

# New Jersey Law Journal

VOL. CLXXXV—NO.5—INDEX 375

JULY 31, 2006

ESTABLISHED 1878

## CORPORATE LAW

---

### Franchise Fairness

New Jersey law seeks to level the playing field between franchisors and franchisees

By Adam Siegelheim

---

In general, franchise agreements are contracts of adhesion. A franchisee oftentimes will have little, if any, ability to negotiate the terms of the contract. As a result, the franchise agreement is not forged from mutual consent, but rather consists of terms imposed by the franchisor. While the franchisor enjoys a superior bargaining position to dictate the terms of its franchise agreements, the enforcement of such provisions may not be enforceable to the extent they conflict with New Jersey law.

The New Jersey Franchise Practices Act, N.J.S.A. 56:10-1, et seq., was enacted by the legislature to address the disparity in bargaining power between the franchisor and the franchisee. In general, the act is designed to prohibit the franchisor from imposing “unconscionable” terms in its agreement. At the same time, the act recognizes the franchisor’s need to protect its tradename and good will associated with its system.

---

*Siegelheim is a member of the franchise group at Stark & Stark of Lawrenceville.*

The act applies to any franchise located in New Jersey with gross annual sales exceeding \$35,000, of which 20 percent or more is derived from the franchise. Under New Jersey law, a franchise exists if: 1) the franchisor granted a license to the franchisee; 2) the parties contemplated that the franchisee would maintain a place of business in New Jersey; and 3) there is a “community of interest” between the franchisor and the franchisee. New Jersey courts have held that there is a “community of interest” when the terms of the franchise agreement requires the franchisee, in the interest of the franchisor’s success, to make a substantial investment in goods or skills that will be of minimal utility outside the franchise.

The act governs and pre-empts both the franchise agreement and the governing state law of the agreement on various issues, including the termination, renewal, and transfer of a franchise. A franchisor cannot deny a New Jersey franchisee the protection afforded by the act, by merely stating that another state’s law will govern the contract. Similarly, any efforts by the franchisor to require a New Jersey franchisee to assent to a release, assignment or novation of a franchisor’s liability under the act would be pre-empted by the act.

Consequently, New Jersey franchisees are often afforded greater protections than they are typically able to obtain in the franchise agreement. For example, the Act does not permit a franchisor to arbitrarily terminate, cancel or refuse to

renew the franchise agreement absent good cause. The Act seeks to curb potential abuses by the franchisor, including the ability to threaten termination of the franchise as a mechanism to coerce the franchisee to maintain unreasonable hours, buy supplies directly from the franchisor or agree to unreasonable rate increases. Rather, the franchisor must demonstrate that the franchisee failed to comply with material requirements imposed upon him or her by the franchise agreement. New Jersey takes a restrictive view of what constitutes “good cause” for termination.

In *Westfield Centre Serv., Inc. v. Cities Serv. Oil Co.*, 86 N.J. 453 (1981), the New Jersey Supreme Court concluded that a franchisor is in violation of the act if it cancels or terminates a franchise for any reason other than the franchisee’s substantial breach, even if the franchisor acted in good faith and for a bona fide reason. The New Jersey Supreme Court recognized that the franchisor’s superior bargaining position enables it to set the terms of its agreement unilaterally, leaving the franchisee with the choice of acquiescence or a total loss of its investment.

The act further requires the franchisor to provide the franchisee with a minimum 60-day notice period, before the termination takes effect. Any provision in the franchise agreement that permits a franchisor to terminate the franchise in less time is not enforceable.

The act does not allow the franchisor to withhold approval of the transfer of the franchise without setting forth its reason for denial, which must relate to the pro-

posed transferee's character, financial or business ability. New Jersey courts have interpreted this section of the act to impose a requirement of reasonableness on a franchisor's decision to disapprove a transfer.

In the event that a franchisor violates any provision in the act, a franchisee can seek damages, including injunctive relief (where appropriate) and reasonable attorney's fees.

Under New Jersey law, forum selection clauses, requiring a franchisee to bring an action against the franchisor in a state designated by the franchisor (typically the franchisor's home state), are not enforceable. In *Kubis & Perszyk Associates, Inc. v. Sun Microsystems, Inc.*, 146 N.J. 176 (1996), the Supreme Court held that forum selection clauses are presumptively invalid. The Court reasoned that the enforcement of such clauses would undermine the protections intended to be afforded to franchisees under the act.

The Supreme Court distinguished between the function of a forum-selection clause in an arms-length commercial contract, where the forum-selection clause may have been negotiated between parties possessing relatively equal bargaining power, and a contract of adhesion where the franchisee is required to negotiate off of a standard contract with numerous provisions that a franchisor typically refuses to change or otherwise revise. In addition, franchisees may also be afraid to request changes to the agreement to avoid the risk of antagonizing the franchisor and losing its opportunity to purchase a franchise.

In *Kubis*, the Court further supported its reasoning by noting that forum selection clauses would increase a franchisee's costs to seek redress against a franchisor. The franchisee may not be in an economic position to fund such litigation. In addition, in instances of claims for wrongful termination, a forum selection clause would deprive the franchisee of a right to seek prompt injunctive relief from a local

court. The Court concluded that the forum selection clause, if enforced, could prevent a franchisee from obtaining protections granted to it under the act, because the franchisee does not have the financial resources to hire out-of-state counsel and other costs to pursue an action in the franchisor's home state.

Notwithstanding the Supreme Court's rationale in *Kubis*, it does not appear that the Supreme Court would reach a similar conclusion regarding forum selection clauses related to arbitration provisions. In a recent unreported Appellate Division decision, *B&S Limited, Inc. v. Elephant & Castle International, Inc.*, May 18, 2006, DDS No. 11-4-3930, the chancery court held that arbitral forum selection clauses in franchise agreements are enforceable. Its decision was based on the rational of decisions in the Third Circuit that have refused to extend the *Kubis* ruling to arbitration clauses on the grounds that such forum selection clauses involve the Federal Arbitration Act, which governs arbitration in contracts involving interstate commerce and pre-empt any rights afforded under the Franchise Practices Act. While there are no reported decisions in New Jersey involving this issue, recent Third Circuit case law, as well as case law from other jurisdictions suggest that if challenged, a New Jersey court would not render an arbitration forum selection clause invalid.

Under New Jersey law, a franchise can be subject to the Consumer Fraud Act, N.J.S.A. 56:8-1 et seq. As with the Franchise Practices Act, the franchisor cannot escape liability under the Consumer Fraud Act by stating that the franchise agreement will be governed by the laws of another state. So long as the franchisor is selling franchises within New Jersey, it will be subject to the Consumer Fraud Act.

Further, any limitations or waivers contained in the franchise agreement shall also be pre-empted by the Consumer Fraud

Act. For example, franchisors typically require franchisees to waive certain legal rights, including the right to seek punitive damages. In the event the franchisor violated the Consumer Fraud Act, it would not be able to rely on this provision to avoid a franchisee seeking treble damages or other punitive damages permitted thereunder.

In New Jersey, all contracts (including franchise agreements) are subject to the implied covenant of good faith and fair dealing. The implied covenant of good faith and fair dealing serves in aid and furtherance of other terms of the agreement of the parties and serves to protect the parties' reasonable expectations. The implied covenant of good faith and fair dealing could be considered by the court in instances where a franchisor is alleged to have not fulfilled its obligations under the franchise agreement, including assistance with site location, training, marketing, etc. For example, if a franchisor states that it will use its "best efforts" to assist the franchisee in finding a location, such efforts will be judged on a "good faith and fair dealing" standard.

Importantly, the covenant of good faith and fair dealing does not necessarily constitute a separate cause of action if it is breached or create any individual, substantive contractual rights. Moreover, any such implied covenant cannot properly be used to override or strike express contract terms.

In general, New Jersey has enacted laws that are designed to "level the playing field" between franchisors and franchisees. Franchisors need to be aware of New Jersey laws when drafting their disclosure documents and franchise agreements — particularly on issues such as termination, renewal and the transfer of the franchise. So long as the franchisor has not included any provisions in its agreement that conflict with New Jersey law, the franchise agreement will likely be enforceable against the franchisee. ■