Leveling the Playing Field: Amending the New Jersey Franchise Practices Act to Better Protect Franchisees

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With thousands of franchises in the State of New Jersey, one of the most important, and lesser known, statutes is the New Jersey Franchise Practices Act, N.J.S.A. 56:10-1, *et seq.* (the "NJFPA"). The NJFPA defines what constitutes a franchise under New Jersey law, and provides statutory protections for franchisees within New Jersey from certain improper termination events and non-renewals by their franchisors. The NJFPA is among the most comprehensive in the nation, and yet, far too many franchisees and their legal counsel are unaware of its existence. The defining feature of the NJFPA is that it does not allow a franchisor to terminate a franchisee without demonstrating cause and providing sixty (60) days' notice and an opportunity to cure, with limited exceptions. Yet, it is not a perfect statute.

On June 6, 2016, New Jersey State Senator Bob Smith (D-17) introduced Senate Bill 2325 (hereinafter, the "Bill") to the New Jersey Senate, which would make several substantive changes to the NJFPA. Senator Smith's proposed revisions are a step in the right direction towards making a more equal playing field between franchisors and franchisees in New Jersey. However, some proposed sections of the Bill seek to reverse decades of ubiquitous franchisor-franchisee relationship practices in a quick and summary manner, which may be too much, too soon. The Bill's proposed revisions include:

In-Term Practices by the Franchisor. The Bill seeks to prohibit, during the term of the franchise agreement, franchisors from: (1) requiring franchisees, as a condition of renewal or transfer, to assent to a general release in favor of the franchisor; (2) restricting the sale of any minor ownership interest in a franchise to employees, personnel of the franchisee, spouse, child or heir of an owner, as long as the basic financial requirements of the franchisor are complied with; (3) competing in a franchisee's exclusive territory/region; (4) imposing unreasonable standards of performance (including facilities, financial, operating, or other requirements) upon a franchisee; and (5) requiring a franchisee to purchase goods and/or services from a third-party vendor (and prohibiting franchisors from taking a commission or other payment from any such vendor) without taking reasonable steps to secure the best possible price.

Fiduciary Duty upon Franchisor. The Bill seeks to place a fiduciary duty upon franchisors for any funds collected by the franchisor from the franchisees for use in advertising. The Bill would further require the franchisor annually detail how those funds are being used.

Termination by the Franchisee. The Bill seeks to allow franchisees to terminate the franchise relationship in a manner similar to that of the franchisor; namely, upon sixty (60) days' notice of termination, cancellation, or non-renewal. However, the Bill does not require the franchisee to demonstrate cause or provide the franchisor with an opportunity to cure.

Post-Termination Obligations. The Bill looks to bar franchisors, upon termination, cancellation, or non-renewal, from: (1) requiring franchisees to pay excessive damages (commonly referred to as liquidated damages); (2) requiring franchisees to personally guarantee the debts of the franchise to the franchisor; and (3) imposing non-competition agreements that extend for more than six (6) months and/or restrict employment outside the county in which the franchise was located.

Franchisor Forum-Selection Clauses. The Bill, in a completely new section, seeks to bar franchisors from requiring a franchisee to sign any agreement—including franchise agreements, lease agreements, or ancillary agreements—which specifies the Court in which a claim may be brought, or otherwise prohibits a franchisee from bringing an action in a particular court otherwise available to the franchisee under the laws of New Jersey.

Many of these sections, while extraordinarily friendly to franchisees, would upend the current franchisor-franchisee relationship and force franchisors to dramatically change not just their existing franchise agreements, but entire business model. By way of example, prohibiting a franchisor from competing in a franchisee's exclusive territory/region may have a significant effect on Internet website sales. Prohibiting franchisors from imposing "unreasonable" standards of performance will likely cause an influx of litigation between franchisees and franchisors. If franchisors are prohibited from taking a commission or other payment from vendors, many franchisors who also own the vendors which franchisees are required to use—which would also cause issues if they are required to take reasonable steps to secure the best possible price—may be required to reorganize their corporate structure or sell off those assets.

Moreover, while the creation of a fiduciary duty regarding advertising funds would certainly reinforce the partnership-style relationship franchisors often suggest exists, such a status may cause financial issues in both emerging and saturated markets. Perhaps the biggest change, however, would be the prohibition against liquidated damages and post-term personal guarantee, which make up a substantial portion of current franchisor/franchisee litigation.

Other sections of the Bill may violate the United States Constitution. Specifically, the Contracts Clause, which applies solely to state legislation retroactively obstructing or limiting existing ordinary contracts between private citizens or entities, including partnerships and corporations. See U.S. Const. art. I, § 10, cl. 1 ("No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ."); see also Energy Reserves Group v. Kansas Power & Light, 459 U.S. 400 (1983) (providing a three-part test for conforming to Contract Clause, similar to that of rational basis review, but importantly noting that the state regulation cannot "substantially impair" an existing contractual relationship).

By way of example, the Bill potentially unlawfully prohibits franchisors from imposing a covenant not-to-compete for more than six (6) months or one that restricts employment outside the county in which the franchise is located. Given the existence of such covenants in many, if not most, franchise agreements, such a prohibition to existing contracts may be problematic, especially given their widespread legality in the New Jersey. See Solari Indus., Inc. v. Malady, 55 N.J. 571 (1970) (permitting enforcement of covenants not-to-compete to the extent "which is reasona-

bly necessary to protect their legitimate interests, will cause no undue hardship on the defendant, and will not impair the public interest").

While some of the proposals will may upset many franchise systems, given the prevalence of franchises in the New Jersey economy, the Bill certainly raises important issues. While there has been no vote regarding the Bill, it is likely going to take input from all stakeholders—including franchisors and franchisees—to craft legislation that adequately protects franchisees, is likely to pass both the Senate and Assembly, and can be signed by the Governor of New Jersey.

Should you have any questions or require further detail regarding this legislation, the Franchise Law Practice Group at Hill Wallack LLP is fully prepared to assist and help guide you through this sea of change.

About the Authors

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