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. ⚖

Salvatore A. Giampiccolo *and* ***Nicole DiBello*** *are partners and* ***Jennifer M. Lahm*** *is an associate at McElroy, Deutsch, Mulvaney and Carpenter, LLP. Giampiccolo and Lahm practice in the area of commercial litigation. DiBello practices in the areas of corporate and commercial transactions.*

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).