

# New Jersey Franchise Practices Act

The New Jersey Franchise Practices Act, N.J.S.A. 56:10-1 et. seq., (the "Act") 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.

N.J.S.A. 56:10-3(a). Emphasis added. This definition provides the basis for a two-part test developed by New Jersey courts to determine whether a given agreement constitutes a franchise contract if the rest of the conditions set forth by the Act are met. These conditions include a restriction on the applicability of the Act,

to a franchise (1) the performance of which contemplates or requires the franchisee to establish or maintain a **place of business** within the State of New Jersey, (2) where gross sales of products or services between the franchisor and franchisee covered by such franchise shall have exceed **\$35,000.00** for the 12 months next preceding the institution of suit pursuant to this act, and (3) where more than **20%** of the franchisee's gross sales are intended to be or are derived from such franchise . . .

N.J.S.A. 56:10-4(a). Emphasis added. The place of business requirement is further narrowed under the Act to include only, "a fixed geographical location at which the franchisee **displays for sale and sells** the franchisor's goods or offers for sale and sells the franchisor's services. Place of

business **shall not mean an office, a warehouse, a place of storage, a residence or a vehicle.**"

N.J.S.A. 56:10-3(f). Emphasis added. Thus, where there is:

- a license to use protected marks;
- a community of interest in marketing goods;
- a place of business, as defined under the Act, and;
- sales exceeding \$35,000 and 20% of gross sales;

a "franchisor" may not unilaterally terminate the "franchise,"

without having first given written notice setting forth all the reasons for such termination, cancellation, or intent not to renew to the franchisee at least 60 days in advance of such termination, cancellation, or failure to renew except (1) [for abandonment of the franchise] and (2) [conviction of an indictable offense related to the franchise]. It shall be a violation of this act for a franchisor to terminate, cancel or fail to renew a franchise without good cause. For the purposes of this act, good cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.

N.J.S.A. 56:10-5.

A leading New Jersey case on the subject is Instructional Systems, Inc. v. Computer Curriculum Corp., 130 N.J. 324 (1992)<sup>1</sup>. There, the New Jersey Supreme Court voided a choice of law provision which required the application of California law in an exclusive,

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<sup>1</sup> This case also has long and interesting factual and procedural history. The action was commenced in New Jersey state court in 1989. The defendant immediately removed the case to federal court on diversity grounds. Subsequently, the defendant moved for partial summary judgment and argued that application of the N.J. franchise law outside New Jersey would violate the Commerce Clause. The District Court then decided to abstain from addressing that question in order to permit the plaintiff to file a declaratory judgment action in New Jersey state court for interpretation of the New Jersey statute. That action led to the Supreme Court decision discussed in this memorandum. Following that decision, the defendant returned to federal court and renewed its motion for summary judgment on the constitutional grounds. In 1999 the District Court granted the motion. (86 F. Supp. 831) On appeal in 1994 the Third Circuit reversed finding that the New Jersey franchise law as applied by the New Jersey Supreme Court did not impose an unconstitutional burden on interstate commerce. (35 F. 3d 813, 827) Cert. was denied by the Supreme Court.

regional distributorship contract for computer systems and found the parties' relationship to be a franchise governed by the Act.<sup>2</sup> The Court held that the Act applied even though the defendant had only sought to terminate the plaintiff's distribution rights in several states other than New Jersey. Id. at 329-330.

#### **A. Factual Basis for Imposing Franchise**

The Court noted that the contract at issue in Instructional Systems:

- gave the distributor the right to use the manufacturer's name, trademark and logo in its advertising, exhibits, trade shows, public relations materials and manuals;
- required the distributor to use its best efforts to promote the manufacturer's products;
- obliged the distributor to devote all its energies to developing a demand for the manufacturer's products;
- obliged the distributor to maintain a certain number of full-time sales representatives;
- obliged the distributor to maintain adequate facilities to promote the manufacturer's products;
- obliged the distributor to promote the manufacturer's products through advertising and exhibitions at trade shows;
- obliged the distributor to prepare customers' sites for installation of the manufacturer's products and to establish and maintain a training program for users of the manufacturer's products, and;
- prohibited the distributor from selling competitive products
- The distributor was also permitted to sublicense the manufacturer's products and to receive fees for such licensing, and 97% of the distributor's sales were tied to the manufacturer's products. Although the distributor agreement contained language to the effect that no right, title or interest in proprietary marks was transferred by the contract,

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<sup>2</sup> The Supreme Court of New Jersey has also held that forum selection clauses will not be upheld unless the manufacturer can prove that the clause was not imposed as a result of the manufacturer's superior bargaining power through evidence of specific negotiations over inclusion of the clause in exchange for concessions to the distributor which show that the clause was not imposed against the distributor's will. Kubis & Perszyk Associates, Inc. v. Sun Microsystems, Inc., 146 N.J. 176 (1996).

and to the effect that the relationship established was one of supplier and distributor, the Court gave little weight to this language.

## **B. Place of Business Requirement**

Subsequent to the factual recital, the Informational Systems Court addressed the "place of business" requirement of the Act and found that if the manufacturer could reasonably anticipate that the distributor would establish a New Jersey place of business at the time of the contract, then the Act's requirements on this point were fulfilled if the distributor could show a "fixed business location" for the sale of the manufacturer's products. Id. at 348. Since the distributor had maintained its principal place of business in New Jersey for more than seven years prior to the contract and had continued to use the premises as a marketing facility for the manufacturer's products for display, training and demonstration, and since the site was not a "[m]ere distribution" point or simply an office location, the Court found the place of business requirement satisfied. Id. at 348-349. But see Liberty Sales Associates, Inc. v. Dow Corning Corp., 816 F. Supp. 1004 (D.N.J. 1993) (master distributor did not maintain a place of business as most of its business constituted sales over the phone and out of a storage facility, even though customers came to the storage facility for some pick-ups and training); Greco Steam Cleaning, Inc. v. Associated Dry Goods Corp., 257 N.J. Super. 594 (Law Div. 1992) (licensee did not satisfy place of business requirement through office used to solicit clients as nothing was sold from the premises).

## **C. License Requirement**

The Instructional Systems Court next considered the Act's license requirement and noted that mere use of proprietary marks would be insufficient absent use of those marks as the distributor's own and in such a way that the consuming public would believe that there was a

connection between the distributor and the manufacturer such that the manufacturer vouched for the activity of the distributor. Id. at 352. The New Jersey Supreme Court found a license had been granted by the manufacturer, even though the distributor did not use the manufacturer's name on its stationery, business cards or signs, since the distributor had agreed to use its best efforts to maintain and promote the manufacturer's name, trademark and logo, and since the products at issue were not "off-the-shelf" products and the distributor was constrained to sell other competitive products. Id. at 353-354. The Court noted that since the public could reasonably conclude that there was a connection or a special relationship between the manufacturer and the distributor, their identities were integrally related in the public mind and the license requirement was fulfilled. Id. at 353-354. But see Liberty Sales Associates, Inc. v. Dow Corning Corp., 816 F. Supp. 1004 (D.N.J. 1993) (master distributor did not have a license even though it derived the majority of its revenues through brand marketed using manufacturer's name because use of that name did not induce the public to buy and goodwill of the distributor's business not attached to the manufacturer's product name); Cassidy Podell Lynch, Inc. v. Syder Gen'l. Corp., 944 F.2d 1131 (3d Cir. 1991) *citing* Finlay & Assocs., Inc. v. Borg-Warner Corp., 146 N.J. Super. 210 (1976) (manufacturer who merely furnishes advertising materials to distributor and allows distributor to place its name alongside manufacturer's name on those materials does not create the license to use the manufacturer's name required by the Act).

#### **D. Community of Interest Requirement**

With respect to the community of interest requirement, the Court in Instructional Systems noted that the Act's main purpose is to protect a franchisee who may be vulnerable to dissolution of its business, and appropriation of its substantial franchise-specific investments, by an unscrupulous franchisor. Id. at 357. As such, the Court found that even though the Instructional Systems distributor had not made significant and specific investments in facilities,

improvements or inventory related to the manufacturer, there existed a "complex of mutual and continuing advantages which induced the [manufacturer] to reach his ultimate consumer through entities other than his own which, although legally separate, are nevertheless economically dependent upon him." Id. at 358. Since the distributor thereby created a reputation and good will which passed back to the manufacturer without compensation to the distributor, this "symbiosis" or financial interdependence induced the distributor, "to make a substantial investment in goods or skill that [would] be of minimal utility outside the franchise" thus satisfying the community of interest requirement Id. at 359. But see Neptune T.V. & Appliance Service, Inc. v. Litton Systems, Inc., 190 N.J. Super. 153 (App. Div. 1983) (licensed service center not a franchise of manufacturer even though it satisfied license requirement of Act by advertising itself as such and so stating on letterhead, cards and service vehicles, because service center's efforts did not contribute to the public goodwill of the manufacturer's product); Cassidy Podell Lynch, Inc. v. Syder Gen'l. Corp., 944 F.2d 1131 (3d Cir. 1991) (even though exclusive distributor granted license under the Act as a result of joint marketing and advertising and the use of the manufacturer's logo on uniforms, signs and vehicles, community of interest not established because distributor could purchase similar products from other manufacturers to satisfy its obligations to its customers); New Jersey Am., Inc. v. Allied Corp., 875 F.2d 58 (3d Cir. 1989) (distributor failed to show community of interest where it used other manufacturer's parts to make its products, only 38% of its sales came from parts supplied by the manufacturer at issue, it purchased parts from fourteen other suppliers and had no substantial investment in the manufacturer's business).

#### **E. Change of Control**

Although the Court in Informational Systems did not face a change of control event, the Act prohibits a franchisor from requiring or prohibiting, "any change in management

of any franchisee unless such requirement or prohibition of change shall be for good cause, which cause shall be stated in writing by the franchisor." N.J.S.A. 56:10-7(c).<sup>3</sup> In addition, although there are restrictions on the sale of a franchise under New Jersey law, it is only a violation of the Act to do so if the franchisee,

transfer[s], assign[s] or sell[s] a franchise or interest therein to another person unless the franchisee shall first notify the franchisor of such intention by written notice setting forth in the notice of intent the prospective transferee's name, address, statement of financial qualification and business experience during the previous 5 years. The franchisor shall within 60 days after receipt of such notice either approve in writing to the franchisee such sale to proposed transferee or by written notice advise the franchisee of the unacceptability of the proposed transferee setting forth material reasons relating to the character, financial ability or business experience of the proposed transferee. If the franchisor does not reply within the specified 60 days, his approval is deemed granted. No such transfer, assignment or sale hereunder shall be valid unless the transferee agrees in writing to comply with all the requirements of the franchise then in effect.

N.J.S.A. 56:10-6. Thus, if the Agreement is found to be a franchise agreement, the provisions dealing with change of control, termination of the Agreement or sale of the distributor will be inapplicable and the above terms and conditions of the Act will apply instead.

## **F. Conclusion**

Whether a specific agreement constitutes a franchise will depend on a fact-specific analysis of the above factors in each case. Attached is a list of questions that will help

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<sup>3</sup> As noted above, for the purposes of this Act, good cause is defined as the failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.

focus that analysis. If the Act applies, the termination and change of control provisions will be superseded by the provisions of the Act. Furthermore, since the Act provides attorneys fees and costs upon successful completion of an action, N.J.S.A. 56:10-10, an added incentive exists for a distributor to file suit.

## QUESTIONS

1. What are the distributor's annual sales figures and what percentage of the business is comprised of the distributed products?
2. Is the distributor required to maintain a place of business in New Jersey? Elsewhere?
3. Does the distributor have an alternative line of products that it could substitute and sell in place of the manufacturer's product line?
4. Has the distributor made capital investments specific to the manufacturer which it could either not use with or not sell to another customer?
5. Is the customer goodwill developed by the distributor specific to the products of the manufacturer?
6. Would competitors be able to denigrate the distributor with references to its prior endorsement of the manufacturer's products should the distributor try to sell the products of another manufacturer?
7. Would the distributor's client base be likely to purchase the products of another manufacturer?
8. Is the distributor free to market and sell the products of other manufacturers?
9. Is the distributor required to maintain a minimum sales staff or minimum marketing staff to promote and sell the manufacturer's products?
10. Do the distributor and the manufacturer engage in joint sales, marketing, promotional or maintenance activities and what is the nature of these activities?
11. Does the manufacturer supply the distributor with marketing or promotional materials or reimburse the distributor for same?
12. Does the manufacturer represent to the public that the distributor's place of business is a "regional office" or "sales office" of the manufacturer?

13. Does the distributor have a show room or a marketing center promoting the manufacturer's products?
14. Does the distributor advertise itself as an authorized distributor or an exclusive distributor of the manufacturer's products or does the manufacturer require the distributor to do so?
15. Do the distributor's employees wear uniforms of the manufacturer, drive vehicles with the manufacturer's logo on them, maintain signs with the manufacturer's logo on them or distribute promotional items with both the manufacturer's and the distributor's names on them?

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