a refusal to pay fees or a violation of non-competes. Of course, not all breaches are so simple. Just because a franchisor can default and/or terminate a franchisee (even for non-payment) does not mean the franchisor should do so. Instead, the franchisor should realistically assess the benefits and costs that may result from terminating or not tolerating a problem franchisee.

For example, a reason to avoid termination is to actually maintain the flow of royalties, advertising fees and other payments and avoid the effect the closure of a location can have. While the failure to pay royalties and other payments may be the reason a franchisor is considering termination, the actual termination of the franchisee will ensure the franchisor receives no payments (unless the franchisor is confident it can immediately take over the business itself or have a new franchisee in place almost immediately). By examining any possible alternatives to termination, the franchisor may be able to continue receiving some payments from the franchisee. In the case of a franchisee simply falling behind in payments, a default notice coupled with alternative solutions could salvage the relationship, provide for ongoing payments and avoid the costs (direct and indirect) of termination.

Termination not only cuts off the flow of royalty and other payments, it could also mean significant indirect costs for the franchisor that far exceed the loss of royalty payments. While some terminations may appear to be straightforward, they can quickly become very expensive—both in terms of legal fees and resources the franchisor will have to devote to the matter and brand detriment.

A potential concern is the damage to the brand. If the franchise relationship ends, does the business close? And if the business closes, without the franchisor or a new franchisee operating at the same location, the public may perceive that the *entire* system/chain is closing, or that there are problems with the system as a whole, since the general public may not realize the business was owned and operated by an independent franchisee. The franchisor, however, must also consider the costs of not terminating a franchisee. Although the franchisor may avoid some legal and operational costs by not starting the process, failure to do so may simply delay the inevitable, and may allow the unconforming franchisee to cause greater damage over time. Legal fees should not be the determining factor of whether it is better to keep a non-compliant franchisee in or out of the system.

There are other 'intangible' costs to not terminating a franchisee. Uniformity is a primary goal of any franchise brand, so an unreasonable amount of dissent may be harmful to that brand. Further, a franchisor must be careful to not develop a reputation with its franchisees for an unwillingness to enforce its franchise agreements. For example, violations of non-compete agreements can be particularly harmful to franchise systems that are not well established.

Are There Alternatives to Termination?

When considering whether to terminate a franchisee, a franchisor should assess what, if any, alternatives exist to termination. One of the most common alternatives to terminating a troubled franchisee is to use workouts. A workout is an agreement between the franchisee and franchisor, and any other relevant parties, whereby the franchisor provides some assistance to the franchisee or agrees to waive certain obligations or payments. A workout can be as simple as the franchisor deferring or forgiving certain franchise payments, or it can involve complex financing and leasing arrangements.

Regardless of the precise details of the workout, its primary importance is that all parties involved acknowledge the benefit of the franchisee continuing to operate the franchised business.

How Will the Brand and System be Impacted?

As alluded to, this might be the most important aspect. The termination of a franchisee may directly impact the existing customers of the franchisee and the brand. When the franchisee does shut down, there is the potential that the franchise system will lose those customers, as there is no guarantee the customers will return to that particular unit even if it is re-opened by a different franchisee, or that the customers will seek out another franchised unit. Additionally, the customers identify the now-closed unit with the franchisor's trademarks, and a closing will likely reflect poorly on the quality or viability of the entire franchise system. To what degree the closing reflects poorly on the brand depends largely on the size of the system and the overall strength of the franchise.

Not only could termination impact customers and their perception of the franchise system, a termination also could have a negative effect on the franchise system with its other franchisees. It is important to consider the effect the termination could have on the morale of other franchisees. Obviously, in large franchise systems, a single termination is not likely to have a considerable effect on franchisee morale. However, if the franchise system is small, or there have been a relatively high number of recent franchisee defaults or terminations, the impact on morale could be substantial. To mitigate the impact of a termination in such circumstances, the franchisor should consider how to present the termination to its franchisees. By focusing on the aspects of the termination that are beneficial to the franchise system—namely protecting the goodwill of the brand—the franchisor can address some of the potential concerns of existing franchisees, but there is still an impact on the general public, and possibly on lenders, vendors, landlords and other third parties. Many lenders, suppliers and vendors may simply choose to stop doing business with a franchisor if they have been on the wrong end of too many franchisee failures.

The termination of a franchisee could also have an effect on prospective franchisees. A franchisor will have to disclose the number of franchisees that have left the system in the FDD.[4] Also, if litigation occurred as a result of any termination, the litigation will have to be disclosed in the FDD.[5] These disclosures could create a negative impression on prospective franchisees. Also, if the franchisor's current or former franchisees believe the franchisor is quick to terminate, the perception can get back to prospective franchisees.[6] A termination affects far more than the terminated franchisee, causing the intangible damage equation.

Termination Methodology

There is no set methodology to initiating the termination process, especially in light of the inherent direct and indirect issues concerning the brand. But, one can use the following as part of a checklist of items for the analysis.

Often the request to terminate a franchisee lands on the in-house or outside counsel's desk, at which point it may be too late to do anything but issue the termination. Many times it is taken for granted that all avenues of reconciliation and/or addressing the issue have been explored, and that there is no other choice but to terminate the breaching franchisee. However, it is often learned during the termination process that the issue could have been addressed differently, or even resolved well before reaching the point of issuing a termination notice. A franchisor should try to develop procedures where defaults (or signs of defaults) are addressed from the outset, outlining the steps to be taken to attempt resolution before the matter reaches the person responsible for issuing default notices.

A franchisor should first gather the relevant facts and information relating to the franchisee. (As basic as this seems, it is often ignored simply because a franchisor representative said the termination process should be set in motion, and it is then assumed that a thorough review already occurred.) The starting point should be the franchisor's own files pertaining to the franchisee, including electronic communications with the franchisee. The franchisor should review files from the legal department, franchise operations department, accounting department, and any other department with relevant information about the franchisee. Avoid the tendency to focus only on the specific circumstances that gave rise to the possible termination; instead, review all factors, as they are bound to come out in the process.

Also, some of the best information can be garnered from the franchisor's operations personnel, who have interacted directly with the franchisee. Obtaining personal accounts can help develop a more complete narrative of the franchisee than can be established through documentation in the files alone.

The Franchise Agreement

While it may seem obvious, it is surprising how often the franchisor fails to review the applicable franchise agreement. This is an essential step to ensure that a termination is handled properly. If the requirements in the franchise agreement are not followed, a termination may not be effective, and could expose the franchisor to a wrongful termination claim and a tarnished reputation.

A common mistake is assuming that all of the franchise agreements are identical. Each year the franchise agreement, by virtue of any required FDD updates, may change. Additionally, the particular franchisee in question may have negotiated its own changes to the franchise agreement. Therefore, it is imperative to review the franchise agreement and any amendments/addenda.

State Relationship Laws

To complicate things even more, a number of states have laws addressing the franchise relationship, including the default and termination of franchisees and certain unfair practices and obligations arising post-termination. Prior to proceeding with a termination, the franchisor should investigate if any state relationship laws would be applicable and, if so, what the impact of those laws would be. These states have created franchise-related laws that are applicable once the parties have entered into a franchise agreement. (They are different from those states that have 'disclosure laws' that supplement the FTC Franchise Rule.)[7] The state relationship laws regulate, at times, how a franchisee can be placed in default and/or terminated, which obviates or supplements the terms of the franchise agreement.

Often, a franchisor relies solely on the terms of the franchise agreement and forgets to address the state relationship laws. By doing so, a franchisor creates a situation in which it may have *had* the upper hand but has now relinquished it to the franchisee, and may have lost its leverage in connection with the termination process. Further, if an applicable state relationship law has not been followed, the franchisor could incur certain sanctions, for example those pursuant to the New Jersey Franchise Practices Act,[8] for what would be deemed a wrongful termination. This is another one of the nuances and complexities of the franchise business model that can be addressed with a simple checklist regarding states with franchise relationship laws and/or consults with franchise attorneys to determine the exact means for the termination process in the relationship states.

In general, the relationship laws extend the notice period for default and/or termination, and determine what situations qualify as a default and allow for termination. Some states even provide for certain remuneration in connection with defaults, such as the buyback of certain inventory and/or furniture, fixtures and equipment.

Further complications arise in implementing the appropriate state relationship laws. In some cases it is assumed that a franchisee resides in a particular state simply because of the notice address in the franchise agreement. It is important to determine the exact location of the franchisee that is being terminated, as that state's law may be applicable. There could be multiple units being terminated that are in multiple states, and the franchisor may need to apply each and every state's relationship laws that are applicable to the situation for a valid termination. Do not assume the address on the franchise agreement is current; do not assume the notice address is the location of the unit; and do not assume the unit is still located at the address noted in the franchise agreement, which may have been entered into several years ago. Any of these oversights could be very costly to the franchisor in terms of embarrassment and, as previously noted, its leverage in the default and termination process.

There are currently 21 states, plus Puerto Rico and the United States Virgin Islands (there are also various international statutes), that have enacted franchise-related statutes that govern in some form the default and/or termination of the franchise relationship by the franchisor, including New Jersey.[9] While general trends can be identified, no two statutes are exactly the same. Under a number of the statutes, a franchisor must have good cause prior to termination. However, the definition of good cause varies among these state relationship laws.

Similarly, some of these statutes require a franchisor provide notice and an opportunity to cure prior to termination, but the time periods can vary, as well as the exceptions to the notice and cure requirements. Accordingly, a franchisor should identify the applicable state relationship law, if any, that applies and what that state law requires.

Determining which state relationship law applies also requires an analysis of the jurisdictional application of the relevant state relationship law. Some states with relationship laws do not specifically address the jurisdictional application of the termination provisions, but the majority do state when the law applies.[10] Out of the jurisdictions that do address the jurisdictional application, Arkansas, Connecticut, Delaware, Illinois, Iowa, Maryland, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Wisconsin, and Puerto Rico have the narrowest jurisdictional application. In these jurisdictions, a franchisor must comply with the termination provisions in the relevant law only if the franchised unit is actually located within the state.

The jurisdictional application of the California[11] and Indiana[12] relationship laws are slightly broader. As with the states discussed above, the California and Indiana relationship laws apply to situations where the franchised unit is located within the state. The California relationship law, however, also applies if the franchisee is domiciled in California, while the Indiana relationship law also applies if the franchisee is a resident of Indiana.

The states with the most comprehensive jurisdictional application are Michigan and Minnesota. The Michigan relationship law applies if: 1) the franchised unit is in Michigan, 2) the franchisee is domiciled in Michigan, or 3) the offer to buy the franchise is accepted in Michigan.[13] The Minnesota relationship law applies if: 1) the franchised unit is in Minnesota, 2) a sale is made in Minnesota, or 3) an offer to sell or purchase is made or accepted in Minnesota.[14]

As these states have varying jurisdictional application provisions, a franchisor should familiarize itself with the applicable laws. Franchisors should also recognize that if the franchise agreement has a choice of law provision designating the law of one of the above states, a franchisee may attempt to argue that the relationship law of that state would apply even if the franchisee has no relationship to the state.[15]

An example of such an argument took place in *1-800-Got Junk? LLC v. Millennium Asset Recovery, Inc*, in which the franchisor terminated the franchisee without notice or an opportunity to cure for failing to report revenue and pay monies due.[16] The franchisee sued the franchisor for breach for terminating the franchise agreement without cause.[17] The franchise agreement stated that Washington law would govern the terms of the contract, yet the *franchisor* sought to apply California law, which would have provided the franchisor with grounds for immediate termination.[18] Following a bifurcated choice of law trial, the trial court held Washington law applied to the action.[19] The court of appeals agreed with the trial court and held that Washington law was applicable because: 1) the franchisor had a reasonable basis for inserting a choice of law provision in the franchise agreement, and 2) Washington law was more protective of the franchisee, which is the more vulnerable party to the agreement.[20]

Most of the state relationship laws require good cause for termination, and also impose mandatory notice and cure periods. However, the precise details of these requirements vary among the state relationship laws. A franchisor must closely examine the relevant state law to understand the applicable requirements governing termination.

Good Cause is Obvious, Right?

Out of the states that do have a good cause requirement, a number of them simply provide a general definition of good cause.[21] While these definitions vary slightly, they generally state that good cause is a failure to comply with the lawful and material provisions of the franchise agreement. Some of these states go further, and outline specific situations that constitute good cause for termination.[22]

Other states that require good cause include a more thorough definition of what constitutes good cause. For instance, Iowa law contains the general definition of good cause discussed above, but also includes a requirement that the termination not be arbitrary and capricious.[23] As another example, Wisconsin[24] and the Virgin Islands[25] define good cause as the failure of the franchisee to comply with material and reasonable requirements of the franchisor. They go on to state that good faith exists only if the franchisee has breached these material and reasonable requirements if the requirements have been uniformly enforced across the franchise system or the franchisee has demonstrated bad faith.

There are two states—Delaware[26] and Virginia[27]—that impose a requirement of good cause for terminations but do not further define what constitutes good cause. In situations such as these, where good cause is not defined, a franchisor can look to what constitutes good cause in other states for general guidance.

Cure and Termination Periods

If a franchisor decides to terminate a franchisee, many states have mandatory notice and/or cure periods. Mandatory cure periods can vary widely in length of time, but three general trends emerge in state relationship laws. First, a number of states do not mandate a cure period but do require notice of termination. Second, some states mandate a cure period, but do not mandate a specific number of days; instead, these states just require the franchisee be provided a 'reasonable' opportunity to cure. Finally, some jurisdictions require a franchisor to provide its franchisees with a specific number of days to cure.

Connecticut, Delaware, Indiana, Mississippi, Missouri, Nebraska, New Jersey, and the Virgin Islands are the jurisdictions that do not require a cure period. However, they do require notice prior to termination. Connecticut, Nebraska and New Jersey require a notice period of 60 days; Delaware, Indiana, Mississippi and Missouri require a notice period of 90 days; and the Virgin Islands require a notice period of 120 days.

The second group of states require a mandatory cure period, but do not mandate that the cure period be a specific number of days. This group includes California, Hawaii, Illinois, Michigan and Washington. These states require a cure period that is 'reasonable,' which generally means the cure period need not be longer than 30 days.[28] These states also require that a franchisor provide a notice of termination, but, as with the cure period, they do not specify how much notice a franchisor must provide.

The final group of states specifically regulates how long the cure period is required to be. This group includes Arkansas, Iowa, Maryland, Minnesota, Rhode Island and Wisconsin. Arkansas, Maryland and Rhode Island require a 30-day cure period; Minnesota and Wisconsin require a 60-day cure period; and Iowa requires a 'reasonable- cure period that is between 30 and 90 days long. The cure periods in Rhode Island and Wisconsin decrease to 10 days in the case of monetary defaults. Similarly, the cure periods in Arkansas are decreased to 10 days in the case of multiple defaults in a 12-month period. These states also require that a franchisor provide notice of termination to the franchisee. This notice period generally ranges from 60 to 90 days, depending on the state. However, sometimes the notice period is reduced depending on the particular type of default.[29]

Conclusion

When it comes to considering termination, there are many other issues that may also need to be addressed, such as franchisees claiming discrimination (in terms of treating one franchisee different than another in connection with termination), waiver issues (failing to act timely), good faith and fair dealing issues, tortious interference claims and a host of other concerns. The conclusion is that terminations are never simple (even though on their face the reason may be) and need to be well thought out, analyzed not only from a legal basis but from the business/franchise standpoint as well.

Most will probably agree that if termination can be avoided, it is usually the best course of action. But there are times when termination is definitely required (even if simply on principle alone, to demonstrate to the system that the franchisor does enforce its contractual terms), and in those instances the franchisor should be prepared to act.

Of course, the best way to avoid a franchisee default and/or termination is to identify potential problems while they are in their infancy. This may be easier said than done, but early identification of potential problems allows the franchisor to work with the franchisee to develop acceptable solutions, which are often cheaper and less disruptive to a franchise system than terminating a franchisee. The early identification and resolution of potential problems also serves to strengthen the franchise relationship, which can increase the chances that a franchisee will be successful and/or at least overcome the default and potential termination.

When warning signs arise, a franchisor should promptly reach out to the franchisee to investigate the situation and attempt to forge a resolution. As with most relationships, open and early communication is essential to ensuring any problems are revealed and addressed. ⚖

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ENDNOTES

1. FTL Franchise Rule – 16 C.F.R. 436.1, *et seq.*
2. *Franchise Business Economic Outlook for 2015*, prepared for International Franchise Association Educational Foundation, by I. H. S. Economics, March 2015, with a total output of over $890,000,000,000 for 2015.
3. Assuming the franchise agreement terms provide for the applicable reasons to terminate and also, if applicable, the relevant state franchise relationship laws (see below in the article).
4. 16 C.F.R. § 436.5(t).
5. 16 C.F.R. § 436.5(c).
6. 16 C.F.R. 436.5(t)(4)-(5).
7. Some states have both franchise disclosure and relationship law—the focus here is only on the relationship states.
8. N.J.S.A. 56:10-1, *et. seq.*
9. N.J.S.A. 56:10-1, *et seq.*
10. Hawaii, Mississippi, Washington and the Virgin Islands do not have specific provisions addressing the jurisdictional application of the termination restrictions in their franchise relationship laws.
11. Cal. Bus. & Prof. Code § 20015.
12. Ind. Code. Ann. § 23-2-2.5-2.
13. Mich. Comp. Laws § 445.1504.
14. Minn. Stat. Ann. § 80C.19.
15. Franchisors often include a carve out in the choice of law provision that the choice of law provision does not include the applicable franchise relationship law if it would not otherwise be applicable.
16. 189 Cal. App. 4th 500 (2010).
17. *Id.*
18. *Id.* at 516.
19. *Id*. at 504.
20. *Id*. at 519-520.
21. These states include California, Connecticut, Hawaii, Illinois, Indiana, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington.
22. The states that outline specific examples of circumstances constituting good cause include Connecticut, Illinois, Minnesota and Rhode Island. On the other hand, Hawaii allows termination for either good cause or if done in accordance with the franchisor's current terms and conditions if such standards are applied equally across the franchise system. *See* Haw. Rev. Stat. § 482E-6(2)(H).
23. Iowa Code § 523H.7.
24. Wis. Stat. § 135.02(4).
25. V.I. Code Ann. tit. 12A, § 132.
26. Del. Code Ann. tit. 6, § 2552.
27. Virginia actually requires "reasonable cause." *See* Va. Code Ann. § 13.1-564.
28. Washington provides that for defaults that cannot be cured within the statutorily mandated cure period, the franchisee may simply initiate "substantial and continuing action" to cure the default within the cure period. *See* Wash. Rev. Code § 19.100.180(2)(j).
29. For example, Arkansas does not require notice to be sent if the basis of termination is multiple defaults within a 12-month period. Ark. Code Ann. § 4-72-204(d).

Breaking Up

Preliminary Injunctions in Contested Termination Lawsuits

by Sheila Raftery Wiggins, Susan V. Metcalfe and Allison S. Khaskelis

In any long-term relationship, breaking up is hard to do—even when there is a detailed termination clause in the franchise agreement.[1] Yet, it can be especially difficult when a franchisee contests whether the franchisor properly terminated the franchise agreement. In such a case, the facts will often be contested. The outcome will depend on the language of the franchise agreement, the requirements of complex statutory regimes, and a court's inherent sense of fairness.

Good Cause: The Standard for Terminating

The fundamental rule is that the termination of a franchise agreement can only occur for good cause and, of course, not merely at the whim of a franchisor. Section 10-5 of the New Jersey Franchise Practices Act defines good cause as a franchisee's failure "to substantially comply with those requirements imposed upon him by the franchise."[2] A franchisor must demonstrate a franchisee failed to comply with the material requirements of the franchise agreement.

The act was enacted by the Legislature to address a perceived disparity in bargaining power between the franchisor and the franchisee. The act is designed to prohibit the franchisor from imposing "unconscionable" terms in its franchise agreement. Yet, the act recognizes the franchisor's business need to protect the trade name and goodwill of its franchise system. New Jersey courts take a restrictive view of what constitutes good cause for termination of a franchise agreement.

The good cause standard has limits. New Jersey case law states that the act does not protect franchisees from their own deliberate misconduct. The New Jersey Supreme Court stated, in *Dunkin' Donuts of America, Inc. v. Middletown Donut Corp.*,[3] that the act "is not designed to protect those franchisees who willfully violate the terms of their franchise agreements," and that the act "does not compensate those franchisees who have lost their franchises as a result of their own neglect or misconduct."[4] Likewise, the district of New Jersey determined in *Dunkin' Donuts Franchised Restaurants LLC v. Strategic Venture Group, Inc*.[5] that a franchisee's repeated non-compliance also constitutes good cause. In that case, the Court found the franchisee's failure to honor payroll tax law requirements was not an isolated mistake, and constituted good cause for the termination of the franchisee.

Franchisor's Goal: Protecting Its Property and the Franchise System

The franchise system thrives by ensuring consistent, high-quality customer experiences among the many franchise locations. The franchisor permits the franchisees' use of the brand logo, brand standards, brand services, and marketing in order to achieve a thriving system. A franchisee may fail to uphold the brand standard by, for example, failing to maintain cleanliness of the location (*e.g.*, a franchise hotel location fails to meet quality assurance requirements), offering products outside the franchise system (*e.g.*, a restaurant sells a competitor's product), or misusing brand logos (*e.g.*, a fitness gym refuses to display the franchise slogan or signage). When a franchisee fails to cure these deficiencies, the franchisor has the goal of accountability—holding the franchisee accountable for maintaining the franchise's brand standard as required by the franchise agreement.

The franchisor's property interest in the franchise brand is protected by federal law. The Lanham Act provides for damages and/or injunctive relief to the owner for the unlawful use of a trademark by another.[6] The term 'trademark' includes any word, name, symbol, or device that distinguishes goods or the source of goods. The term 'service mark' means any word, name, symbol, or device that distinguishes a service or the source of the service.[7] When the franchisee contests the termination, a franchisor can seek a preliminary injunction to prevent the franchisee from damaging its trademark by continuing to operate in a manner at odds with the brand standards specified in the franchise agreement while the underlying termination suit against the franchisee is pending.

An injunction is an order by the court requiring a party to stop certain activities. For a preliminary injunction to be properly issued, the court must state the reasons why it was issued, state its terms specifically, and describe in reasonable detail the acts restrained or required.[8] Thus, the party seeking to obtain a preliminary injunctive order must demonstrate to the court the existence of the following four factors: 1) a substantial likelihood of prevailing on the merits of the lawsuit; 2) a substantial threat that it will suffer irreparable injury if the injunction is not granted; 3) the threatened injury outweighs the threatened harm if the injunction is not issued; and 4) granting the preliminary injunction is in the public interest.[9]

Franchisee's Goal: Protecting the Individual Business

The franchise system also thrives by ensuring the franchisee invests capital, time, and effort to promote the franchisor's products or services. The franchisee's goal is to protect the value of the going business at its specific location. Franchisees often view themselves as protecting their livelihood and the jobs and services they provide to the neighborhood.[10]

Like the franchisor, the franchisee may also seek a temporary restraining order or a preliminary injunction to maintain the *status quo* pending the resolution of the lawsuit in which the franchisee disputes whether the franchisor properly terminated the franchise agreement. The franchisee typically seeks to continue operating the franchise location and obtaining access to the franchise products while the termination lawsuit is pending. It is not uncommon to have both the franchisor and franchisee seek competing injunctions at the outset of a termination dispute.

The franchisee's primary argument is that an injunction is necessary to prevent irreparable harm that may otherwise occur if the franchisor is permitted to withhold franchise brand support and merchandise during the pendency of the termination lawsuit. The franchisee typically argues that either: 1) the breach of the franchise agreement did not occur, or 2) the breach was *de minimis* and not worthy of the drastic step of terminating a franchise. A franchisee's secondary argument is that, during the lawsuit, the franchisor will benefit via the money earned from fees paid by the franchisee.

Convincing the Court of a Likely Win

To establish likelihood of success on the merits of the case, a franchisor's best bets are often to demonstrate: 1) repeated, deliberate, and/or substantial breaches of contract by the franchisee; and 2) the strong prospect that its trademark will be infringed by the franchisee's continued operations.

To prevail on a breach of contract claim under New Jersey law, a franchisor must demonstrate that: 1) a valid contract existed; 2) a franchisee breached the contract; 3) the franchisor performed its obligations under the contract; and 4) the franchisor was damaged as a result of the franchisor's breach.[11] When a franchisor dutifully maintained its contractual obligations prior to discovering evidence of the franchisee's breaches, the franchisor should be able to demonstrate the franchisee breached the franchise agreement.[12]

To prevail on a trademark infringement claim, a franchisor must demonstrate that: 1) it has a valid and legally protectable mark; 2) it owns the mark; and 3) the franchisee's use of the mark to identify goods or services causes a likelihood of confusion.[13] A trademark holder is entitled to unfettered control over its trademarks, a right that is effectively nullified when a franchisee continues to use those trademarks after the agreement has been terminated.

Case law from the Third Circuit establishes that the unauthorized use of a trademark causes inevitable customer confusion because a customer assumes he or she is purchasing a product from its authorized retailer.[14] A franchisor is likely to succeed on a Lanham Act claim if it can demonstrate a properly terminated franchisee continues to: 1) market and sell trademarked products; 2) utilize trademarked work apparel; or 3) otherwise operate by relying on or exploiting the franchisor's trademarks.

The franchisee will seek to present evidence to raise doubts regarding the franchisor's ability to establish the merits of its claims. In particular, the franchisee is likely to argue the continued use of the trademark by the franchisee presents no real danger of confusion concerning the mark. If the franchisor has allowed nonconforming trademark use by the franchisee (or others), delayed enforcing its rights, or tacitly encouraged or caused the breach of the franchise agreement for the purpose of creating grounds to terminate, the franchisee may also assert defenses such as the doctrine of waiver, laches, and/or unclean hands.[15]

Convincing the Court There Will be Irreparable Harm

The harm the franchisor suffers if the offending franchisee retains control of the store must go beyond recompense by money damages. A franchisor often asserts a 'quality control' argument, specifically that the inability to oversee and control the use of the mark during the pendency of the litigation will irretrievably dilute the value of the mark. The Third Circuit stated, in *S&R Corp. v. Jiffy Lube International, Inc.,* that in a trademark infringement case the "grounds for irreparable injury include loss of control of reputation, loss of trade, and loss of goodwill."[16] Likewise, the Third Circuit also stated, in *Opticians Association of America v. Independent Opticians of America,* that the key in trademark infringement cases "is lack of control which potentially might result in a damaged reputation."[17] Thus, the franchisor argues, this inability to protect its trademarks results in irreparable harm that cannot be compensated by an award of money in the future.

The loss of control of a trademark is compelling because the trademark is a unique property. Monetary damages are insufficient to compensate for the loss of control of a trademark. Moreover, a franchisor asserts that when its "interests involving real property [such as physical stores] are at stake, preliminary injunctive relief can be particularly appropriate...."[18]

On the other hand, the franchisee will argue the risk of irreparable harm is not to the franchisor but one the franchisee bears. The franchisee will attempt to show the award of money damages at the end of the case is an insufficient remedy. Typically, the franchisee will urge it stands to lose a going business as a result of the failure of the franchisor to honor brand and merchandise obligations during what could be a long and protracted lawsuit. Inevitably, the persuasiveness of this argument is impacted by the strength of the franchisor's case on the merits. If the court finds the franchisee's harm is 'self-inflicted' because the franchisee chose to stop performing under the parties' agreement, the court will likely find any risk of irreparable harm to the franchisee is outweighed by "the immeasurable damage done to the franchisor."[19]

Convincing the Court That Helping is Fair

A franchisor must show the benefits outweigh the harm a franchisee will suffer if a court issues the injunction. This is accomplished by showing the injunction will protect the franchisor while the harm to the franchisee flows entirely from the franchisee's breaches: "[A violator can] hardly claim to be harmed, since it brought any and all difficulties occasioned by the issuance of an injunction upon itself."[20] Deliberate offending behavior of a franchisee is the best evidence that fairness favors the franchisor.

A franchisor should assure the court that, if the court grants injunctive relief allowing the franchisor to operate the stores, it will maintain meticulous records to ensure that any and all income that may be due to the franchisee, should it ultimately prevail, will be properly accounted for during the operation of the injunction. This will establish that the injunction sought by the franchisor is fair, because even if the franchisee prevails in the termination dispute the franchisee will not lose any income as a result of the injunction having been granted.

Conversely, the franchisee will argue the injunction sought by the franchisor is not fair because removing the franchisee from control of the business will damage or deprive the franchisee of its livelihood and customer and employee relationships during the pendency of the lawsuit. The franchisee will claim that replacing management of the business is a step that will cause more problems than it will solve. Finally, even if the franchisor accounts for the income while it controls the business, the franchisee may assert depriving the franchisee of that income may impede the franchisee's ability to prosecute or defend the lawsuit.

Convincing the Court of the Public Interest

This final factor is often regarded as the least significant in a court's preliminary injunction calculus. As the district of New Jersey declared, "[w]here a party demonstrates both the likelihood of success on the merits and irreparable injury, it almost always will be the case that the public interest will favor the issuance of an injunction."[21] Nonetheless, this factor should not be ignored by the parties.

A franchisor may argue the public interest is better served if consumers have access to franchises that are run properly, efficiently and with integrity. The enforcement of contractual obligations and compliance with state and federal law and trademark protection are clear public values.[22] In the trademark context, courts often define the public interest at stake as the right of the public not to be deceived or confused.[23] Conversely, the franchisee will claim the disruption to employees occasioned by the takeover sought by the franchisor is contrary to public interest.

Discovery and Hearing

The court rules governing the issuance of a preliminary injunction require notice be given to the other party so it may oppose the preliminary injunction. The district court, generally, will then hear oral testimony—rather than merely relying on affidavits and other proofs—to determine whether to issue a preliminary injunction. The court may afford the parties an opportunity to conduct limited, expedited, discovery before the hearing on a preliminary injunction, often seeking the parties' cooperation in stipulating to the scope and timing. For example, when a franchisor terminates the franchise agreement because of the franchisee's failure to maintain accurate financial records—and this issue is disputed—the court may permit discovery regarding the franchisee's record keeping or permit an audit of the franchisee's financial records.

The benefit to seeking injunctive relief is to obtain a *preliminary* decision on the merits of the ultimate issue in dispute. For example, when a franchisor terminates the franchise agreement because of the franchisee's failure to maintain accurate financial records, the court may expedite a trial on the merits when the franchisor is able to demonstrate the likelihood of success on the merits of the claim. This preliminary decision can be useful in promoting settlement discussions as well.

Conclusion

A franchisor seeking a preliminary injunction to gain control of the stores of a franchisee who has disregarded its contractual obligations would be well served to remember two salient points. First, the franchisor must terminate the offending franchisee properly in compliance with the act.

Second, the crux of the franchisor's argument should focus on the immeasurable ways in which the franchisor will be harmed if the court denies the preliminary injunction. Quantifiable financial harm simply won't do because it is inherently reparable through an award of money damages. By contrast, damage to the franchisor's reputation and goodwill cannot be measured, and, therefore, adequately repaid. Such irreparable damage to reputation and goodwill will only worsen, in ways that cannot be predicted and checked, if speedy relief—in the form of a preliminary injunction—is not granted. ⚖

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ENDNOTES

1. This article addresses requests for preliminary injunctive relief within the context of the Federal Rules of Civil Procedure. Prior to the application for a preliminary injunction, a party may seek a temporary restraining order (TRO), which is typically issued without notice or with limited notice to the adverse party. The purpose of a preliminary injunction is to preserve the 'status quo' and to protect a party from irreparable harm

pending a final decision on the merits of the lawsuit. Unlike a TRO, a preliminary injunction may only be issued on notice to the adverse party. Fed. R. Civ. P. 65(a). An order granting, continuing, or modifying a preliminary injunction is immediately appealable. 28 U.S.C. § 1292(a)(1).

2. N.J.S.A. 56:10-5.
3. 100 N.J. 166, 495 A.2d 66 (1985).
4. *Id.*, 100 N.J. at 178, 495 A.2d at 72.
5. No. 07-1923 (SRC), 2010 WL 4687838 (D.N.J. Nov. 10, 2010).
6. 15 U.S.C. § 1127.
7. *Id.*
8. Fed. R. Civ. P. 65(d)(1).
9. *Opticians Ass'n of Am. v. Independent Opticians of Am.*, 920 F.2d 187, 191-92 (3d Cir. 1990).
10. A court may require a bond or other security when issuing a preliminary injunction or TRO to pay the costs and damages sustained by a party found to have been wrongfully enjoined or restrained. Fed. R. Civ. P. 65(c).
11. *See, e.g.*, *Video Pipeline, Inc. v. Buena Vista Home Entm't, Inc.*, 275 F. Supp. 2d 543, 556 (D.N.J. 2003).
12. One nuance to keep in mind is that the Third Circuit and its sister jurisdictions make a distinction between preliminary and mandatory injunctions, finding that the former typically maintain the *status quo* and prohibit actions, while the latter alter the *status quo* through affirmative steps. *Edge v. Pierce*, 540 F. Supp. 1300, 1303 (D.N.J. 1982); *Acierno v. New Castle Cty*, 40 F. 3d 645, 653 (3d Cir. 1994); *Tom Doherty Assocs., Inc. v. Saban Entm't, Inc.*, 60 F.3d 27, 34 (2d Cir. 1995). A franchisee's ouster is a change to the *status quo*. In situations seeking a change to the *status quo*, parties "bear a particularly heavy burden in demonstrating its necessity." *Acierno*, 40 F. 3d at 653. Courts will apply a heightened analysis of the merits of the claims, requiring the moving party to demonstrate a greater likelihood of success by a clear or substantial showing. *Tom Doherty Assocs.*, 60 F.3d at 34. Franchisors should keep this heightened standard in mind as they prepare their injunction requests.
13. *A & H Sportswear, Inc. v. Victoria's Secret Stores*, 237 F.3d 198, 210-11 (3d Cir. 2000); *see also* 15 U.S.C. § 1114.
14. *See, e.g.*, *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 375 (3d Cir. 1992); *Opticians*, 920 F.2d at 191-92.
15. *S&R Corp.*, 968 F.2d at 377.
16. *Id.* 378.
17. *Opticians*, 920 F.2d at 195.
18. *RoDa Drilling Co. v. Siegal*, 552 F.3d 1203, 1210 (10th Cir. 2009). *See also Equilon Entm't LLC v. Shahbazi*, No. 06-05818 (JF), 2006 WL 3507928, *5 (N.D. Cal. Dec. 5, 2006).
19. *Pappan Enter., Inc. v. Hardee's Food Sys., Inc.*, 143 F.3d 800, 806 (3d Cir. 1998).
20. *Opticians*, 920 F.2d at 197.
21. *Marsellis-Warner Corp. v. Rabens*, 51 F. Supp. 2d 508, 532-33 (D.N.J. 1999).
22. *See, e.g.*, *Certified Restoration Dry Cleaning Network, LLC v. Tenke Corp.*, 511 F.3d 535, 551 (6th Cir. 2007); *Marblelife, Inc. v. Stone Res., Inc.*, 759 F. Supp. 2d 552, 563-64 (E.D. Pa. 2010).
23. *Wetzel's Pretzels, LLC v. Johnson*, 797 F. Supp. 2d 1020, 1029 (C.D. Cal. 2011).

Defending Against the Termination of a Franchise in New Jersey

Some Practical Considerations

by Edward T. Kole and James E. Tonrey Jr.

When a client's franchise is purportedly terminated by the franchisor, there are a number of practical considerations to keep in mind when attempting to fend off the termination.

The New Jersey Franchise Protection Act

First and foremost is determining whether the client's franchise is governed by the New Jersey Franchise Protection Act (NJFPA).[1] The NJFPA is remedial legislation designed to level the unequal playing field between franchisors and franchisees caused by the fact that the franchisee, having invested money and time in promoting and selling the franchisor's product, may have no recourse in the event the franchisor unilaterally terminates the relationship.

One former federal judge described the plight of the franchisee as follows:

> Thomas Hobson, an English liveryman who lived in the seventeenth century, required his customers to take the horse nearest to the stable door or none at all. Accordingly, a "Hobson's choice" refers to an apparently free choice that offers no real alternative. Here, the Defendant franchisor...offered the Plaintiff franchisee...a Hobson's choice—either to accede to [the franchisor's] new business plan, which would result in the loss of forty percent of [franchisee's] revenue, or, after a twenty-three-year-long relationship with [franchisor] to be cut out of doing any business with [the franchisor] at all. This case illustrates the very reason the New Jersey Franchise Practices Act ("NJFPA"), N.J.S.A. §§ 56:10-1, *et seq.,* was enacted—to protect franchisees, possessed of less bargaining power than their franchisors, from such daunting "choices."[2]

Determine the Applicability of the NJFPA

Generally speaking, the NJFPA applies to a business located in New Jersey, where certain minimum gross sales requirements are met, there is a written business relationship between the parties and there is in existence a "community of interest"[3] between the parties.[4] In the event the NJFPA applies, a franchisee is provided broad protections against termination, including a prohibition on termination of the relationship in the absence of "good cause."[5]

In cases where the NJFPA applies, the franchisor is not free to terminate the franchise relationship with the franchisee. To the contrary, the franchisor must demonstrate the franchisee failed to substantially comply with the parties' franchise agreement.[6] This "substantial compliance" must be measured by the effect of the franchisee's actions or inactions on the trade name, trademark, good will and image of the franchisor.[7] Indeed, it is a violation of the NJFPA "...to cancel a franchise for any reason other than the franchisee's substantial breach, even if the franchisor acts in good faith and for a bona fide reason."[8] A franchisor may not fail to renew a franchise agreement even where the franchise is not economically feasible, or for other good faith economic reasons.[9]

Analysis of the Franchise Agreement/Choice of Law Provisions

Assuming, however, the NJFPA applies to the termination, making that determination is merely the beginning of the analysis. In addition to making the threshold determination of applicability of the NJFPA, counsel should also review the franchise agreement between the parties. Consider, for example, that the franchise agreement contains what is often contained in any garden-variety commercial agreement, a choice of law provision. Consider further that the franchise agreement contains a provision clearly, specifically and unequivocally stating the franchise agreement will be construed pursuant to the laws of a state other than New Jersey, and disclaims any applicability of the NJFPA. It is commonplace for parties to include a choice of law provision in their agreements; counsel unfamiliar with the NJFPA may conclude the NJFPA does not apply to the transaction in question.

But the NJFPA cannot be supplanted by any such choice of law provision. Consistent with the purpose of protecting franchisees from overreaching by the franchisor, the NJFPA, by its terms, prohibits a franchisor from waiving the protections of the statute.[10] The act expressly prohibits franchisors from directly or indirectly requiring a franchisee to assent to a release or waiver of the NJFPA at the time of entering into a franchise arrangement.[11]

Forum Selection Clauses

Similarly, it would not be surprising if the franchise agreement contains a forum selection clause. Just as a choice of law provision is commonplace in commercial agreements, it would not be uncommon for the franchise agreement to set forth with specificity that any claims under the franchise agreement be filed in a distant forum, often in a forum that would be more convenient for the party in the superior bargaining position (the franchisor) and just as inconvenient for the franchisee, such that the franchisee may be inhibited from asserting its rights under the NJFPA. Once again, counsel unfamiliar with the NJFPA or the decisions construing it may summarily conclude the forum selection clause would be an impediment to a lawsuit in New Jersey and advise the franchisee accordingly.

But the New Jersey Supreme Court has squarely addressed this issue, and has determined a forum selection clause contained in a franchise agreement is presumptively unenforceable.[12] In *Kubis & Perszyk Assoc., Inc. v. Sun Micro Systems, Inc.,* the New Jersey Supreme Court determined a forum selection clause in a franchise agreement is presumptively invalid. The Court in that case focused on the unequal bargaining position between the franchisee and franchisor, and found the franchisee should be protected from the added expense and inconvenience of litigating a claim in a distant forum.

The Court concluded as follows:

> [W]e are convinced that forum selection clauses in the vast majority of franchise agreements are not the subject of arms-length negotiation between parties of comparable bargaining power.
>
> . . .
>
> Accordingly, we hold that forum selection clauses in franchise agreements are presumptively invalid, and should not be enforced unless the franchisor can satisfy the burden of proving that such a clause was not imposed on the franchisee unfairly on the basis of its superior bargaining position.[13]

Thus, while the franchise agreement, on its face, may require the franchisee to litigate any dispute under the agreement in a distant, inconvenient forum, such clauses are presumptively invalid.

Additional Substantive Considerations Under the NJFPA

Beyond review of the terms of the franchise agreement, another important consideration is the conduct by the franchisor. In many different factual scenarios, a franchisor may impose conditions on a franchisee and then claim 'good cause' for terminating the franchise agreement based on the franchisee's failure to substantially comply with the terms of the conditions. In such situations, it may conclude that the franchisee has not complied with the terms of the franchise agreement and advise the franchisee that the chances of prevailing in a lawsuit under the NJFPA are minimal.

However, the NJFPA, by its terms, prohibits a franchisor from imposing "unreasonable standards of performance upon a franchisee."[14] In other words, in cases where the franchisor establishes a standard or condition of performance on the franchisee, benign on its face, and then attempts to terminate the franchisee based on its failure to 'substantially comply' with the condition or standard, counsel should scrutinize the standard to determine if it is reasonably attainable or impossible to reach. If the condition falls into the latter category and is objectively unattainable, the franchisor's purported termination of the franchise agreement based on non-compliance with the franchise agreement may be ineffectual.

By way of example, the United States District Court for the District of New Jersey, applying the NJFPA, confronted a scenario in which a franchisee with a relationship in excess of 20 years with a franchisor faced termination of its franchise. In *Beilowitz v. GMC*, the franchisor, GMC, had imposed a new sales program on the franchisee, Beilowitz, which would result in the franchisor losing $11 million in sales, representing approximately 40 percent of the franchisor's total revenue.[15] The new program, which did not specifically target the franchisee or terminate the franchisee's relationship with the franchisor, would, among other things, restrict the franchisee from selling outside the Philadelphia area, and restrict the franchisee's market area to a region already served by two competitors.[16] Moreover, the court found the franchisee could incur over $1 million in pre-tax operating losses during the pendency of the case.[17] Yet, the new sales program was even-handed on its face, purportedly represented a good faith program by the franchisor to run its business as it deemed fit, and almost all of the franchisor's franchisees entered into the new program.[18]

The franchisee filed an application for a preliminary injunction to enjoin the franchisor's failure to renew the franchise agreement in light of the franchisee's refusal to take part in the new program. In reviewing the application, the court found the franchisor's new program was untried, and that its implementation would have the aforesaid negative economic consequences on the franchisee. The court found the program was not reasonably attainable by the franchisee and enjoined GMC from refusing to renew the franchise agreement with the franchisee.

Thus, while the franchisor's new program was facially neutral, and was accepted by most of the other franchisees, the court found the application of the new program to the franchisee at issue would have an economically crippling effect on the franchisee, and that the terms of the program, related to the franchisee, were not attainable. In such circumstances, the court applied the NJFPA and enjoined the franchisor from terminating the franchise. Thus, even where there is no termination, *per se*, of a franchise agreement, careful scrutiny of the facts and familiarity with the NJFPA are important in addressing matters regarding the potential termination of a franchise in New Jersey.

Remedies Under the NJFPA

Having determined the applicability of the NJFPA, having scrutinized the franchise agreement as well as the franchisor's conduct, and having concluded a viable cause of action exists under the NJFPA, the remaining arrows in counsel's quiver consist of the remedies available under the NJFPA for the aggrieved franchisee.

The NJFPA authorizes an award of damages as well as injunctive relief.[19] Typically a combination of both will come into play; first, to enjoin the termination of the franchise agreement and, secondly, to compensate the franchisee for any lost sales or other losses compensable with monetary damages. Additionally, consistent with the remedial purposes of the NJFPA, and to act as a disincentive for arbitrary conduct by franchisors, the NJFPA also permits a franchisee who prevails in an action under the NJFPA to recover its costs and reasonable attorneys' fees for the action.[20] Thus, an aggrieved franchisee required to bring an action under the NJFPA who prevails, may be made whole through recovery of fees and costs.

Conclusion

The NJFPA is broad legislation designed to eliminate the disparity of bargaining power between a franchisor and franchisee. While the franchise agreement defines and governs the relationship between the franchisor and franchisee, the NJFPA adds another layer of terms to the parties' relationship that not only adds protections for the franchisee but also invalidates certain provisions the parties included in their agreement. For this reason, counsel is well advised to tread carefully in any franchise termination matter. The foregoing factors should be part of any analysis. ⚖

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ENDNOTES

1. N.J. Stat. Ann. 56:10-1 to -15.
2. *Beilowitz v. GMC*, 233 F. Supp. 2d 631 (D.N.J. 2002) (footnotes omitted).
3. In *Beilowitz*, 233 F. Supp. 2d at 640, Judge Orlofsky explained: "[w]hat characterizes community of interest is the potential for abuse that is triggered 'when the reputation and good will of the network, created primarily by the efforts of each of the individual franchisees, passes back to the franchisor without compensation to the franchisee.'" (*citing Instructional Sys., Inc. v. Computer Curriculum Corp.,* 130 N.J. 324, 358 (1992) (ISI) (*quoting Neptune T.V. & Appliance Serv., Inc. v. Litton Sys., Inc.*, 190 N.J. Super. 153, 164 (App. Div. 1983)). Further, the court explained that "A 'community of interest' exists when the terms of the agreement between the parties or the nature of the franchise business requires the licensee, in the interest of the licensed business's success, to make a substantial investment in goods or skill that will be of minimal utility outside the franchise." *Id.* at 359.
4. *Id.* 56:10-3 and -4.
5. The NJFPA reflects the New Jersey Legislature's concerns regarding abuse of franchisees that may arise from the disproportionate bargaining positions between the parties. *Shell Oil CO. v. Marinello*, 63 N.J. 402, 409 (1973).
6. N.J. Stat. Ann. 56:10-5.
7. *Amerada Hess Corp. v. Quinn*, 143 N.J. Super. 237, 251 (Law Div. 1976).
8. *General Motors Corp. v. Gallo GMC Truck Sales*, 711 F. Supp. 810, 816 (D.N.J. 1989) (*citing Westfield Centre Serv. v. Cities Serv. Oil Co.*, 86 N.J. 453, 469 (1981)).
9. *General Motors Corp.,* 711 F. Supp. at 816; *Westfield Centre Serv.*, 86 N.J. at 453.
10. N.J. Stat. Ann. 56:10-7(a). In *Instructional Systems, Inc. v. Computer Curriculum Corp.*, *supra*, 130 N.J. at 345, the Supreme Court of New Jersey addressed New Jersey's interest under the NJFPA in the face of a contractual choice of law provision in a franchise agreement:

   "Few franchises are intrastate," and were parties free to dispense with the protection afforded by franchise acts, any "large franchisor by insertion of a choice of law provision requiring the application of the franchisor's home state's law, could with a stroke of a pen remove the beneficial effect of the franchisee's state's remedial legislation." "We will reject even the parties' choice of New Jersey local law in order to preserve the fundamental public policy of the franchisee's home state where its statutes afford greater protection." (citations omitted).

11. The NJFPA provides in this regard as follows:

    It shall be a violation of this act for any franchisor, directly or indirectly, through any officer, agent or employee, to engage in any of the following practices:

    a. To require a franchisee at time of entering into a franchise arrangement to assent to a release, assignment, novation, waiver or estoppel which would relieve any person from liability imposed by this act....N.J. Stat. Ann. 56:10-7(a).

12. *Kubis & Perszyk Assoc., Inc. v. Sun Micro Sys., Inc.*, 146 N.J. 176 (1996).
13. *Id.* at 194-95.
14. N.J. Stat. Ann. 56:10-7(e).
15. *Beilowitz*, 233 F. Supp. 2d at 638.
16. *Id.* at 636.
17. *Id.* at 639.
18. *Id.* at 638.
19. *Id.* 56:10-10.
20. *Id.*

Will New Court Rulings Make it Harder for Franchisors to Rescue a Hostage Trademark?

by Bryan Couch

Trademark infringement is a significant concern for all businesses, since trademarks act as a kind of guaranty on behalf of consumers and businesses alike. For consumers, they are an assurance of a standard of quality for the goods and services associated with the mark; while for businesses, trademarks represent the accumulated reputation and goodwill built up by the trademark owner.

Trademark infringement, however, is particularly burdensome for franchisors. That's because in a franchise transaction, the franchisor/trademark holder typically licenses the use of its mark to a franchisee, subject to specified contractual arrangements that may include the payment of fees and, typically, a requirement to maintain certain standards designed to ensure that consumers will associate the brand with a certain style and level of quality. Indeed, a franchise agreement may be terminated if a franchisee fails to comply with its contractual obligations.

A consumer's positive association with a brand may become threatened when a terminated franchisee—especially one that was terminated due to quality deficiencies—continues to use the franchisor's marks after termination. This conduct, often referred to as 'holdover usage,' is a common obstacle faced by franchisors at the conclusion of a franchise relationship.

Here is the typical scenario (using fictitious names): Frankie's Franks, a franchisor of hot dog stands, terminates its franchise relationship with cause when its franchisee, Main Street Franks, LLC, fails to maintain quality standards as called for in the franchise agreement. Under the terms of the contract, Main Street Franks has 14 days to 'de-identify' the stand by removing all trademarks, tradenames, and service marks that would identify the stand with the Frankie's Franks franchise system.

But well after the 14-day period has passed, Frankie's Franks gets a lengthy email from an angry customer, complaining about the lack of cleanliness and service at the restaurant. The customer also posts several negative reviews on various third-party websites, advising people to steer clear of all Frankie's Franks locations. On a post-termination site inspection, Frankie's Franks finds its signs are still being displayed, and the employees at the disenfranchised restaurant continue to answer phone calls with the Frankie's Franks name. Despite repeated requests by the franchisor and its attorneys, Main Street Franks, LLC refuses to cease and desist from its use of the Frankie's Franks trademarks.

A franchisor faced with this situation has little choice but to file a lawsuit coupled with an application for a preliminary injunction, since a court-ordered preliminary injunction is generally a franchisor's best remedy against additional harm.

Traditionally, in holdover usage cases—where an individual, group or organization continues to use a franchisor's federally registered trademark even after the franchise agreement has been terminated—obtaining a preliminary injunction was a relative certainty. But thanks to a series of recent decisions, a franchisor can no longer be assured of that outcome.

In the Third Circuit, a plaintiff must establish four elements before a district court will grant a preliminary injunction: 1) the plaintiff is likely to succeed on the merits of the case; 2) the plaintiff is likely to suffer irreparable harm in the absence of such preliminary relief; 3) the balance of equities tips in the plaintiff's favor; and 4) a preliminary injunction is in the public interest.[1]

A franchisor in a holdover usage case typically has little difficulty demonstrating it is likely to succeed on the merits of the case. Until recently, once a franchisor satisfied this prong, the second prong of irreparable harm was presumed. The Third Circuit has generally recognized that irreparable harm is caused if a holdover franchisee causes consumers to confuse a franchisor's high-quality brand with the former franchisee's inferior or defective brand.[2]

The Supreme Court Upset the Applecart with its *eBay* and *Winter* Rulings

The irreparable harm presumption was weakened by two decisions—e*Bay Inc. v. MercExchange, L.L.C.*[3] and *Winter v. Natural Resources Defense Council, Inc.*[4] In *eBay*, a patent case, the U.S. Supreme Court ruled the traditional, four-factor test must be applied by courts when addressing permanent injunctions. While the *eBay* ruling did not specifically address the validity of the presumption of irreparable harm, it held that "traditional equitable principles" did not allow broad classifications similar to the presumption of irreparable harm.[5]

In *Winter*, the Supreme Court specifically addressed the irreparable harm standard in a preliminary injunction context. The Court held that "issuing a preliminary injunction based only on a possibility of irreparable harm" would no longer suffice.[6] Instead, the Court concluded an award of injunctive relief can only be made after an evaluation of the entire four-factor test.[7]

Following that decision, circuit courts began to use *Winter*, and the permanent injunction holding in *eBay*, to hold that the presumption of irreparable harm would no longer be valid in trademark infringement cases.

The Third Circuit followed suit, denying the validity of the presumption in *Ferring Pharmaceuticals*, where plaintiff Ferring filed a false advertising claim pursuant to the Lanham Act.[8] Ferring sought a preliminary injunction to prevent a competitor from continuing to assert demonstrably false statements about the superiority of its products. The district court denied relief, finding that Ferring was not entitled to a presumption of irreparable harm.[9]

In affirming the district court ruling, the court of appeals held that parties seeking preliminary injunctive relief under the Lanham Act are no longer entitled to a presumption of irreparable harm.[10] Unfortunately, *Ferring* did not provide much guidance for franchisors, or others seeking a preliminary injunction, on what was required to demonstrate irreparable harm.

The Third Circuit next confronted this issue in *Groupe SEB USA, Inc. v. Euro-Pro Operating, L.L.C.*[11] In *Groupe SEB*, Euro-Pro advertising claimed its products were better than those of Groupe SEB. But Groupe SEB used internal laboratory and independent testing to demonstrate its products were actually more powerful than those of Euro-Pro. Groupe SEB then sued Euro-Pro for false advertising under the Lanham Act, and requested a preliminary injunction to halt the false and harmful claims.

The district court granted the preliminary injunction, relying on scientific evidence provided by Groupe SEB, in addition to testimony from Groupe SEB that the advertising at issue was likely to harm their brand's reputation.[12] The Third Circuit upheld, noting that although *Ferring* barred a presumption of irreparable harm, the evidence presented by Groupe SEB created a reasonable inference that harm was likely.[13] The court specifically distinguished its finding of a likelihood of irreparable harm with the presumption of irreparable harm prohibited by *Ferring*. However, the *Groupe SEB* court noted that *Ferring* "does not bar drawing fair inferences from facts in the record," which it described as a critical aspect of fact finding.[14] This decision offers some direction for franchisors seeking to demonstrate irreparable harm.

The Third Circuit addressed the irreparable harm presumption most recently in *Arrowpoint Capital Corp. v. Arrowpoint Asset Management et al.*[15] In this case, trademark holder Arrowpoint Capital Corp., which provided insurance and investment-related financial services, brought an action for infringement of six trademarks against alleged infringers that included an investment management company and two private investment funds.

Arrowpoint Capital submitted evidence of 11 incidents of actual confusion. The district court denied its request for a preliminary injunction, ruling the confusion was among brokers and dealers, instead of "actual customer confusion." The district court thus determined that Arrowpoint Capital could not show a likelihood of success on the merits and did not analyze the three remaining factors for preliminary injunctive relief.

The Third Circuit remanded the case to the district court, noting the Lanham Act protects against "the use of trademarks which are likely to cause confusion, mistake, or deception of any kind, not merely of purchasers nor simply as to source of origin."[16]

While the Third Circuit did not have to discuss the irreparable harm element, it did address the recent rulings discussed above in a footnote. In response to Arrowpoint Capital's argument that a showing of actual confusion creates a presumption of irreparable harm, the court—citing *eBay*, *Winter*, and *Ferring*—stated "that a party bringing a claim under the Lanham Act is not entitled to a presumption of irreparable harm when seeking a preliminary injunction and must demonstrate that irreparable harm is likely."[17]

What Do These Rulings Mean for Franchisors?

While none of the Supreme Court or Third Circuit cases specifically address holdover usage by a franchisee, it seems clear that franchisor trademark holders seeking a preliminary injunction will likely have to take comprehensive, documented steps to prove a likelihood of irreparable harm, even in a straightforward holdover usage case. Until further guidance is provided, the *Groupe SEB* case provides the best roadmap for a franchisor: Specifically, in order to draw a reasonable inference of irreparable harm, a franchisor must testify regarding the likely harm it will suffer if the infringement is not prevented.

Franchisor counsel should advise clients that they can no longer assume they will secure a preliminary injunction based on the likely success on the merits of their case. Franchisor counsel should also prepare their clients to demonstrate actual and irreparable harm caused by the ongoing infringement. Counsel will need to document the harm their clients suffer from a holdover franchisee, and should—along with their client—take steps to collect evidence of such irreparable harm, including the loss of control of reputation, loss of trade, loss of goodwill, and the possibility of confusion.

Franchisor counsel and their clients should gather evidence regarding any customer complaints and service calls, as well as complaints by nearby franchisees who believe their franchised name is developing a bad reputation as a result of the behavior of the holdover franchisee. Franchisor counsel and their clients also should be prepared to document any negative customer reviews issued in connection with holdover franchisees, and to document the loss of customers resulting from the loss of goodwill.

Finally, to further bolster the claim of irreparable harm, franchisor counsel should prepare their clients to testify that once the holdover franchisee is out of the system, there is no way to monitor its service, even though the holdover continues to use the client's trademark and other identifying characteristics. ⚖

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ENDNOTES

1. *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 374 (3d Cir. 1992).
2. *Id.* at 375 (burden of showing a likelihood of confusion met under Section 43(a) by demonstrating that the moving party and infringer are concurrently using moving party's trademarks after the termination of the franchise agreement).
3. *eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).
4. *Winter v. Natural Resources Defenses Council, Inc.*, 555 U.S. 7 (2008).
5. *eBay*, 547 U.S. at 393.
6. *Winter*, 555 U.S. at 29.
7. *Id.* at 20.
8. *Ferring Pharmaceuticals v. Watson Pharmaceuticals, Inc.*, 765 F.3d 205 (3d Cir. 2014).
9. *Ferring Pharmaceuticals*, 765 F.3d at 209.
10. *Id.* at 216.
11. *Groupe SEB USA, Inc. v. Euro-Pro Operating, L.L.C.*, 774 F.3d 192 (3d Cir. 2014).
12. *Id.* at 196-197.
13. *Id.* at 205.
14. *Id.*
15. *Arrowpoint Capital Corp. v. Arrowpoint Asset Management, LLC*, 2015 WL 4366571.
16. *Id.* at *6 (*citing Kos Pharm., Inc. v. Andrx Corp.*, 369 F.3d 700, 711 (3d Cir. 2004).
17. *Id.* at *8, n15.

Am I My Brother's Keeper?

Franchisor Liability for a Franchisee's Conduct

by Justin M. Klein

When a consumer visits a Dunkin' Donuts store, they may recognize on some level that the store is a franchised business owned and operated by an individual or corporate entity separate and apart from Dunkin' Donuts (*i.e.*, the franchisor). But while the consumer may be aware that the store is owned by a franchisee, and not Dunkin' Donuts, most are unaware of the identity of the franchisee operating the store. Simply stated, as a result there often is no perceived distinction between the individual store operator and the franchisor, primarily due to the shared name and concurrent use of trademarks and trade dress by the parties. However, despite this blurring of legal independence, the franchisor and franchisee are, in fact, separate legal entities with a business relationship that is formed at arms length.[1]

This fundamental misunderstanding of how a franchise relationship works creates a multitude of issues for the legal system. One such issue arises when an injury occurs at a franchised location. Because consumers (and their lawyers) are not familiar with the respective roles of the franchising parties, franchisors often are named as defendants in lawsuits for alleged misconduct on the part of one of its franchisees. This may be because the franchisor is the assumed 'deeper pocket,' or, more likely, because the injured party does not know against whom the suit should be brought.

To be successful against a franchisor, a plaintiff will need to adequately allege and prove the franchisor can be held vicariously liable for the acts of its franchisee. Vicarious liability claims must involve allegations that the injury occurred because the franchisor either mandated the wrongful conduct or failed to monitor the franchisee's operations appropriately.[2] While prevailing in an action against a franchisor for the acts of its franchisee is possible—if the plaintiff has the right set of factual circumstances and submits a very precise pleading—it is rare.

This article discusses when a franchisor may be held liable for the conduct of its franchisees. Many lawmakers view the franchisor/franchisee relationship to be akin to an employer/employee relationship.[3] While a variety of arguments can be made with respect to the accuracy of such a comparison, the resulting analysis becomes one based on an agent/principal theory of relationship. It is through this lens that the vicarious liability inquiry in this article is scrutinized.

Demonstrating Actual Authority

In order to establish vicarious liability of a party, a plaintiff must prove the existence of either actual or apparent authority.[4] In the franchise context, a showing of actual authority requires a principal/agent relationship be established between the franchisor and franchisee.[5] This type of relationship can be difficult to prove because it is common practice in franchise agreements for the parties to explicitly state that the franchisee is not an agent of the franchisor, is a separate and independent businessperson, and cannot bind the franchisor in connection with any of its actions.

Beyond the four corners of the franchise agreement, however, courts will look to the level of control exerted by the franchisor relating to the particular type of alleged wrongful conduct. For example, in *J.M.L. ex rel. T.G. v. A.M.P.* the New Jersey Appellate Division addressed the issue of the liability of a karate chain franchisor for the tortious acts of its franchisee.[6] In this case, the court found "the relationship between [the franchisee] and [the franchisor]…[did] not evince the degree of control that would warrant the imposition of vicarious liability under agency principals or liability as an aider or abettor."[7] Here, the Appellate Division looked to see the extent to which the franchisor "compelled, coerced, encouraged or assisted" the franchisee to determine the degree of control held over them.[8] As such, the franchisor was successful on summary judgment.

Similarly, in *Simpkins v. 7-Eleven, Inc.* the Appellate Division again analyzed the issue of the franchisor's alleged liability for its franchisee's actions.[9] The court determined the franchisor could not be held vicariously liable under the theory of actual authority for the wrongful acts of its franchisee.[10] In that case, "there [was] no evidence that 7-Eleven participated in the day-to-day affairs of the [franchised] store, other than in respect to certain financial activities."[11]

Likewise, the Appellate Division in *Bahrle v. Exxon Corp., et al*. also concluded that an oil company franchisor may not be held liable for injuries caused by its service station franchisee on a vicarious liability theory.[12] The *Bahrle* court contrasted the United States Court of Appeals for the Third Circuit's decision in *Gizzi v. Texaco*, which held the plaintiff's reliance upon Texaco's advertisements inviting patrons to use the service station could be enough to impose liability on Texaco for the service station's negligence.[13]

The Appellate Division, in *Bahrle,* stated:

> Unlike *Shadel*[14] and *Gizzi*, this is not a case where a patron had relied on the oil company's insignia or its advertising in seeking out the service of a local station, and was injured as a result of that service being rendered. Plaintiffs produced absolutely no evidence that they in any manner relied upon the fact that [Franchisee's] station was a Texaco station. Not a single plaintiff testified that they moved into the area ultimately contaminated in reliance on the fact that the station displayed the Texaco insignia. Nor is there any proof that plaintiffs remained residents in the neighborhood during the Texaco/[Franchisee] era because they had relied on the fact that Texaco was in control of the station and would thus prevent it from becoming a source of contamination. Therefore, there was no factual or legal basis to hold Texaco liable on a vicarious liability theory.[15]

Note, however, that while the plaintiffs in *Gizzi* were unable to show they had specifically relied on the advertising, the court's *dicta* in *Gizzi* opened the door to the notion that such reliance, if properly pled and evidenced, may be sufficient to establish vicarious liability.

New Jersey courts are in agreement with many other states around the country on the issue. In New York, for example, in *Cullen v. BMW of North America, Inc.*, the United States Court of Appeals for the Second Circuit reversed the decision of the Eastern District of New York and held that the franchisor in question—BMW—could not be held liable on either an agency or negligence theory based upon the alleged tortious acts of its franchisee, which included theft and conversion of customer funds.[16] The Second Circuit determined that BMW, as franchisor, had no obligation to protect customers from unforeseeable injuries caused by its franchisee's intervening and unforeseeable tortious acts. The court rejected the lower court's holding that BMW was liable for the franchisee's fraud because it was "apprised of [the franchisee's unscrupulous] business transactions" and had an obligation to "police the operation of the BMW name and supervise the operation of its franchise."[17]

However, when actual authority cannot be proven, plaintiffs may rely on apparent authority with the goal of achieving the same result.

Demonstrating Apparent Authority

If an argument for actual authority cannot be made based on the facts of the individual case, a claimant may attempt to prove the existence of apparent authority. The law in New Jersey regarding the doctrine of apparent authority is well settled—apparent authority exists only "where the actions of a principal have misled a third party into believing the relationship of authority existed."[18] The doctrine looks to the actions of the principal and not those of the alleged agent.[19] In addition, before the doctrine of apparent authority can be applied, it is essential that the "element of reliance...be present."[20]

In actions against franchisors based on an apparent authority theory, it is also crucial for the plaintiff to establish that he or she reasonably believed the franchisee's representations were binding on the franchisor.[21] Consequently, these are fact-intensive claims that require specific circumstances and detailed pleading.

Finding a franchisor liable on the theory of 'apparent authority' is the exception and not the rule—so it is not advisable for litigators to focus their complaints on such a theory. While the amount of cases in New Jersey addressing this issue is scant, the issue has been addressed by a number of state and federal courts across the United States, and the relevant authority in support of dismissing these claims is overwhelming.[22]

Conclusion

Industry statistics demonstrate that, in the United States, a newly franchised business opens every eight minutes of every business day.[23] As this trend toward franchising continues, the number of claims brought against franchisees and their franchisors will likely increase as well. In an attempt to create leverage and go after the 'deep pocket,' consumers will continue—more often unsuccessfully than not—to pursue claims against franchisors on a vicarious liability basis. Before suing a franchisor for the acts of its franchisee, plaintiffs and their counsel should weigh the costs, risks and benefits of bringing such an action—and, most significantly, consider the scope of factual support they will need to sustain these claims under the current state of the law. ⚖

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ENDNOTES

1. *See Katsiavrias v. Cendant Corp.*, Civ. Action No. 06-4465, 2009 U.S. Dist. LEXIS 25744 (D.N.J. March 30, 2009) ("[T]he parties contract at arms' length and…the parties are negotiating at arm's length for a franchise.").
2. *See J.M.L. ex rel. T.G. v. A.M.P.*, 379 N.J. Super. 142 (App. Div. 2005) (noting that vicarious liability claims typically follow the Restatement (Second) of Agency § 219).
3. *See Morgan v. Air Brook Limousine*, 211 N.J. Super. 84, 105 (Law Div. 1986) (weighing whether or not an employer/employee relationship existed in a franchisor/franchisee context).
4. *See Lehmann v. Toys 'R' Us, Inc.*, 132 N.J. 587, 601 (1993) ("An employer will be found vicariously liable if the supervisor acted within the scope of his or her employment. Moreover, even if the supervisor acted outside the scope of his or her employment, the employer will be vicariously liable if the employer contributed to the harm through its negligence, intent, or apparent authorization of the harassing conduct, or if the supervisor was aided in the commission of the harassment by the agency relationship.").
5. *See J.M.L. ex rel. T.G.* 379 N.J. Super. at 142.
6. *See id.* at 151.
7. *Id.* at 152.
8. *Id.*
9. *See Simpkins v. 7-Eleven, Inc.*, 2008 N.J. Super. Unpub. LEXIS 2450 (App. Div. April 7, 2008).
10. *See id.*
11. *Id.*
12. *See Bahrle v. Exxon Corp., et al.,* 279 N.J. Super. 5, 27-28 (App. Div. 1995).
13. *See Gizzi v. Texaco*, 437 F.2d. 308 (3d. Cir. 1971).
14. In *Shadel v. Shell Oil Co.*, 195 N.J. Super. 311 (Law Div. 1984), the superior court of New Jersey, Law Division, Passaic County, denied Shell Oil Company's motion for summary judgment on the issue of apparent authority. The trial court found that the evidence, if believed by the jury, presented a cause of apparent authority, and there was nothing peculiar about the independent contractor agreement that would preclude the doctrine from applying to the defendant.
15. *Id.* at 26–27.
16. *See Cullen v. BMW of North America, Inc.*, 691 F.2d 1097, 1101 (2d Cir. 1983).
17. *Id.* at 1101-1102; *see also Ciofo v. Hungry Howie's Pizza*, 1997 Mich. App. LEXIS 1676, at *1 (Mich. Ct. App. May 16, 1997) (stating that "to determine whether a…franchisor and franchisee had a principal-agent relationship sufficient to impose vicarious liability on the franchisor, [the court should] examine the defendant's control of the franchisee in terms of the defendant's right to take part in the day-to-day operation of the franchisee's business"); *see also Kerl v. Rasmussen*, 682 N.W.2d 328, 341 (Wisc. 2004) (requiring for a vicarious liability claim that the franchisor had "control or a right of control over the daily operation of the specific aspect of the franchisee's business that is alleged to have caused the harm"); Philip F. Zeidman, *Franchising and Other Methods of Distribution: Regulatory Pattern and Judicial Trends,* 1408 P.L.I./CORP. L. & PRAC. 529, 683 (2004) (in determining whether vicarious liability exists, "courts have measured the extent of the franchisor's control over the day-to-day operations of the franchised business").
18. *Lobiondo v. O'Callaghan*, 357 N.J. Super. 488, 497 (App. Div.), *cert. denied*, 177 N.J. 224 (2003) (*quoting Rodriguez v. Hudson County Collision Co.*, 296 N.J. Super. 213, 221 (App. Div. 1997)).
19. *See Busciglio v. Della Fave*, 366 N.J. Super. 135, 140 (App. Div. 2004).
20. *See Wilzig v. Sisselman*, 209 N.J. Super. 25, 36 (App. Div.), *cert. denied*, 104 N.J. 417 (1986); *see also Bahlre*, *supra*, 295 N.J. Super. at 28 (opining that in the absence of reasonable reliance, claims for vicarious liability based upon apparent authority cannot be sustained).
21. *See, e.g., Mann*, *supra*, 1990 WL 205286, at *5 (holding that the facts alleged failed to support any inference that the plaintiffs "could reasonably have believed" that the franchisee's alleged misrepresentations concerning the viability of its business were authorized or binding on the franchisor); *O'Banner v. McDonald's Corp.*, 670 N.E.2d 632, 634-35 (Ill. 1996) (approving lower court's entry of summary judgment in favor of defendant-franchisor, noting that the plaintiff failed to show that "he actually did rely on the apparent agency in going to the restaurant where he was allegedly injured"); *Theos & Sons, Inc. v. Mack Trucks, Inc.*, 729 N.E.2d 1113, 1121-22 (Mass. 2000) (holding that neither the use of a trademark or logos of the defendant nor the representation by the franchisee as an authorized dealer of the defendant was sufficient to raise a genuine issue of material fact that the plaintiff reasonably believed that an agency relationship existed for non-warranty work); *Little v. Howard Johnson Co.*, 455 N.W.2d 390, 394 (Mich. Ct. App. 1990) (noting the absence of evidence that the plaintiff "was harmed as a result of relying on the perceived fact that the franchisee was an agent of defendant" or "which indicated that plaintiff justifiably expected that the walkway would be free of ice and snow because she believed that defendant operated the restaurant"); *Phillips v. Rest. Mgt. of Carolina, L.P.*, 552 S.E.2d 686, 695 (N.C. Ct. App. 2001) (summary judgment for franchisor, holding no evidence that the plaintiff "would have chosen to eat elsewhere or done anything differently had he known that the restaurant at issue herein was not owned and operated by Taco Bell").
22. *See e.g. Mann v. Prudential Real Estate Affiliates, Inc.*, No. 90-C-5518, 1990 WL 205286, at *5 (N.D. Ill. Dec. 10, 1990) (granting the franchisor's motion to dismiss an apparent agency vicarious liability claim, finding that the plaintiffs failed to allege "acts or words" by the franchisor that would create an impression of an agency relationship); *see also Mobil Oil Corp. v. Bransford*, 648 So. 2d 119, 120-21 (Fla. 1995) (granting summary judgment in favor of the franchisor, holding that the facts alleged against Mobil, as the franchisor, were "legally insufficient" to support apparent agency theory because they did not reach the "minimum level of a 'representation' necessary to create an apparent agency"); *BP Exploration & Oil, Inc. v. Jones*, 558 S.E.2d 398, 403-04 (Ga. Ct. App. 2001) (finding that "it is common knowledge that independent gasoline stations use the trademarks, emblems, and colors of national oil companies," and, therefore, given this knowledge, the failure to post a sign indicating that the station was independently operated does not, standing alone, "permit an apparent agency finding").
23. *See* Roger D. Blair and Francine Lafontaine, *The Economics of Franchising*, 23 (2005).

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Can a Franchisor be Deemed the Employer of a Franchisee's Employee?

The Unsettled Landscape of Joint Employer Status

by Robert C. Brady, Philip W. Lamparello and Michael Poreda

It is long settled that a franchisor is not liable for the conduct of its franchisees merely based on the existence of the franchise relationship.[1] Recently, courts around the country have begun to question the validity of this maxim and tinker with the elements for finding joint employer status. More specifically, doubt has been expressed related to the concept that a franchisor is not an employer of an individual working for an independently owned franchise.[2] In the past year, both the National Labor Relations Board (NLRB)[3] and the New Jersey Supreme Court[4] have issued significant rulings that—albeit not specifically in the context of the franchisor and franchisee relationship—are likely to impact the obligations of a franchisor when relating to its dealings with the employees of its franchisees.

On Aug. 27, 2015, the NLRB issued a decision that dramatically altered the standard to assess 'joint employer liability' under the National Labor Relations Act (NRLA).[5] In *Browning-Ferris*, the NLRB changed a decades-old framework and applied the traditional joint employer doctrine to hold a company that retained services of a temporary employment service (and its temporary employees) could be deemed a joint employer if it shared or codetermined matters governing the essential terms and conditions of employment.[6] This decision will likely have a significant impact on franchises because, for the first time in decades, the NLRB considered 'indirect control' to be a factor in determining whether a joint employer relationship existed under the NLRA.

Similarly, the New Jersey Supreme Court's decision in *Hargrove v. Sleepy's LLC,*[7] in response to a question of law certified and submitted by the United States Court of Appeals for the Third Circuit, adopted the 'ABC' test[8] to determine whether a worker should be classified as an independent contractor or employee under the New Jersey Wage and Hour Law (WHL), at N.J.S.A. 34:11-4.1 to -4.14, and the New Jersey Wage Payment Law (WPL), at N.J.S.A. 34:11-56a to -56a38.[9] The ABC test begins with the presumption that the alleged employer is actually the employer and this presumption remains unless it can be shown that: 1) the individual has been and will continue to be free from control or direction over the performance of the services; 2) such services are either outside the usual course of the business or performed outside of all the places of business of the enterprise; and 3) such individual is customarily engaged in an independently established trade, occupation, profession, or business.[10] The failure by the employer to satisfy even one of the three criteria will result in a finding of 'employment.'

This article reviews both cases, the impact these cases may have on franchise relationships, and potential legislative responses. It concludes with a reminder of steps a franchisor can take to minimize the possibility of it being found to be an employer of its franchisees' employees.

Browning-Ferris: Opening the Door to Franchisor Liability

Pre-*Browning-Ferris*, a company would be considered a joint employer if it *actually exercised* direct and immediate control over essential employment conditions and the terms of the workers at issue.[11] In light of the *Browning-Ferris* decision, one can be found a joint employer because it *merely possesses* sufficient control over the workers' essential employment terms.

Browning-Ferris involved a union's desire to organize the temporary workers of an independent contractor who worked at a recycling facility.[12] Browning-Ferris Industries (BFI) owned a recycling facility where it employed unionized machine operators who would move materials in preparation of sorting inside the facility.[13] BFI contracted with Leadpoint Business Services to provide temporary workers to sort the materials inside the facility.[14] The union claimed BFI and Leadpoint jointly employed the temporary workers.[15] Notably, the vast majority of workers were temporary workers.

In analyzing the issue, the NLRB looked to the operations, management, hiring, orientation and training, wages and benefits, and discipline. Pursuant to an agreement between BFI and Leadpoint, Leadpoint would screen, hire, discipline and supervise the Leadpoint employees, with BFI being given the ability to involve itself in matters of hiring, discipline, scheduling and wages.[16] The agreement forbade Leadpoint from paying its employees more than it paid BFI's own employees, or from hiring employees BFI had already considered ineligible.[17]

The NLRB decided to 'return' to the 'traditional' joint employer test to determine whether a company incurs obligations to engage in collective bargaining with workers. Under the traditional test, two or more entities may be joint employers of a single workforce if: 1) they are both employers within the meaning of the common law, and 2) they share or codetermine those matters governing the essential terms and conditions of employment. The focus of the test is whether the alleged employer exercised significant control over the workers.[18] The NLRB found both BFI's control over the manner and method of operations and the language in the parties' agreement were sufficient to create joint employer liability.

Relevant to the franchise context, the decision opens the door to the argument that a franchisor that exercises control through a franchisee, even without any direct interaction with the individual workers, yet reserves the ability to influence the employees' terms and conditions of employment, may qualify as a joint employer with the franchisee.[19]

Hargrove v. Sleepy's: The ABCs of Joint Employer Status in New Jersey

In last year's New Jersey Supreme Court case, *Hargrove v. Sleepy's LLC*,[20] three plaintiffs who delivered mattresses for Sleepy's alleged that Sleepy's violated wage and hour laws by misclassifying them as independent contractors. The plaintiffs alleged that Sleepy's used independent driver agreements as a ruse to avoid paying employee benefits.[21]

The plaintiffs commenced a federal action in the United States District Court for the District of New Jersey. That court dismissed the claims at summary judgment, using the common law agency test that the United States Supreme Court adopted in *Nationwide Mutual Insurance Co. v. Darden*.[22] *Darden* involved the meaning of 'employee' under the Employee Retirement Income Security Act (ERISA), which is similar to other employee protection statutes in its circular definition of employee, which ERISA defines as "any individual employed by an employer."[23] In *Darden*, the United States Supreme Court held that where a statute defines a term with circular language, the meaning of the term should be construed according to the common law.[24]

The plaintiffs sought appellate review to the United States Court of Appeals for the Third Circuit, which certified a question of state law to the New Jersey Supreme Court on the issue of "which test should a court apply to determine a plaintiff's employment status for purposes of the New Jersey Wage Payment Law, N.J.S.A. [ ]34:11–4.1, *et seq.* and the New Jersey Wage and Hour Law, N.J.S.A. [ ]34:11–56a, *et seq.*?"[25] Among the two parties and the nine *amici*, no less than four employment status tests were proposed.

The Department of Labor (DOL), one of the *amici*, asked the court to adopt the ABC test, so called because it derives from Subsections (A), (B), and (C) of N.J.S.A. 43:21–19(i), a New Jersey's Unemployment Compensation Law statute for distinguishing independent contractors from employees.[26] The DOL had been applying the test to the WHL and the WPL for 20 years, so there was a developed body of law in its application.[27]

> The 'ABC' test presumes a worker is an employee unless the employer can make certain showings regarding the individual employed, including: (A) Such individual has been and will continue to be free from control or direction over the performance of such service, both under his contract of service and in fact; and (B) Such service is either outside the usual course of the business for which such service is performed, or that such service is performed outside of all the places of business of the enterprise for which such service is performed; and (C) Such individual is customarily engaged in an independently established trade, occupation, profession or business. The failure to satisfy any one of the three criteria results in an 'employment' classification.[28]

The ABC test is markedly different from other tests utilized to evaluate employment liability under other employee protection statutes in that many others are totality of the circumstances tests. A key distinction being that totality of the circumstances tests, while unpredictable for both workers and companies alike, preserve the traditional notion that a plaintiff must prove his or her case. By contrast, the ABC test arguably erodes this notion by beginning with the presumption that an individual is an employee.

The Supreme Court adopted the ABC test in this context for two reasons. First, deference was given to the DOL's opinion.[29] Second, the ABC test was viewed as more predictable than the multiple totality of the circumstances tests proposed. As explained by Judge Mary Catherine Cuff for an unanimous court, "the 'ABC' test fosters the provision of greater income security for workers, which is the express purpose of both the WPL and WHL."[30]

Meaning of the Cases: It's All About Control

Both *Browning-Ferris* and *Hargrove* reflect the mounting public concerns in the use of non-traditional labor relationships. Collectively, these cases demonstrate a push toward the finding of a traditional employer-employee relationship. Arguably, such progressive decisions are admirable in their efforts to provide increased protections for individual employees. Such determinations, however, also lend credence to the legal maxim that "hard cases make bad law."[31]

The theme of unintended legal consequences is present throughout the *Browning-Ferris* dissent, which highlighted the potential impact of the majority's decision on multiple industries, including franchises.[32] It noted that "[f]or many years, the Board has generally not held franchisors to be joint employers with franchisees, regardless of the degree of indirect control retained" and that, in light of the absence of guidance on how the majority's decision effects franchise relations, it is likely the decision will be "momentous and hugely disruptive" to franchises.[33] Notably, the general counsel for the NLRB submitted an *amicus* brief in *Browning-Ferris* conceding that franchisors should be exempt from "joint employer status to the extent that their indirect control over employee working conditions is related to a legitimate interest in protecting the quality of their product or brand."[34] The majority's broad test, however, arguably supports a finding that a franchisor with this type of indirect control should be deemed a joint employer.

Franchisors have a self-interest in maintaining strict control of a franchisee. A franchisor's controls—whether it be how food is prepared, how signage is displayed, or what employees are to wear to work—all help create uniformity in the customer experience, to the benefit of both the franchisee and franchisor. However, often a franchisor's controls may have "nothing to do with a labor policy but rather compliance with federal statutory requirements to maintain trademark protections."[35] Under the Lanham Act, a licensor/franchisor is required to maintain sufficient controls over its marks and the failure to do so can be considered "naked franchising" and result in abandonment of the mark.[36] As such, a franchisor is placed in an untenable situation: Implement controls to protect its mark and be potentially subject to joint-employer status or fail to maintain sufficient controls to protect against joint employer status and risk abandonment of the mark.

Hargrove, on the other hand, was likely decided without consideration of its potential effects on franchisors. However, the language of the ABC test's three prongs is ripe for conflict. As noted, the test contains a presumption that an individual is an employee unless the employer can demonstrate three elements. Again, the focus of the ABC test utilized in *Hargrove* is whether the employee is free from direction and control. Similar to *Browning-Ferris,* a court's analysis of control has the potential to cause a troublesome result for franchisors.

In sum, both of these opinions add new layers of uncertainty to an already fraught legal landscape of franchisor employment liability. How courts will interpret the employment tests in the franchisor/franchisee context is uncertain. In a case where a franchisee or its employees sue a franchisor for discrimination, the court is, by implication, faced with a decision that balances the broad remedial nature of social legislation against the intent of the parties that entered into the contractual franchise relationship. A court's perspective on these issues can influence the weight given to the particular facts of the case. This phenomenon is readily apparent in *Patterson v. Domino's Pizza, LLC*.[37]

Patterson was a sexual harassment case filed under California's Fair Housing and Employment Act (FEHA). The plaintiff, a franchisee's employee, alleged that one of the franchisee's managers had sexually harassed her.[38] The franchisee testified that representatives from Domino's had pressured him to fire the accused manager.[39] The franchisee did terminate the manager, but he also testified that the decision to terminate was ultimately his own.[40] The trial court found no employment relationship between Domino's and the plaintiff.[41] An intermediate appellate court disagreed.[42] In evaluating an employment relationship under the FEHA, California courts are to look to the totality of the circumstances, including the control exercised among the parties.[43] The California Supreme Court overturned the appellate court's ruling, finding that "no reasonable inference can be drawn that Domino's...retained or assumed the traditional right of general control of an 'employer' or 'principal'...of the franchisee's employees."[44]

Although ultimately absolved from liability, *Patterson* demonstrates the potential unintended consequences when analyzing a franchisor's control over the franchisee. Similarly, the recent decisions of *Browning-Ferris* and *Hargrove*, which employed a similar analysis, may spark claims against franchisors operating in New Jersey.

A Possible Legislative Solution

Earlier this year, three states passed pro-franchisor laws that add certainty to a franchisor's relationship with its franchisees and its franchisees' employees.[45] This may be a good solution to the uncertain legal landscape. Tennessee law now provides that neither a franchisee nor a franchisee's employees will be "deemed to be an employee of the franchisor for any purpose."[46] Texas enacted a statute providing that a franchisor is not considered an employer for claims related to employment discrimination, wage payment, minimum wage and worker's compensation, unless a Texas court concludes the franchisor "exercises a type or degree of control over the franchisee or the franchisee's employees not customarily exercised by a franchisor for the purpose of protecting the franchisor's trademarks and brand."[47] Louisiana passed a law stating that "an employee of a franchisee may be deemed to be an employee of the franchisor only where the two entities share or co-determine those matters governing the essential terms and conditions of employment and directly and immediately control matters relating to the employment relationship such as hiring, firing, discipline, supervision, and direction."[48]

In addition, Congress has introduced legislation in an attempt to reverse the new *Browning-Ferris* standard.[49] Unfortunately, for practitioners representing franchisors, at this point no such revision to the New Jersey Franchise Practices Act has been formally proposed.

Impact for Franchisors Going Forward

In the absence of legislation adding clarity to the status between franchisors and franchisees, franchisors should continue to follow the general practices they have (hopefully) been using in order to avoid unintended employment obligations. Franchisors *should not*:

- become too involved in the day-to-day operations of the franchised locations and the management of the franchisees' employees;
- control the pay rates and classifications of franchisee employees;
- set, control or modify the employment conditions of the franchisee employees (*e.g.*, scheduling, meal and rest breaks, timekeeping procedures, etc.);
- control the hiring, firing, promotion or demotion of franchisee employees;
- micro manage, train, or directly supervise franchisee employees;
- set the employment policies for franchisees; or
- run the payroll and benefits or maintain the employment records of franchisee employees. ⚖

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ENDNOTES

1. *J.M.L. v. A.M.P.*, 379 N.J. Super. 142 (App. Div. 2005) (affirming summary judgment in the franchisor's favor in a Law Against Discrimination sexual harassment case involving allegations that the franchise owner had sex with the plaintiff); *see also Capriglione v. Radisson Hotels Int'l Inc.*, No. 10-2845, 2011 U.S. Dist. LEXIS 115145, at *7 (D.N.J. Oct. 5, 2011) (granting franchisor summary judgment in negligence

action because franchisor's "right to control uniformity of appearance, products and administration" was insufficient to impose duty of care upon franchisor); *Chen v. Domino's Pizza, Inc.*, No. 09-107, 2009 U.S. Dist. LEXIS 96362, at *10 (D.N.J. Oct. 16, 2009) (granting franchisor's motion to dismiss in a wage and hour action and explaining that "[c]ourts have consistently held that the franchisor/franchisee relationships does not create an employment relationships between a franchisor and a franchisee's employees");[1][1] *Simpkins v. 7-Eleven, Inc.*, No. 3702-06, 2008 N.J. Super. Unpub. LEXIS 2450, at *1-*2 (App. Div. April 7, 2008) (affirming summary judgment in the franchisor's favor in a tort action because the plaintiff "had not shown that [the franchisor] had exhibited sufficient control over the individual franchisee....").

2. *See, e.g., Meyers v. Garfield & Johnson Enter.,* 679 F. Supp. 2d 598 (E.D. Pa. 2010); *Contra Orozco v. Plackis,* No. A-11-CV-703 ML, 2013 WL 3306844 (W.D. Tex. 2013) (the court found that there was sufficient evidence to support a jury finding that the franchisor was a joint employer based on language in the franchise agreement that required the franchisee to comply with certain policies and procedures of the franchisor for the "selection, supervision, or training of personnel." The jury's finding was further supported by testimony from a representative of the franchisor that he had met with the franchisee to examine work schedules and had provided advice as to those work schedules to assist the franchisee.).
3. *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery*, 362 NLRB No. 186 (2015) (hereinafter, *Browning-Ferris*).
4. *Hargrove v. Sleepy's LLC*, 220 N.J. 289 (2015).
5. 29 U.S.C. §§ 151-169.
6. *Browning-Ferris*, *supra*.
7. *Hargrove*, 220 N.J. at 289.
8. The ABC test is derived from the New Jersey Unemployment Compensation Act (UCA), N.J.S.A. 43:21-1, *et seq*.
9. *Hargrove,* 220 N.J. at 295.
10. *Id.* at 305.
11. *TLI, Inc.*, 271 NLRB 768 (1984); *Laerco Transp.*, 269 NLRB 324 (1984).
12. *Browning-Ferris*, *supra*.
13. *Id.* (slip op. at 2).
14. *Id.* (slip op. at 3).
15. *Id.*
16. *Id.* (slip op. at 3-6).
17. *Id.* (slip op. at 4).
18. While in a slightly different context, the United States Court of Appeals for the Third Circuit has determined in *In re Enterprise Rent-a-Car Wage & Hour Employment Practices Litigation*, No. 11-2883, 2012 WL 2434747 (3d Cir. June 28, 2012), that courts should consider the following factors when determining whether a company is a joint employer under the Fair Labor Standards Act: 1) the alleged employer's authority to hire and fire the relevant employees; 2) the alleged employer's authority to promulgate work rules and assignments and to set the employees' conditions of employment: compensation, benefits, and work schedules, including the rate and method of payment; 3) the alleged employer's involvement in day-to-day employee supervision, including employee discipline; and 4) the alleged employer's actual control of employee records, such as payroll, insurance, or taxes.
19. The general counsel for the NLRB has publically stated "there is no interest or attempt in any way, shape or form [in the *Browning-Ferris* decision] to target the franchise industry" but whether or not franchises are targeted has yet to be determined. *See* Brian Mahoney, *Agency edition: Weil on the gig economy*, (Dec. 22, 2015, 11:16 a.m.), politico.com/tipsheets/morning-shift/2015/12/agency-edition-weil-on-the-gig-economy-griffin-on-joint-employer-211687.
20. *Hargrove,* 220 N.J. at 295*.*
21. *Id.* at 295-96.
22. *Hargrove v. Sleepy's LLC*, No. CIV.A. 10-1138 PGS, 2012 WL 1067729, at *5 (D.N.J. March 29, 2012) (*citing Nationwide Mutual v. Darden,* 503 U.S. 318 (1992)).
23. *Darden*, 503 U.S. at 318.
24. *Darden*, 503 U.S. at 327-28.
25. 220 N.J. at 296 (editing marks omitted).
26. *Id.* at 311.
27. 220 N.J. at 316.
28. *Hargrove*, 220 N.J. at 305 (internal citations and editing marks omitted).
29. *Id*. at 301-02, 313.
30. *Id*. at 301-02.
31. *Northern Securities Co. v. United States* 193 U.S. 197, 400 (1904) (Homes, J., dissenting)
32. *Browning-Ferris*, *supra*. (slip op. at 45).
33. *Id.*
34. *Id.*
35. *Id.*
36. *See* 15 U.S.C. § 1064(5)(A); *see also Barcamerica Int'l USA Trust v. Tyfiled Imps., Inc.* 289 F.3d 589, 596 (9th Cir. 2002).
37. *Patterson v. Domino's Pizza, LLC*, 60 Cal. 4th 474, 507 (2014), *reh'g denied* (Sept. 24, 2014).
38. *Id.* at 477.
39. *Id.* at 485.
40. *Id.* at 483.
41. *Id.* at 477.
42. *Id.* at 503.
43. *Id*. at 500.
44. *Id.* at 504-05.
45. *See* Tenn. Code Ann. § 50-1-208 (2015); Act of June 19, 2015, Texas S.B. 652, 84th Leg., R.S. (2015); LA. Stat. Ann. § 23:921 (2015).
46. Tenn. Code Ann. § 50-1-208 (2015).
47. Act of June 19, 2015, Texas S.B. 652, 84th Leg., R.S. (2015), available at capitol.state.tx.us/billlookup/history.aspx?legsess=84r&bill=sb652 (codified as amended in scattered sections of Labor Code).
48. LA. Stat. Ann. La. § 23:921 (2015).
49. Protecting Local Business Opportunity Act, H.R. 3459, 114th Cong. (1st Sess. 2015).

Special Industry Laws for Car Dealers

Franchised Automobile Dealers' Unique Statutory Protections in New Jersey and Other States—What They are and Why We Have Them

by Eric L. Chase

In the franchise legal community, it is no secret that legislative oversight of the relationship between franchised automobile dealers and their franchisors throughout America exceeds that of any other kind of franchise. In some states, including New Jersey, relationship protections and prohibitions are lengthy and detailed. Moreover, every year a number of states amend existing laws to address new concerns as they arise in the automotive industry. As recently as 2011, New Jersey enacted substantial amendments to provisions governing the state's franchised auto dealers and their franchisors.

A prominent example of these legislative initiatives has been the reaction in a number of states to the Tesla phenomenon. As in New Jersey, a majority of states prohibit retail auto sales by automakers and importers.[1] Tesla, which has *no* franchised dealers and owns all its outlets, has been partially successful in gaining retail footholds, notwithstanding efforts, with mixed results, by dealer associations to persuade state legislatures or courts to stop or limit its retail operations.

Over a period of decades, starting in the middle of the last century, all states eventually enacted protective laws covering the automotive franchise relationship: that is, the relationship between manufacturers or distributors with their franchised dealers. Such laws vary considerably in scope and detail. All 50 states, however, have in common that automotive franchisors cannot involuntarily terminate, or fail to renew, their dealer agreements, except for good cause or a similar formulation, and upon advance written notice.[2] As New Jersey's Supreme

Court famously put it in 1985,[3] New Jersey franchises (*all* franchises) are "infinite" unless the franchisor has satisfied its burden, measured by the good cause standard.

The state's general franchise law, the New Jersey Franchise Practices Act[4] (applicable to all defined franchises in the state), has significant protections for all franchisees. But the act's specified auto franchise provisions constitute arguably the strongest dealer protections in the country.

By way of overview, these are five of the core provisions that apply to *all* New Jersey franchises of any type:

- franchisee protection against termination/non-renewal without good cause; (Good cause is "limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.")[5]
- right to transfer the franchised business unless the franchisor sets forth "material reasons [for disapproval] relating to the character, financial ability or business experience of the proposed transferee;"[6]
- prohibition against requiring a waiver of the franchisor's liability under the law;[7]
- prohibition of the franchisor's imposition of unreasonable standards on franchisees;[8]
- an award of costs, including reasonable attorneys fees, to a prevailing *franchisee* (but not a prevailing franchisor) in litigation.[9]

These provisions in the act are among those *applicable only to franchised auto dealers*:

- dealer's right to "protest" the franchisor's establishment of new or relocated same-line auto dealer competition within "relevant market area;"[10]
- dealer's right to reimbursement at retail price by the franchisor for warranty labor and parts used in auto warranty work;[11]
- procedural protections for dealers during disputes with their franchisors, including: allocation of burden of proof to the franchisor in protests under Section 16 and termination disputes under Section 5;[12]
- stay of franchise termination when challenged[13]

Today, some may view the muscular protections of certain rights of auto franchisees as 'the norm' and settled law, but the reality is that such protections dawned only in the 1950s, in the federal Dealer Day in Court Act,[14] and developed over several decades. This seminal federal law, and the ensuing legislative trend in the states, developed because dealers were seen as disadvantaged by the enormous bargaining disparity between them and the automakers and importers.

Unlike most kinds of franchised businesses, auto dealers must invest in large realty tracts and build large, costly facilities compliant with franchisor requirements. Many dealers employ large and highly trained workforces, including franchisor-trained service technicians. For a large dealership, the basic investment can amount to many millions of dollars, and such properties are not easily or inexpensively converted to other uses. Ongoing inventories of vehicles and parts are also usually valued in the millions. Dealerships attract large consumer expenditures, and employ numerous well-paid employees, all contributing in taxes and commerce to the surrounding community and the state. Thus, state legislatures have afforded car dealerships a degree of protection as a matter of equity, as well as consumer and public interest.

Not surprisingly, auto franchisors have tried to fight back against the avalanche of state initiatives, with court challenges to the constitutionality of such laws, as well as litigation and lobbying efforts to narrow or minimize the scope or reach of existing or new enactments.[15] The Alliance of Automobile Manufacturers, composed of 12 major auto franchisors, describes itself as "the leading advocacy group for the auto industry."[16] It frequently provides testimony to state legislatures in opposition to new auto franchise laws or amendments to laws that would further dealer protections. It unsuccessfully launched a series of constitutional challenges against state warranty reimbursement laws.[17]

State and metro dealer associations, as well as the National Automobile Dealer Association, are formidable advocates for dealer rights. In this state, the New Jersey Coalition of Automotive Retailers (NJCAR) has regularly, mostly successfully, lobbied for amendments to dealer laws to address perceived franchisor abuses. On occasion, it has stepped in as a representative litigant on behalf of New Jersey dealers, and it has participated in important cases as *amicus curiae*. NJCAR led the campaign against Tesla operations in New Jersey—with mixed results.[18]

The uniqueness of auto franchise legislation, along with a growing body of case law, should provide fair warning to practitioners. This is an area of the law that often differs markedly in substance and procedure from other practice areas. First, parties' customary autonomy in entering into contracts must be read in conjunction with franchise laws that decisively trump contractual provisions that usurp rights afforded franchisees. Second, specific requirements or measures set forth in franchise laws are, more often than not, in derogation of common law. Thus, lawyers who enter this field must do so with a full understanding of both the substantive and procedural peculiarities that would not exist but for what is understood to be remedial legislation, to be interpreted broadly in favor of franchisees.[19]

For the foreseeable future, automotive franchise law in New Jersey will challenge practitioners with a bevy of developing case law, as well as foreseeable statutory developments. Inevitably, the tension among automotive franchisors, their dealers and the consuming public will remain. At the same time, the universal need and demand for the product—the automobile—will assure that each of these constituencies will have its say in the courtroom as well as the Legislature. ⚖

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ENDNOTES

1. N.J.S.A. 56:10-28.
2. *See Franchise and Dealership Termination Handbook* (Second Edition 2012), Appendix B (State Laws Restricting Termination In Regulated Industries).
3. *Dunkin Donuts of America v. Middletown Donut Corp.*, 100 N.J. 166 (1985).
4. N.J.S.A. 56:10-1 *et seq.*
5. *Id.* at 5.
6. *Id.* at 6.
7. *Id.* at 7(a).
8. *Id.* at 7(e).
9. *Id.* at 10.
10. *Id.* at 16, *et seq.*
11. *Id.* at 15.
12. *Id.* at 30(c).
13. *Id.* at 30(b).
14. 15 U.S.C. 1221-1226.
15. *See, e.g., New Motor Vehicle Bd. v. Orrin W. Fox Co.*, 439 U.S. 96 (1978), which upheld the constitutionality of California's protest law.
16. *See* Alliance website at autoalliance.org.
17. *Alliance of Auto. Mfrs., Inc. v. Curry*, 2015 U.S. App. LEXIS 5528 (2d Cir. 2015); *Alliance of Auto. Mfrs., Inc. v. Gwadosky*, 430 F. 30 (1st Cir. 2005), *cert. denied*, 547 U.S. 1143 (2006).
18. In March 2015, Governor Chris Christie signed into law a bill allowing four direct Tesla sales operations and a service center in New Jersey.
19. *Westfield Centre Service, Inc. v. Cities Service Oil Co.*, 158 N.J. Super. 455 (Ch. 1978), *aff'd* 86 N.J. 453.

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