

News & Types: Commercial, Competition & Trade Update

Without a License, Distributor Not Franchisee, Says New Jersey Federal Court

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Practices: Commercial, Competition & Trade, Litigation

One of the banes of a commercial lawyer is the distinction between an ordinary distributorship and a "franchise" under state law. Most states have franchise statutes that protect small franchised businesses from unfair or oppressive conduct by big franchisors. Some businesses are clearly franchises - the McDonalds, KFCs, and Burger Kings. But state statutes are often written in a general or vague manner so that they potentially bring in what many would consider ordinary distributorships, not usually considered franchises. A recent New Jersey case shows how far some alleged franchisees may try to stretch the statute, but also shows the limits the courts will place on the application of state franchise statutes. (*McPeak v. S-L Distribution Company, Inc.*, U.S. District Court, New Jersey, Civil No. 12-00348, December 19, 2012)

On October 27, 2006, McPeak contracted with S-L Distribution Company, Inc. (formerly SOH Distribution Company, Inc.) and obtained the exclusive right to sell and distribute S-L products in Southern New Jersey. At the time, S-L seemed very aware of the risks of McPeak claiming to be a franchise. Indeed, the Distributor Agreement went to great lengths to make clear that McPeak would not be a franchise. The Agreement classified McPeak as an independent contractor and stated that "nothing herein shall be construed: . . . (ii) as constituting Distributor as the franchisee, partner, agent, or employee of SOH." It even required McPeak to acknowledge that "this Agreement is not a franchise agreement. This Agreement does not provide the Distributor with a franchise to distribute the Authorized Products under a marketing plan or system prescribed by SOH." The Agreement prohibited McPeak from conducting business under SOH's name or the trademarks or tradenames of any SOH (now S-L) products. So S-L probably thought it covered all of its bases to avoid the franchise designation.

In November, 2011 S-L (the successor to SOH) notified McPeak that his distributorship was being terminated. The court then describes some facts which, while not determining the ultimate outcome, raise some curiosity as to what was going on. After termination, McPeak claimed his business became "worthless." On January 3, 2012, McPeak and S-L signed a revised Agreement to reduce McPeak's territory. But the revised Agreement apparently did not cover or release McPeak's claims. Less than three weeks after signing the revised Agreement, on January 19, 2012, McPeak filed the lawsuit against S-L under the New Jersey Franchise Practices Act (NJFPA). Then, less than two months later, on March 8, 2012, McPeak sold his distributorship back to S-L. So it appears S-L had two opportunities to resolve McPeak's claims – the revised Agreement in January 2012 and the purchase of the distributorship in March 2012 (which was even after the lawsuit was

filed). Why the lawsuit was not resolved as part of the sale and purchase of the distributorship is not discussed by the court.

Although S-L argued that McPeak had no standing to sue, since he had sold the distributorship, McPeak countered that he was mitigating damages. The court decided that McPeak alleged sufficient damages so that his claim could not be dismissed for lack of standing. But his claim could be dismissed for failure to state a claim, which the court did. So McPeak failed on his claim under the NJFPA.

The NJFPA is similar to other state franchise protection statutes. Under the NJFPA, a franchise is 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." (NJFPA, Section 56:10-3)

So there are two elements to a claim under the NJFPA – a) a license and b) a community of interest. The court said McPeak did not even meet the first element, the need for a license.

McPeak had an exclusive right to distribute S-L products within a defined territory. But, said the court (citing the New Jersey Supreme Court),

"not every grant of permission to use a trademark in the sale of goods or services is a 'license' within the meaning of the [NJFPA]. . . . Instead, the hallmark of the franchise relationship is the use of another's trade name in such a manner as to create a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee by which the licensor vouches, as it were, for the activity of the licensee in respect of the subject trade name."

So even the exclusive right to sell S-L's products in a territory did not confer a license. Said the court, ". . . [C]ourts have repeatedly stated that merely allowing a distributor to use the manufacturer's insignia does not in itself create a license. . . . Otherwise, 'any business selling a name brand product would, under New Jersey law, necessarily be considered as holding a license.' "

But McPeak was not quite done. New Jersey had amended the NJFPA in 2010 so that it covered not just retail businesses, but also wholesale distribution franchisees "that, through their efforts, enhance the reputation and goodwill of franchisors in [New Jersey]." So McPeak argued that earlier court precedents interpreting the statute more narrowly should be disregarded. But the court found that the amendment still would not have expanded the statute to cover McPeak's situation, since it retained the element that a license is necessary to create a franchise in New Jersey.

So S-L prevailed in its argument that it did not grant a franchise to McPeak. Yet, there are interesting points about the court's opinion. First, other than citing the self-serving language that S-L had put in the Agreement in which McPeak acknowledged it was not a franchise, the court did not use that language to support its decision, with one key exception. That exception is the language which explicitly stated that McPeak was not being granted a license in S-L's trademarks. Second, the court did not reach, and did not discuss, whether there was a community of interest between McPeak and S-L. Presumably, without a license there would be no

community of interest. But it would have been helpful for the court to elaborate on the distinction between a license and a "community of interest."

In any event, the court's opinion does provide some guidance and protection for those appointing what they believe to be distributors, and not franchisees. But, given the time and expense for S-L to prevail even at the early stage of dismissing McPeak's lawsuit, the case still highlights the scope and ambiguity of the state franchise protection statutes.