



## Choice of Law in Franchise Relationships: Staying Within Bounds

BY THOMAS M. PITEGOFF

Seventeen states and the District of Columbia have laws that require good cause for termination and nonrenewal of franchise agreements, without regard to industry.<sup>1</sup> If it has ever been doubted that these laws lead to increased litigation, the long, torturous history of the case of *Instructional Systems, Inc. v. Computer Curriculum Corp.*<sup>2</sup> should dispel any such doubt. This case has been in and out of federal and state courts at all levels, from the New Jersey Chancery Division to the New Jersey Supreme Court to the federal district and appeals courts.<sup>3</sup> Still, the courts have yet to reach the substantive question of whether the franchisor had good cause under the New Jersey Franchise Practices Act (the NJFPA)<sup>4</sup> not to renew the franchise agreement in parts of the assigned territory outside New Jersey. Instead, the battles have been fought over choice of law, the definition of *franchise* under the NJFPA, the extraterritorial application of the NJFPA, and the Commerce Clause of the U.S. Constitution.<sup>5</sup>

While there is no easy solution to the problem that gave rise to the franchise relationship laws—namely, a perception of economic injustice<sup>6</sup>—the application of the NJFPA can hardly be said to have led to justice in the *Instructional Systems* case. This case involved an agreement between a California franchisor and a New Jersey franchisee whose territory covered New Jersey and several other states. Upon the expiration of the agreement, the franchisor had reduced the franchisee's territory by removing from it a few states, other than New Jersey, in which the franchisee was carrying on very little business. The New Jersey Supreme Court held that the NJFPA applied to the partial nonrenewal of the



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agreement even though the contract called for the application of California law.<sup>7</sup> Moreover, the court held that the NJFPA applied even though all of the franchisee's territory within New Jersey was included in the renewal agreement. In a subsequent decision in the *Instructional Systems* case, the Third Circuit Court of Appeals reinforced the expansive result of the New Jersey Supreme Court by holding that the extraterritorial application of the NJFPA does not violate the Commerce Clause of the U.S. Constitution.<sup>8</sup>

The outcome in these cases was an insult to the principle of party autonomy for several reasons. For one thing, it disregarded the parties' choice of California law. In addition, the NJFPA, which limits the right of parties to contract freely, was applied in states that otherwise would follow the common law policy of freedom of contract.

The *Instructional Systems* holding that the NJFPA can apply beyond the borders of New Jersey is significant. The NJFPA, like the franchise relationship laws of other states, covers more than just business format franchises. It also covers many distributorship arrangements that would not be characterized as franchises under franchise disclosure laws. While most business format franchise agreements are confined to one state, many dealership and distribution agreements cover territories that include more than one state. Controversies arising under the franchise relationship laws are likely to raise the question of the territorial reach of the law. To the extent that these laws apply extraterritorially, they are likely to catch unsuspecting suppliers.

In reaching its holding that New Jersey law applies, the New Jersey Supreme Court cited an article by this author for the proposition that "[m]ost courts . . . have held that the parties to a franchise agreement cannot avoid the franchise [relationship] law of the state in which the franchisee is located by providing in their agreement that the laws of another state will govern."<sup>9</sup> This is correct when one franchise location is at issue and that location is in the state in which the franchise law was enacted. Where rights to a location in another state are being terminated or are not being

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renewed, however, other considerations come into play, and these considerations come sharply into focus in a multistate context.

Unless the parties specifically indicate in their agreement that a particular relationship law should apply to the entire contract, the better approach is to apply the state franchise relationship law only within its state boundaries or, if the contract or the issue is not severable, not to apply the relationship law at all. This territorial approach can be grounded wholly on choice of law principles, without resort to constitutional law. As discussed below, the New Jersey Supreme Court would have reached a better result in the *Instructional Systems* case if the court had not held that the NJFPA applies outside the state of New Jersey.

### Prior Multistate Franchise Relationship Cases

Choice of law disputes frequently encumber termination or nonrenewal. While the decisions are far from consistent, the *Instructional Systems* case is not the only case in which the courts have applied the franchise relationship law of the franchisee's state to activities of a franchisee in states that do not have franchise relationship laws, notwithstanding the contractual choice of the law of the franchisor's state.

In *Wright-Moore Corp. v. Ricoh Corp.*,<sup>10</sup> the Seventh Circuit Court of Appeals held that the Indiana Franchise Practices Act applied to a national distributor based in Indiana, although the contract called for the application of New York law. The New York supplier in that case had refused to renew a one-term distribution agreement. The holding was surprising because the agreement was by its terms to last for one year, and it specifically provided that renewal would require negotiation and the execution of an entirely new written agreement.

The *Wright-Moore* holding is less far-reaching than the *Instructional Systems* case because on remand of *Wright-Moore*, the district court dismissed, refusing to apply the Indiana Franchise Practices Act extraterritorially. The court held, "Clearly, other states' legislatures can give protection to franchises within the states' borders if they so wish."<sup>11</sup> The Seventh Circuit affirmed the dismissal, holding that even viewing the agreement as constituting an Indiana franchise, it was a nonrenewable contract within the meaning of § 1(8) of the Act.<sup>12</sup> This section of the statute specifically allows franchise agreements in Indiana to "provide that the agreement is not renewable upon expiration or that the agreement is renewable if the franchisee meets certain conditions specified in the agreement."<sup>13</sup>

In *Department of Motor Vehicles v. Mercedes-Benz*,<sup>14</sup> a Florida court reached the shocking holding that the NJFPA applied where the agreement called for the application of New Jersey law, even though the franchisee and the franchised business were in Florida. The court ruled that the contractual choice of New Jersey law evidenced an intent that the NJFPA should apply. The outcome in the *Mercedes-Benz* case must have been a terrible embarrassment for the franchisor.

The outcomes in the *Wright-Moore* and *Mercedes-Benz*

cases would have been different if the court had viewed the state franchise law in question as being one that applies only within the territory of the state in which it was enacted. This approach was taken by a federal district court in New York in *Carlos v. Philips Business Systems, Inc.*<sup>15</sup> In that case, the plaintiff had places of business in and distributorship agreements for parts of New Jersey, Connecticut, and Ohio. The defendant was a supplier whose principal place of business was in New York. Although the agreements provided that New York law would govern, the court applied the franchise relationship laws of Connecticut and New Jersey with respect to the agreements covering those states. The court held that the only states with a "true interest" in the outcome of the litigation were those in which the distributorship was being terminated, because they would bear any economic burdens associated with business failures occurring within their borders. Accordingly, the court in the *Carlos* case applied New Jersey law to determine whether the termination was valid in New Jersey and Connecticut law to determine whether the termination was valid in Connecticut. The court applied neither franchise act to the nonrenewal in Ohio, holding that the relationship laws of Connecticut and New Jersey did not have extraterritorial effect.<sup>16</sup>

### *Instructional Systems v. Computer Curriculum*

In the *Instructional Systems* case, the franchisor, Computer Curriculum Corporation (CCC), produced and marketed an integrated learning system comprising computer hardware, UNIX operating system software, and application software, or "courseware," which was used to help students improve their skills in math, reading, science, and other subjects. CCC's principal office was located in California. While CCC sold its products directly to school districts throughout most of the United States, it sold in the Northeast through a distributor, Instructional Systems, Inc. (ISI). ISI, whose only place of business was in New Jersey, had been the exclusive distributor of CCC's products in the northeastern United States since 1974.

In 1984, CCC and ISI entered into an agreement appointing ISI as the exclusive reseller of certain CCC products in a territory consisting of the states of Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont, and Washington, D.C. The agreement required ISI to sell only in this assigned territory and to deal only in CCC's products. The governing-law clause provided that the agreement "shall be construed and interpreted, and the legal relations created by it shall be determined, in accordance with the laws of the State of California." By its terms, the agreement was to expire on July 31, 1989, and it contained no provision requiring renewal beyond the expiration date.

ISI had not paid a franchise fee of any kind for its right to resell CCC's products. ISI conducted its business under its own name rather than CCC's. Although neither CCC's name nor its logo appeared on ISI's stationery or business cards, the agreement authorized ISI to use CCC's name, trademark, and logo in its advertising, trade shows, public relations materials,

and manuals during the term of the agreement. ISI managed its operations in the entire territory from its New Jersey office in a commercial office building. The agreement did not require ISI to maintain a place of business in any specific state, although ISI's only office was located in New Jersey.

By the late 1980s, the educational computer product market had grown exponentially and become increasingly crowded. In 1988, CCC took a number of steps in an effort to remain competitive. One step was to reexamine its relationship with ISI. In doing so, CCC noted that ISI was devoting disproportionate effort to selling in three states and was neglecting the other parts of its exclusive territory. Accordingly, after the agreement expired CCC refused to extend it for the entire territory. CCC did, however, agree to extend it for a period of two years in the three states in which the franchisee had its major sales activity: New Jersey, New York, and Massachusetts. CCC would then be able to distribute its products directly in the other states that had been part of ISI's territory.

ISI executed the 1989 renewal agreement under protest and simultaneously sued CCC in New Jersey state court, alleging that the 1984 agreement constituted a franchise under the NJFPA and that CCC had violated the NJFPA by failing, without good cause, to renew the agreement. ISI sought both an injunction restraining CCC from terminating its relationship with ISI and damages. CCC removed the case to federal court on the basis of diversity of citizenship.

### **Procedural History**

Following discovery, ISI moved in federal district court for a preliminary injunction and partial summary judgment on the issue of whether the 1984 agreement constituted a franchise agreement under the NJFPA. CCC opposed and filed a cross-motion for partial summary judgment, arguing that (1) California law applied to the 1984 Agreement; (2) application of the NJFPA outside New Jersey would violate the Commerce Clause; (3) the 1984 agreement was not a franchise under the NJFPA; and (4) CCC's actions did not violate the NJFPA. ISI responded by petitioning the district court to abstain so that the New Jersey courts could consider the NJFPA claim. The district court granted ISI's request for abstention, reasoning that if the New Jersey courts determined that the arrangement between CCC and ISI was not a franchise under the NJFPA, or that the NJFPA does not apply to states other than New Jersey, then there would be no need to address the Commerce Clause question.

The New Jersey Chancery Division then issued a declaratory judgment that the relationship between the parties constituted a franchise under the NJFPA.<sup>17</sup> The Chancery Division ruled first that the importance of New Jersey's interest in protecting its franchisees nullified the choice of California law under the 1984 agreement. The Appellate Division reversed, holding that the 1984 agreement did not constitute a franchise, because CCC did not grant a license to ISI as that term is used in the NJFPA's definition of *franchise*.<sup>18</sup>

### **New Jersey Supreme Court Holding**

In 1992, the New Jersey Supreme Court reversed the Appellate Division's decision and reinstated the holding of the Chancery Division.<sup>19</sup> With two judges dissenting, the court determined that the relationship between ISI and CCC was a franchise within the meaning of the NJFPA. The court found sufficient evidence to support a finding that the 1984 agreement contemplated that ISI would have a place of business in New Jersey, that CCC had granted ISI a trademark license, and that sufficient facts existed to determine that there was a "community of interest" between CCC and ISI. The court went on to hold that the NJFPA had, at best, only incidental extraterritorial effect.

On the question of whether the NJFPA applied in view of the contractual choice of California law, CCC argued unsuccessfully that New Jersey did not have an interest in this litigation, let alone one that was "materially greater" than California's or the other states' whose interests were affected. The nonrenewals were in states other than New Jersey, and according to CCC, New Jersey has an interest in regulating only those franchise terminations that occur within its borders. CCC attempted to sever the contract, applying the NJFPA only to ISI's rights in New Jersey. The court disagreed, holding that application of California law would violate New Jersey's public policy and that "[t]o strip away the spokes of a 'hub-type' franchise would counter the purpose of [the NJFPA]."<sup>20</sup>

The holding that the agreement contemplated or required ISI "to establish or maintain a place of business within the State of New Jersey," thereby bringing the relationship within the definition of *franchise* under the NJFPA, may be the weakest part of the court's analysis. The court focused on the definition of *place of business*, finding that the facts supported the holding that the ISI location was a place of business. The thrust of the court's discussion of the NJFPA "place of business" requirement was that ISI's location in New Jersey, which was equipped with a demonstration room designed to simulate a classroom "laboratory," was more than merely an office or warehouse, which would not have been a "place of business" within the NJFPA. The court did not address the fact that ISI's facility could have been located anywhere in or near ISI's territory. In fact, the owner of ISI had begun with a Connecticut location, and then moved to New Jersey.<sup>21</sup> It does not appear to have been important to CCC where ISI's office was located, so long as ISI could service the territory.

The court did not address an NJFPA provision that the agreement "contemplate or require" the franchisee to establish or maintain its place of business in New Jersey. If it had, it might have reached a different and better result. As written, the holding might arguably mean that the mere inclusion of the address of the distributor in the agreement is enough to constitute a requirement to locate in New Jersey.

Whether there was enough evidence to support the holding that a license had been granted and that a community of interest existed were also close questions that could have been decided either way. Indeed, two of the seven justices held that the agreement between CCC and ISI did not constitute a franchise within the meaning of the NJFPA.<sup>22</sup>

### Subsequent History of the Case

After the decision of the New Jersey Supreme Court, CCC moved in federal district court for partial summary judgment on the issue of the application of the NJFPA outside New Jersey. The district court granted CCC's motion,<sup>23</sup> holding that extraterritorial application of the NJFPA constitutes a *per se* violation of the Commerce Clause. The court held that by applying the NJFPA extraterritorially, CCC would not regain the right to sell its products in the entire eight-state territory until it established, to the satisfaction of a New Jersey court, that it had met New Jersey's statutory requirement of termination or nonrenewal for good cause. "Until that time, the 1984 Agreement would continue in virtual perpetuity, despite its contractually agreed-upon expiration date."<sup>24</sup> The district court went on to hold that:

... because extraterritorial enforcement of the statute would impose rights and restrictions granted by New Jersey that do not exist in most of the states within the Marketing Territory, the Commerce Clause—as well as the notions of state autonomy and comity which support the Commerce Clause—dictate that the Franchise Practices Act not be given extraterritorial application. New Jersey cannot impose its regulation or policy choices on other states.<sup>25</sup>

The district court's holding was probably the first judicial holding that extraterritorial application of a franchise law violates the Commerce Clause, and it would have been significant if it had not been overturned. However, the Third Circuit reversed, holding that

... it is inevitable that a state's law, whether statutory or common law, will have extraterritorial effects. The Supreme Court has never suggested that the dormant Commerce Clause requires Balkanization, with each state's law stopping at the border. [Citation omitted.] In traditional contract litigation, courts must apply some state's law to interpret the contract. While a contract which covers multiple states may raise a difficult choice-of-law question, once that question is resolved there is nothing untoward about applying one state's law to the entire contract, even if it requires applying that state's law to activities outside the state.<sup>26</sup>

### The Need for Judicial Restraint

In a dissenting opinion to the holding of the Supreme Court of New Jersey in the *Instructional Systems* case, Judge A.D. D'Annunzio held that the NJFPA is "very strong medicine," which should be applied sparingly.

In light of the Act's restrictions on a franchisor's business discretion and, therefore, on its ability to adjust to market developments and competitive pressures, and the Act's abrogation of common-law principles regarding termination and expiration of contracts, we scrupulously must avoid extending the Act's reach beyond the Legislature's intent.<sup>27</sup>

In a similar vein, the federal district court held:

The Act prohibits CCC from changing its distribution methods no matter how much the industry has changed over the course of the 1984 Agreement and irrespective of whether CCC or a different distributor could do a better job than ISI. [Citations omitted.] It is significantly burdensome for the Franchise Practices Act to prohibit CCC from pursuing marketing opportunities in states otherwise neglected by ISI—such as Maine, New Hampshire and Vermont—given the highly competitive nature of the Integrated Learning Systems business.<sup>28</sup>

Even the New Jersey Supreme Court expressed reserva-

tions over the workability of the NJFPA. Referring to the NJFPA, the court held: "In many ways this case illustrates the profound difficulties of encapsulating a concept of economic fairness in statutory language."<sup>29</sup> This is a basic problem with all franchise relationship laws. These laws attempt to define economic fairness by creating rights for franchisees that do not exist in most states or under the common law of contracts, and they do so in a way that often ignores the economic needs of franchisors and franchise systems.<sup>30</sup>

The NJFPA defines *good cause* for termination or nonrenewal solely in terms of the franchisee's conduct, irrespective of the needs of the franchisor.<sup>31</sup> This interpretation has been consistent even in the face of the conclusion that it has the potential of requiring "infinite" franchises.<sup>32</sup> According to the courts, the sole question in these cases is whether the franchisee has complied with the terms of the franchise agreement.<sup>33</sup> Under this reading of the NJFPA, if a franchisee complies with the terms of the agreement, the franchisee has a right to a perpetual franchise agreement. To put it another way, the NJFPA has the potential of insulating dealers from economic reality by requiring suppliers to continue their dealerships in perpetuity. The NJFPA simply does not account for changes in economic circumstances.<sup>34</sup>

The NJFPA is an exceptional statute, both in its abrogation of the common law of freedom of contract and because a minority of states have adopted franchise relationship laws. It is unfortunate that the result of the *Instructional Systems* decisions is to impose the NJFPA, one of the toughest of the franchise relationship laws, on states that have not adopted similar laws. It would be tempting to say that the NJFPA is a bad law and that the lesson of the *Instructional Systems* case is that a bad statute leads to a bad court decision. However, this would not be a rational basis for a system of choice of law rules in a multistate system. Who is to decide whether the NJFPA is the "better rule of law"?<sup>35</sup> Certainly, if the federal courts ask the New Jersey courts that question, the New Jersey courts are likely to find that the New Jersey law is better than the law of most other states. Fortunately, the problem can be approached in another way.

### Stripping Away the Spokes

The New Jersey Supreme Court held in the *Instructional Systems* case that only one law could apply to the franchise agreement: "To strip away the spokes of a 'hub-type' franchise would counter the purpose of [the NJFPA]."<sup>36</sup> This forced a mechanistic either/or decision. Given this holding, it might have been appropriate for the New Jersey Supreme Court to honor the parties' contractual choice of California law to apply in all states in the territory, rather than New Jersey law.<sup>37</sup> This would have been preferable to applying the restrictive law of New Jersey in states that had no franchise relationship laws. After all, a majority of the states do not have franchise relationship laws.<sup>38</sup>

A better approach in this case would have been to apply more than one set of laws to the contract. This would have allowed the court to apply the NJFPA in a more measured way that might have been more in line with the parties'

expectations. Applying the laws of different states to govern different issues in the same case is not a new idea. In academic circles, this approach is called *dépeçage*.<sup>39</sup> Although this approach is absent from the First Restatement of Conflicts of Laws, *dépeçage* is taken for granted in the Second Restatement. Section 187 of the Second Restatement deals with the law relating to a "particular issue."<sup>40</sup>

Once the monolithic approach of applying a single law is abandoned, many possibilities emerge. For example, a court might choose to honor the contractual choice of law with respect to the interpretation of the contract, while imposing the restrictions of a local protective law to the extent that the controversy involves issues covered by such law. In the *Instructional Systems* case, the court could have enforced the choice of California law, while applying the NJFPA to the issues the NJFPA covers. California law might then have applied to the other states in ISI's exclusive territory.

The issues covered by the NJFPA are matters of local concern. The NJFPA, like other franchise relationship laws, is intended to apply in a specific territory. By its terms, it covers agreements that contemplate that the franchisee will have a place of business in New Jersey. Where, as in the *Instructional Systems* case, the territory covers more than one state, a court might inquire whether the agreement is severable. If so, the obligations created by the NJFPA would extend only as far as the borders of the state of New Jersey.

The fact that CCC desired to renew the agreement in some of the states in the territory should be conclusive evidence that the agreement was severable. Those who draft multistate franchise agreements might consider avoiding any doubt by allowing partial termination during the term based on a failure to perform in a particular part of the territory. Even without such a provision, however, there is good reason for a court to limit the application of such laws to one state.

Whether or not application of the NJFPA outside New Jersey was a violation of the Commerce Clause, its application outside the state offends basic principles inherent in our federal system and in the U.S. Constitution. The allocation of authority among states is territorial. As one commentator has written, this territorial allocation of state authority "is a fundamental constitutional principle, even though that principle is not attributable to any particular constitutional clause."<sup>41</sup> A reasoned approach to choice of law should reflect this territorial allocation of state authority.

Certainly, there will be limits to a territorial approach. Issues might arise under the relationship laws that do not lend themselves to territorial severability. For example, in California, the surviving spouse and heirs of a deceased franchisee have the right to participate in the ownership of the franchise for a reasonable time after the franchisee's death and to transfer the franchise if the spouse or heirs do not satisfy the franchisor's then current standards for a new franchisee. Other states may allow the franchisor to terminate the agreement upon death of the franchisee, if the contract so provides. By its nature, the question of whether California law applies to a franchise succession dispute requires an

either/or answer. In this type of case, just as in a case in which the contract is severable, a court should exercise care in applying the franchise law extraterritorially. Where the contract provides for the application of the law of another state, it may be that the contractually chosen law should apply to the entire territory.

### Choice of Law Objectives

From the days of the American Revolution until the early part of the twentieth century, Anglo-American law followed a system of territorial choice-of-law rules.<sup>42</sup> The European roots of these principles long predate the Revolution.<sup>43</sup> These territorial rules were embodied in the First Restatement of Conflicts, published in 1934 by the American Law Institute. Contract rights, according to the First Restatement, vested under the law of the place of the last event necessary to assertion of the right, which might be the place of contracting or the place of performance.

The 1963 decision of the New York Court of Appeals in *Babcock v. Jackson*<sup>44</sup> initiated the modern choice of law revolution, which takes interest and policy factors into account. The academic reaction was intense in the years that followed. The Second Restatement, published in 1971, was an attempt to accommodate the various competing theories of the day. Unfortunately, the Second Restatement is overly complicated and leads to unpredictable results.

One commentator has written that although the Second Restatement is far superior to the First Restatement's "single-contact, policy-blind rules," its fatal flaw is its complexity, which leads to decisions in any given jurisdiction that are "wildly" inconsistent.<sup>45</sup> Other commentators have argued that conflicts cases have become so unpredictable today that a federal choice of law statute should be enacted.<sup>46</sup> Unnecessary litigation would also be reduced if Congress were to enact a federal franchise relationship law that would preempt all state franchise relationship laws. The challenge in this approach would be to fashion a law that would encapsulate the needs and reflect the concerns of all sides in the debate. This would be no easy task. In the absence of such a law, conflicts issues will continue to arise, and a reasoned, consistent approach to these issues will continue to be a worthy goal.

Franchise agreements almost always contain a choice of law clause, and distributorship agreements often do as well. The fact that a contract contains a choice of law clause greatly simplifies the task of determining the governing law. One of the important developments in conflicts of law in the second half of the twentieth century is the general acceptance of the concept of party autonomy, or at least an acceptance that party autonomy is the starting point of any conflicts analysis when the parties have chosen a governing law by contract.

Joseph Beale, the reporter of the First Restatement, objected to enforcing a contractual choice of law because, according to Beale, to do so would allow the parties "to do a legislative act."<sup>47</sup> Quite to the contrary, party autonomy is one of the underlying principles of § 187 of the Second Restatement.<sup>48</sup> When the parties have chosen an applicable

law, the Second Restatement will generally honor that choice. Even courts in states that do not follow the Second Restatement<sup>49</sup> generally start today from the premise that the contractual choice of law will be enforced. Party autonomy also is an accepted principle of choice of law outside the United States, in both civil and common law countries.<sup>50</sup>

Most of the various conflicts theories that emerged in academic circles in the years since the First Restatement had nothing to do with enforcing the contractual choice of law.<sup>51</sup> To the extent that these theories deal with contracts, they focus on the law applicable to contracts in the absence of a contractual choice of law. These theories include, among others, the center-of-gravity test, Brainerd Currie's interest analysis, and Robert Leflar's five considerations.<sup>52</sup> Leflar's five considerations are: predictability of results, maintenance of interstate and international order, simplification of the judicial task, advancement of the forum's governmental interests, and application of the better rule of law.<sup>53</sup>

In the setting of commercial contracts, parties must know the rules of conduct that are to govern their business relationship.<sup>54</sup> Choice of law rules relating to business conduct should be narrowly drawn and designed to vindicate party expectations.<sup>55</sup> Enforcing the contractual choice of law is one way to allow the parties to know in advance the rules that will govern their relationship so they can conduct themselves accordingly. Where application of the chosen law would be contrary to a fundamental policy of another state's franchise relationship law, a similar narrow, hard-and-fast rule should govern the application of such franchise relationship law.

Conflicts issues involving a contractual choice of law can be reduced to two basic questions.<sup>56</sup> First, what does the contract provide? This goes to this issue of party autonomy. Second, is application of the chosen law contrary to a fundamental policy of another state's laws?<sup>57</sup> This second question is the wild card, on which most contract choice of law cases are argued and on which differences of opinion are most likely to arise. A consistent and just approach is attainable, however, if one takes into account both territoriality and the possibility of applying more than one law to the contract. The franchise relationship law should be applied only within the intended territory and only to the issues covered by that law, and the contract should be governed in all other respects by the law specified in the contract.

Limiting the application of a franchise relationship law territorially and substantively can almost always, if not always, be based on the contract itself. If there is a local protective law, and the contract does not specifically provide for its application outside the state, the parties cannot have expected that the local law would apply outside the state. Theoretically, parties might specifically contemplate that a franchise relationship law will apply in states other than that in which the law was enacted. Such a case is so unlikely in a franchise context, however, that it may never rise above the level of theory. Franchise contracts are drafted by franchisors, and it is not in their interest to expand the application of franchise relationship laws. Accordingly, it is reasonable to start from the presumption that the contract did

not contemplate that such law would apply beyond the territory in which it was enacted. If, for some reason, the parties desire that such law apply extraterritorially, the contract should indicate this desire clearly. A presumption of limited territorial reach makes sense whether the law chosen is the law of the state that has a relationship law or whether a relationship law of another state arguably applies as a matter of fundamental policy. Moreover, from a substantive point of view, if the contract provides that the law of California governs, the parties must have intended that California law will be applied generally, even if a local protective law must apply to certain aspects of the parties' relationship as a matter of fundamental policy.

Limited territorial and substantive application of franchise relationship laws also can be grounded in state policy objectives. Even where the application of the chosen law would be contrary to a fundamental policy of a franchise law of another state, that other state's franchise law does not extend to all aspects of the contract but only to those covered by the statute. Moreover, the policy objectives of franchise relationship laws have a limited territorial reach. Most of the state franchise relationship laws specifically apply when the franchisee has a place of business within the state.<sup>58</sup> This evidences a policy that a state has an interest only when the franchise is located in the state.

Finally, a territorial approach would give deference to the majority of states that do not have franchise relationship laws. There have been so many state legislative initiatives over the years that one can reasonably conclude that states not having a franchise relationship law have made a reasoned decision not to enact such a law.

For these reasons, then, if the contract calls for the application of California law, but New Jersey has a fundamental policy restricting certain aspects of the parties' conduct, then New Jersey law may be applied, but only to the extent of the franchisee's rights in New Jersey, and only on questions governed by the particular New Jersey statute evidencing such policy. Other questions should be governed by the contractually chosen law of California. If the issue in question or the contract does not allow for territorial severability, and the parties have not specifically agreed to the extraterritorial application of a franchise law in a multistate context, then it would be better not to apply that law at all rather than to impose it on states that have made a decision to follow the principle of freedom of contract and not to enact such laws.

Introducing the elements of territoriality and *dépeçage* into choice of law disputes in the franchise and dealership context enhances predictability and allows the parties to know in advance how to conduct themselves lawfully. Although the territorial basis for the choice of law approach embodied in the First Restatement has been extensively criticized, it appears from recent literature that it is no longer taboo to include a territorial dimension in choice of law discussions.<sup>59</sup> A "new territoriality" is becoming academically acceptable.

In addition to franchise relationship law disputes, a territorial approach can assist in deciding choice of law disputes

that revolve around franchise disclosure laws. Specifically, it might be a starting point for limiting application of state franchise disclosure laws in a way that would eliminate the possibility of conflicting disclosure requirements.<sup>60</sup>

## Conclusion

To apply a franchise relationship law outside the state in which such law was enacted, based on conflict of laws principles, is tantamount to allowing choice of law to become the tail that wags the dog. It is doubtful that extraterritorial application will promote fairness or lead to a just outcome. Such laws are generally intended to apply locally, and the vast majority of states have made a determination not to adopt franchise relationship laws. Moreover, when the franchise contract calls for the application of the law of a particular state, the parties must have intended that the chosen law will govern all aspects of the relationship, except for those specific aspects that are governed by a local law the application of which is a matter of fundamental policy. In all other respects, parties should be able to regulate their conduct in accordance with the contractually chosen law.

## Endnotes

1. See *Franchise Protection: Laws Against Termination and the Establishment of Additional Franchises*, ABA Section of Antitrust Law Monograph (1990); Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW 289 (1989). Iowa enacted a franchise relationship law in 1992. Bus. Franchise Guide (CCH) ¶ 2002.

2. 35 F.3d 813 (3d Cir. 1994), cert. denied, 63 U.S.L.W. 3477 (February 21, 1995).

3. The federal district court in New Jersey held as follows, in a ruling in this case in 1993:

This case illustrates the fact of delay, as well as impact on interstate commerce, by the application of the Franchise Practices Act. The present dispute has been ongoing for four years. During this time, the case has been reviewed by the Chancery Division of the New Jersey Superior Court, the Appellate Division of the New Jersey Superior Court, the New Jersey Supreme Court and now is back before this court. Nevertheless, after four years of litigation, the only issues that have been decided are those related to the preliminary issue of whether the CCC/ISI relationship constituted a franchise subject to the provisions of the Franchise Practices Act. Although this question has been answered by the New Jersey Supreme Court in the affirmative, CCC's right to market its products in the Eight States outside of New Jersey has still not been resolved. The New Jersey Supreme Court did not decide, *inter alia*, whether CCC had good cause to not renew the 1984 Agreement or whether ISI waived its right to renewal by signing the 1989 Agreement. See *Instructional Systems*, 130 N.J. at 373, 614 A.2d 124. After four years of litigation, extraterritorial application of the Franchise Practices Act still prohibits CCC from selling its products in the Eight States outside of New Jersey.

826 F. Supp. 831, 848 (D. N.J. 1993). Although the case was before the federal courts on the basis of diversity jurisdiction, the federal district court had abstained so that the New Jersey courts could determine whether the arrangement was a franchise under the NJFPA and whether the NJFPA applies to states other than New Jersey.

4. N.J. Rev. Stat. §§ 56:10-1 through 56:10-12.

5. U.S. Const. art. I, § 8, cl. 3.

6. See generally Jean Wegman Burns, *Vertical Restraints, Efficiency, and the Real World*, 62 FORDHAM L. REV. 597 (1993); Lee A. Rau, *Implied Obligations in Franchising: Beyond Terminations*, 47 BUS. LAW 1053 (May 1992).

7. 130 N.J. 324, 614 A.2d 124, Bus. Franchise Guide (CCH) ¶ 10,119 (N.J. 1992).

8. *Instructional Systems, Inc. v. Computer Curriculum Corp.*, No. 93-5414 (3d Cir. Sept. 16, 1994) (slip opinion), modifying the district court's decision.

9. 130 N.J. at 344; Thomas M. Pitegoff, *Choice of Law in Franchise Agreements*, 9 FRANCHISE L.J. 1 (Summer 1989) [hereinafter Pitegoff, *Choice of Law*].

10. 908 F.2d 128, Bus. Franchise Guide (CCH) ¶ 9665 (7th Cir. 1990).

11. 794 F. Supp. 844, 860, Bus. Franchise Guide (CCH) ¶ 10,020 (N.D. Ind. 1991), *aff'd*, 980 F.2d 432, Bus. Franchise Guide (CCH) ¶ 10,111 (7th Cir. 1992). The court also held that "giving Indiana's franchise statute extraterritorial effect raises Commerce Clause issues." 794 F. Supp. at 861.

12. IND. CODE § 23-2-2.7-1(8) (1991).

13. The court also held that the minimum inventory purchase and training expenses did not constitute franchise fees under the Indiana statute.

14. 408 So. 2d 627 (Fla. 1981), modified, 455 So. 2d 404 (Fla. 1984), petition for rev. denied, 462 So. 2d 1107 (Fla. 1985).

15. 556 F. Supp. 769 (E.D.N.Y.), *aff'd*, 742 F.2d 1432 (2d Cir. 1983). In another case involving a multistate franchise, the court applied the Connecticut Franchise Act only to the franchises located within Connecticut. *Power Draulics-Nielsen v. Libbey Owens-Ford*, Bus. Franchise Guide (CCH) ¶ 9075 (S.D.N.Y. 1988).

16. 556 F. Supp. at 777.

17. No. C-4116-89E (N.J. Super. Ct. Ch. Div. Oct. 30, 1989).

18. *Instructional Systems, Inc. v. Computer Curriculum Corp.*, 243 N.J. Super. 53, 58, 578 A.2d 876 (Ct. App. Div. 1990).

19. *Instructional Systems*, *supra* note 7.

20. 130 N.J. at 345.

21. See *id.* at 336 n.3.

22. Dissenting opinion of Judge D'Annunzio. Justice Clifford joined in the dissent.

23. 826 F. Supp. 831 (D. N.J. 1993).

24. *Id.* at 847.

25. *Id.* at 852.

26. 35 F.3d at 825.

27. *Supra* note 7.

28. 826 F. Supp. at 848 n.24.

29. 130 N.J. at 371; 614 A.2d at 148, Bus. Franchise Guide (CCH) ¶ 10,119 (NJ 1992).

30. For a discussion of the way in which the creation of rights leads to more conflict rather than less, see PHILIP K. HOWARD, *THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA* (1994). Mr. Howard makes the point that in the period since the mid-1960s, it became a fad to give out rights to one group after another. *Id.* at 125. Most franchise relationship laws were enacted in the 1970s.

31. See *Westerfield Center Services, Inc. v. Cities Service Oil Co.*, 86 N.J. 453, 432 A.2d 48 (1986); *Carlos v. Phillips Business Systems, Inc.*, 556 F. Supp. 769 (E.D.N.Y.), *aff'd*, 742 F.2d 1432 (2d Cir. 1983).

32. See *Dunkin' Donuts of America, Inc. v. Middletown Donuts Corp.*, 495 A.2d 66, 76 (N.J. 1985).

33. *General Motors Corp. v. Gallo GMC Truck Sales, Inc.*, 711 F. Supp. 810, Bus. Franchise Guide (CCH) ¶ 544 (D. N.J. 1989).

34. For a more reasonable interpretation of another franchise relationship law, namely, the Wisconsin Fair Dealership Act, see *Ziegler Co. v. Rexnord, Inc.*, 407 N.W.2d 873 (Wis. 1987), remanded, 433 N.W.2d 8 (Wis. 1988).

35. Applying the "better rule of law" was one of Robert Leflar's five considerations in a choice of law analysis. See text accompanying note 53 *infra*.

36. 130 N.J. at 345.

37. See *Cherokee Pump & Equip. Inc. v. Aurora Pump*, Bus. Franchise Guide (CCH) ¶ 10,594 (5th Cir. 1994) (enforcing a contractual choice of Illinois law, even though Illinois permitted the termination of a Louisiana distributorship in a manner that would have been pro-

hibited by Louisiana); *Modern Computer Systems v. Modern Banking Systems*, 871 F.2d 734 (8th Cir. 1989) (declining to apply the franchise relationship law of Minnesota, the state in which the franchise was located, citing the parties' choice of Nebraska law); *Tele-Save Merchandising v. Consumers Distributing*, 814 F.2d 1120 (6th Cir. 1987) (declining to apply the Ohio Business Opportunity Plans Act, citing the contractual choice of the law of New Jersey, the franchisor's state).

38. In a footnote in *Cooney v. Osgood Mach., Inc.*, 612 N.E.2d 277, 283 n.2 (N.Y. 1993), the New York Court of Appeals held:

New York law permitting contribution against an employer is clearly a minority view [citation omitted]. A result that might impose New York law on the carefully structured workers' compensation schemes of other states—especially when the accident occurred there—is undesirable.

39. See Willis L.M. Reese, *Dépeçage: A Common Phenomenon in Choice of Law*, 73 COLUM. L. REV. 58 (1973); RUSSELL J. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS, 71-78 (3d ed. 1986). Willis L.M. Reese was the reporter for the Second Restatement.

40. Section 187 of the Second Restatement of Conflicts of Laws provides:

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

41. Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. REV. 249, 318 (1992) [hereinafter Laycock, *Equal Citizens*]. According to Professor Laycock, this principle "is largely implicit, so obvious that the Founders neglected to state it." *Id.* at 251.

42. See *id.* at 252.

43. See Edith Friedler, *Party Autonomy Revisited: A Statutory Solution to a Choice-of-Law Problem*, 37 KAN. L. REV. 471 (1989) [hereinafter Friedler, *Party Autonomy Revisited*].

44. 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963). See Gregory E. Smith, *Choice of Law in the United States*, 38 HASTINGS L.J. 1041, 1044 (1987) [hereinafter Smith, *Choice of Law*]; *Symposium on Conflict of Laws: Celebrating the 30th Anniversary of Babcock v. Jackson*, 56(4) ALB. L. REV. (1993).

45. Smith, *Choice of Law* at 1042. Another commentator has described the Second Restatement as a pragmatic compromise. Dennis J. Tuchler, *A Short Summary of American Conflicts Law: Choice of Law*, 37 ST. LOUIS U. L.J. 883, 391 (1993) [hereinafter Tuchler, *American Conflicts Law*]. For other reactions to the Second Restatement, see EUGENE F. SCOLES & PETER HAY, CONFLICT OF LAWS 38 (1984).

46. See Laycock, *Equal Citizens* at 283; Michael H. Gottesman, *Draining the Dismal Swamp: The Case for Federal Choice of Law Statutes*, 80 GEO. L.J. 1 (1991) (arguing that modern choice of law rules "have become chaotic producers of waste and unfairness").

47. JOSEPH H. BEALE, A TREATISE ON THE CONFLICT OF LAWS § 332.2 (1934).

48. See *supra* note 40.

49. In 1987, one commentator wrote that fewer than half the states continue to follow the First Restatement, and in many of these states where the courts had not had a recent opportunity to replace the old rules, they "might well be inclined to do so at the next opportunity." Smith, *Choice of Law* at 1044. Professor Smith wrote that the Second Restatement "is the most popular of the modern choice of law theories, having been adopted *in toto* by thirteen states, and in part by several others." *Id.* at 1046. See also Tuchler, *American Conflicts Law* at 391 ("between twenty and thirty percent of the states still claim to follow Professor Beale's vested rights theory").

50. See Friedrich K. Juenger, *The Inter-American Convention on the Law Applicable to International Contracts: Some Highlights and Comparisons*, 42 AM. J. COMP. L. 381 (1994) [hereinafter Juenger, *International Contracts*]; George F. Carpinello, *Testing the Limits of Choice of Law Clauses: Franchise Contracts as a Case Study*, 74 MARQ. L. REV. 57 (1990).

51. [P]arty autonomy plays a key role in upholding the reasonable expectations of the parties to multistate and international agreements by promoting predictability and uniformity. Party autonomy issues are incompatible with the modern approaches to choice-of-law problems and should be analyzed independently from modern conflict principles.

Friedler, *Party Autonomy Revisited* at 473.

52. For a summary of these various approaches and a state-by-state analysis, see Smith, *Choice of Law* at 1042.

53. Section 6(b) of the Second Restatement directs a court to consider the following factors in the absence of statutory direction from the forum state:

(a) the needs of the interstate and international systems,

(b) the relevant policies of the forum,

(c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,

(d) the protection of justified expectations,

(e) the basic policies underlying the particular field of law,

(f) certainty, predictability, and uniformity of result, and

(g) ease in the determination and application of the law to be applied.

54. One commentator said about the need for clarity in advance of action:

People cannot obey the law unless they know it; they cannot know the law unless they know which law to learn. If I am to know the law that governs an act or transaction, I must be able to identify, before I act, the one state empowered to govern.

Laycock, *Equal Citizens* at 319.

55. [I]n multistate cases courts should choose the most just of the available loss-allocation rules, but in the area of conduct regulation they should announce narrow, hard and fast rules designed to vindicate party expectations.

Patrick J. Borchers, *Conflicts Pragmatism*, 56 ALB. L. REV. 883, 911 (1993).

56. A third question is whether there is a reasonable basis for the parties' choice, as required by Restatement (Second) of Conflicts § 187(2)(a). Similarly, UCC § 1-105(1) provides that the law chosen must have some link with the agreement. One commentator has written: "Such spurious restrictions on party autonomy make little sense as long as the parties are of equal bargaining power." Juenger, *International Contracts* at 388. Is there a reasonable basis for the parties' choice when the parties are in New Jersey and Connecticut, and they select New York law because that is where the drafting attorney is located?

57. Restatement (Second) of Conflicts § 187 refers to the fundamental policy "of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the

absence of an effective choice of law by the parties." *See supra* note 40. These qualifications are helpful in deciding difficult cases. In most situations, the basic two questions will suffice.

58. See Pitegoff, *Choice of Law* at 20 n.58.

59. "No set of choice-of-law rules has yet achieved a high degree of predictability in hard cases, but only territorial rules offer any hope." Laycock, *Equal Citizens* at 319.

60. A territorial approach would have led to a different holding in, for example, *Mon-Shore Management v. Family Media*, 584 F. Supp.

186 (S.D.N.Y. 1984). In that case, the court applied the New York Franchise Sales Act when the offer merely originated in New York, even though the offerees and the franchised businesses were outside the state. For an example of a franchise disclosure law designed to avoid conflicts with the disclosure laws of other states, *see* Uniform Franchise and Business Opportunities Act § 102, promulgated in 1987 by the National Conference of Commissioners on Uniform State Laws (NCCUSL) but not adopted by any state. *Bus. Franchise Guide* (CCH) ¶ 3600.