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DISTRIBUTION OF VEHICLES IN THE U.S. AND THE IMPACT OF STATE LAW

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Morgan Lewis Automotive Hour Webinar Series

Series of automotive industry focused webinars led by members of the Morgan Lewis global automotive team. The 10-part 2019 program is designed to provide a comprehensive overview on a variety of topics related to clients in the automotive industry. Upcoming sessions:

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NOVEMBER 13 | Joint Ventures and Alliance Issues in the Automotive Space

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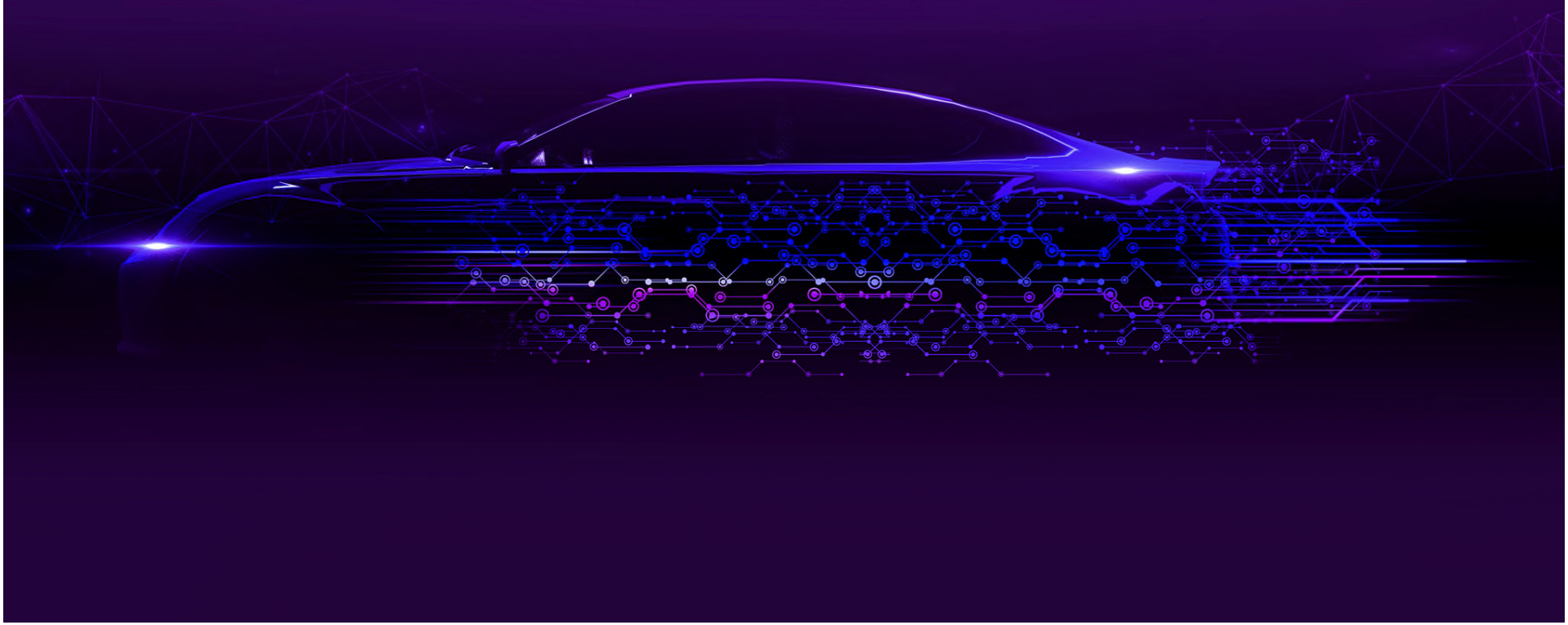
INTRODUCTIONS



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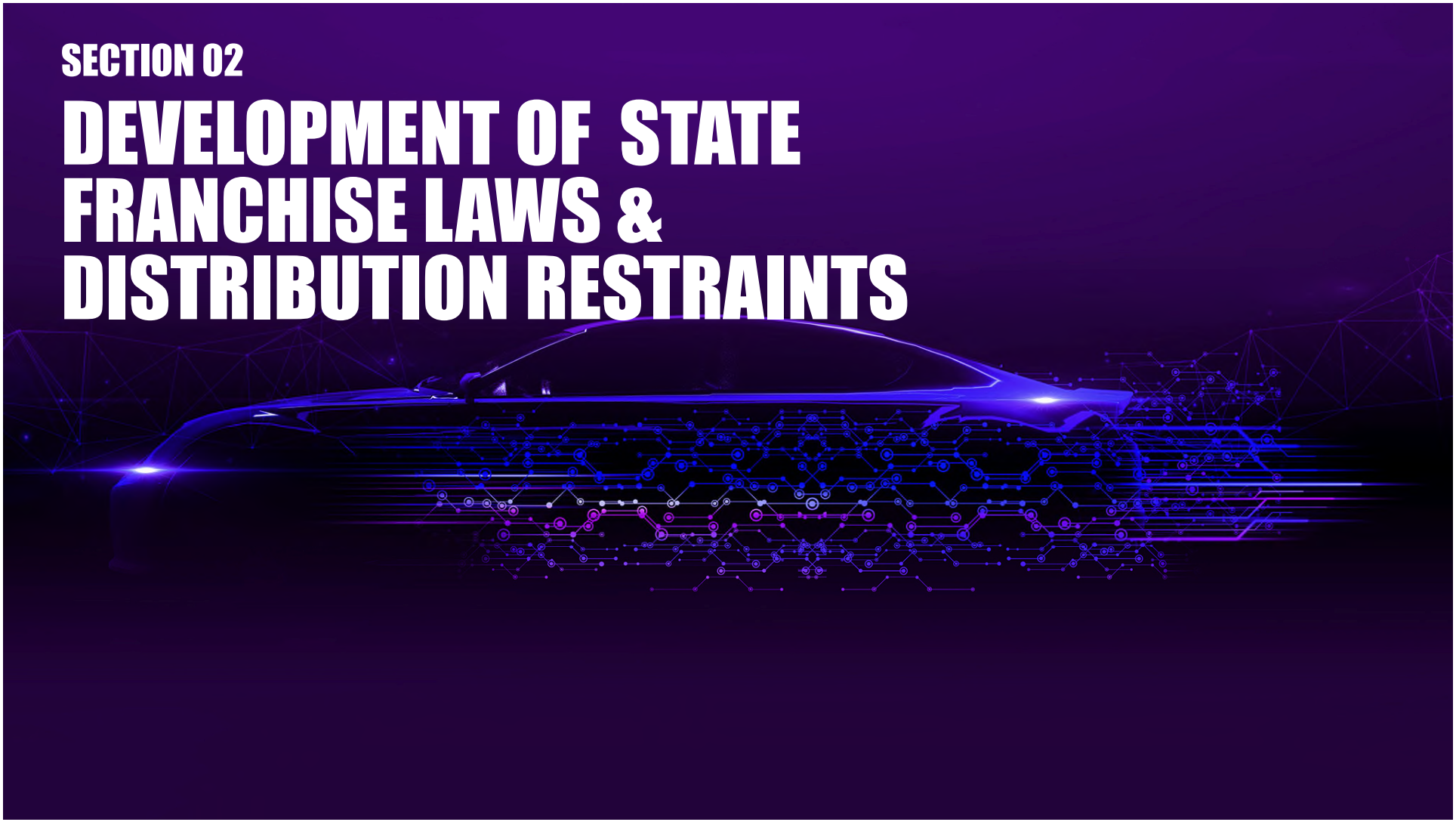
SECTION 02

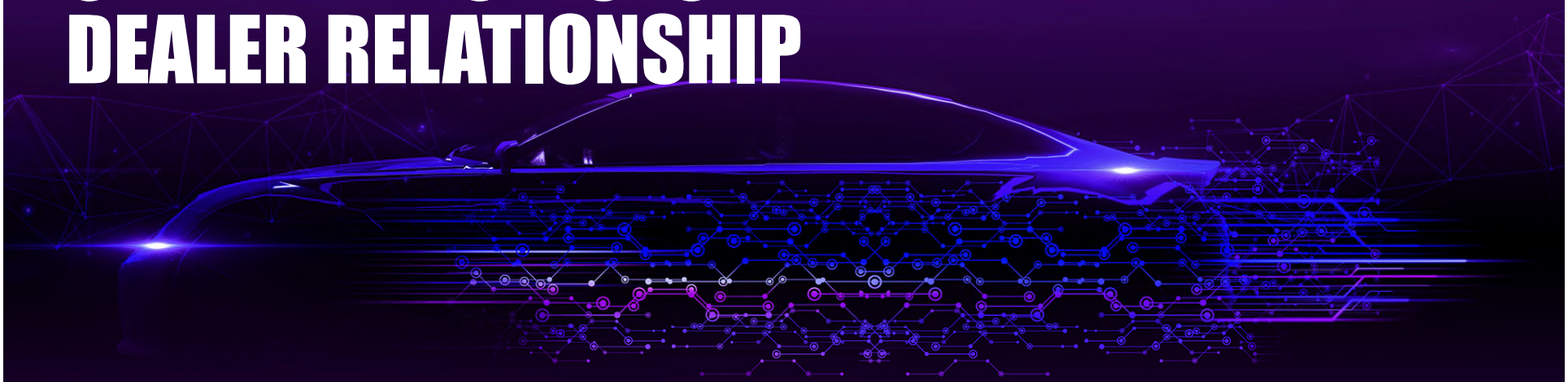
DEVELOPMENT OF STATE FRANCHISE LAWS & DISTRIBUTION RESTRAINTS



- State regulation gained traction in the mid-twentieth century on the heels of federal legislation.
- At the time, a few large manufacturers with considerable resources accounted for the vast majority of new motor vehicles sold in the U.S.
- The typical motor vehicle dealer was a small business with limited financial resources.
- Perceived differences in bargaining power led many states to impose statutory protections for dealers that closely regulate the conduct of manufacturers.
- Many of those protections remain in place today, although the business landscape has changed considerably.

SECTION 03

THE SCOPE OF REGULATION OF THE MANUFACTURER-DEALER RELATIONSHIP

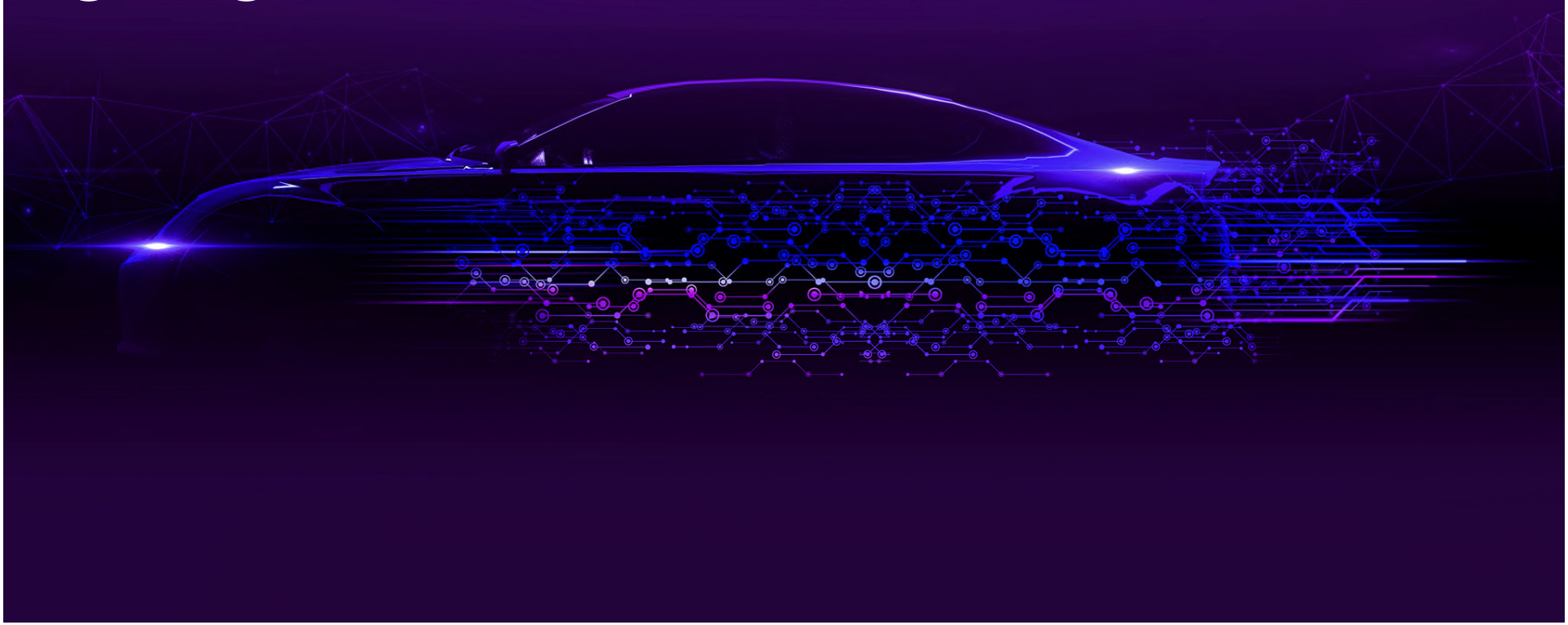


- Today, nearly every facet of the manufacturer-dealer relationship is subject to regulation at the state level.

- Regulation covers, among other issues:
  - Direct sales by manufacturers to consumers
  - Sales incentive programs offered by manufacturers
  - Rates at which manufacturers must reimburse dealers for warranty work
  - Termination of franchise relationships
  - "Unfair" and "unreasonable" activities by manufacturers, including wide-ranging prohibitions against bad faith and arbitrary or unconscionable treatment of dealers

SECTION 04

LIMITATIONS ON DIRECT SALES



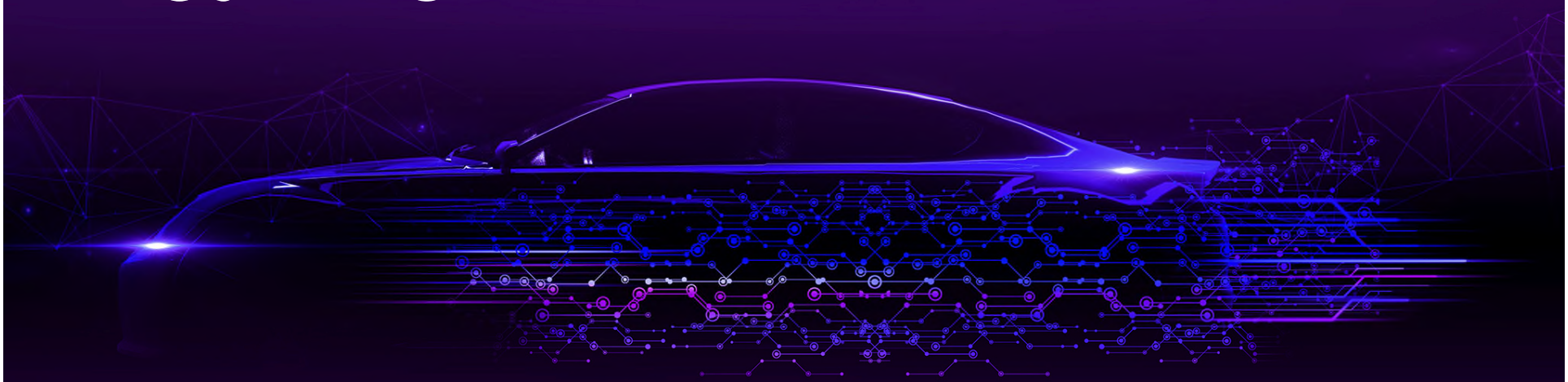
- The majority of states restrict the ability of manufacturers to sell vehicles directly to consumers. These states require, instead, that the manufacturer sell through a franchised dealership.
- These restrictions typically take one of two forms (or both in some states):
  - Express prohibitions on direct vehicle sales to consumers
  - Prohibitions on the ability of the manufacturer to operate a vehicle dealership
- 34 states have at least one of these restrictions
- 4 states that prohibit ownership of dealerships by manufacturers and/or prohibit direct sales to consumers have carve-outs that allow manufacturers to sell electric (non-fossil fuel-burning) vehicles directly to consumers.
  - Maryland, Nevada, New Jersey, Pennsylvania

- N.Y. Veh. & Traf. Law § 463(2)(bb) ("It shall be unlawful for any franchisor . . . To acquire any interest in any additional motor vehicle dealer in this state . . .").
  - Many states that prohibit manufacturer ownership of dealerships have exceptions that apply in limited circumstances.
  - For example, in Colorado, a manufacturer may own a dealership during a brief transitionary period where the dealership has been sold or transferred from one owner to another.
- Mich. Comp. Laws § 445.1574(1)(i) ("A manufacturer shall not . . . [s]ell any new motor vehicle directly to a retail customer other than through franchised dealers . . . .").

- A minority of states permit (or do not expressly prohibit) manufacturers from owning a dealership.
  - *E.g.*, California, Florida, Illinois, Massachusetts, Ohio
- However, many of these states limit the right of manufacturers to own a dealership if there is an existing network of franchised dealerships in the state.
  - Fla. Stat. § 320.645(1) ("No . . . manufacturer . . . shall own or operate . . . a motor vehicle dealership in this state for the sale or service of motor vehicles which have been or are offered for sale under a franchise agreement with a motor vehicle dealer in this state.").

- Tesla has sought to disrupt the market for direct sales through lobbying efforts at the state level.
- Tesla has achieved some level of success. In certain states, Tesla can sell vehicles directly to consumers under provisions that permit direct sales to consumers by manufacturers that offer only all-electric vehicles.
  - *E.g.*, Maryland, Nevada, New Jersey, Pennsylvania
- Tesla's pitch to state legislatures focuses on the argument that existing combustion engine dealers are not equipped to sell electric vehicles. This strategy was successful in gaining initial approval in Virginia.
- Challenges to Tesla's model have generally come from automobile dealer associations. Some courts have held that these organizations lack standing to pursue legal challenges.
  - *E.g., Mass. State Automobile Dealers Ass'n, Inc. v. Tesla Motors MA, Inc.*, (Massachusetts Supreme Judicial Court 2014)
- Tesla has been unsuccessful in a number of states, including Michigan, which has a broad dealer franchise law. Tesla is involved in ongoing litigation challenging the constitutionality of that statute. Simultaneously, Tesla has plans to open a service center in Toledo, Ohio to service vehicles owned by Michigan residents.

SALES INCENTIVE PROGRAMS



- Many states impose restrictions that require that any sales or service incentive be made available on equal terms to all dealerships in the state.
  - Cal. Veh. Code § 11713.3(u)(1)(A)(iv) – unfair discrimination includes "sales or service incentives, discounts, or promotional programs that are not made available to all California franchises of the same line-make on an equal basis."

  Some statutes are even more restrictive:

  - Fla. Stat. § 320.64(38) – manufacturer may not "fail[] or refuse[] to offer a bonus, incentive, or other benefit program, in whole or in part, to a dealer . . . in this state which it offers to all of its other same line-make dealers nationally or to all of its other same line-make dealers in the licensee's designated zone, region, or other licensee-designated area of which this state is a part, unless the failure or refusal to offer the program in this state is reasonably supported by substantially different economic or marketing considerations than are applicable to the licensee's same line-make dealers in this state."

- Can be an active area of litigation. For example, dealers have recently challenged a manufacturer's program that awards incentives on a sliding scale based, in part, on its calculation of "customer experience." Dealers alleged that the program is subjective and results in unequal treatment.

Robinson-Patman Act Claims

- Robinson-Patman claims are basis for potential liability arising out of alleged discrimination with respect to dealer incentive programs.
- Although such claims typically are not resolved on a Rule 12 motion, they are very difficult to prove because, *unlike most state dealer laws*, there is a requirement that the disfavored dealer show competitive injury.
- There are also a number of additional defenses available to manufacturers/line-makes:
  - Introductory allowances
  - Meeting competition
  - Cost justification
  - Changing conditions
- Most critically, an RPA violation will not exist if the incentive program is "functionally available" to all dealers even if the claimant chooses not to take advantage of it. *See Metro Ford Truck Sales, Inc. v. Ford Motor Co.*, 145 F.3d 320 (5th Cir. 1998); *Mathew Enter., Inc. v. Chrysler*, 5:13-cv-04236 (N.D. Cal. Oct. 13, 2016) (ECF No. 331) (Jury verdict).

WARRANTY REIMBURSEMENT

- States regulate the amounts at which manufacturers reimburse dealers for performing warranty work.

- In the absence of these laws, manufacturers typically reimburse dealers a percentage markup over cost or at MSRP for parts installed in a warranty repair and a markup over the hourly labor costs.

- Today roughly 40 states have enacted warranty reimbursement legislation.

- The statutes typically:
  - Authorize the dealer to calculate the parts and labor markup for which the manufacturer must reimburse the dealer based on 50 or 100 consecutive customer-paid (i.e., retail) repair orders
  - Authorize the dealer to exclude specials or promotional discounts from its calculation of the mark-up for parts and labor
  - Specify the procedures by which manufacturers are authorized to rebut the dealer's declared reimbursement rate
    - *E.g.*, Cal Veh. Code § 3065(a)-(b); Con. Gen. Stat. § 42-133s; Mass. Gen. Laws ch. 93B; N.J. Stat. Ann. § 56:10-15(a); N.Y. Veh. & Traf. Law § 465(1).
- In some form, roughly 20 states now prohibit manufacturers from raising prices within the state to recover the increased costs imposed by the retail reimbursement regulation.
  - *E.g.*, Fla. Stat. § 320.696; Va. Code Ann. § 46.2-1571; Me. Rev. Stat. Ann. Tit. 10, § 1176.

SECTION 04

TERMINATION OF THE FRANCHISE RELATIONSHIP

- The establishment of a franchise relationship between a manufacturer and a dealer vests in the dealer substantial rights against termination.
- Many states permit termination of a dealership franchise solely for cause.
  - *E.g.*, New York, Oregon, Texas
  - The definition of good cause varies from state to state, but generally it may consist of deficient performance, failure to operate the business for an extended period, etc.
- Other states permit termination without stated cause, but often with required notification periods.
  - *E.g.*, California (60 days); Florida (90 days)
  - Even in these states, dealers have recourse via an administrative appeals process in which they can argue that the manufacturer lacked cause or otherwise acted in bad faith

Dealer Termination Litigation

- Dealer terminations (or failure to renew) frequently result in hotly contested and often expensive litigation over "cause" under state law:
  - Inadequate sales performance (Individual v. Comparable dealers)
  - Warranty or other fraud
  - Financial health of the dealer
  - Failure to comply with "reasonable and material" provisions of the dealer agreement
- The ADDICA also provides a cause of action for (1) a termination that is not in good faith, or (2) a dealer who is forced to terminate as a result of coercive tactics.
- Common law claims for breach of contract, tortious interference, implied covenant of good faith and fair dealing.
- Injunctive relief is often available and can be potent weapon for dealers.
- Many statutes provide for an automatic award of attorneys' fees to a prevailing dealer (but not manufacturer-line make), which incentivizes litigation.

SECTION 04

PROHIBITIONS ON “UNFAIR” AND “UNREASONABLE” TREATMENT OF DEALERS

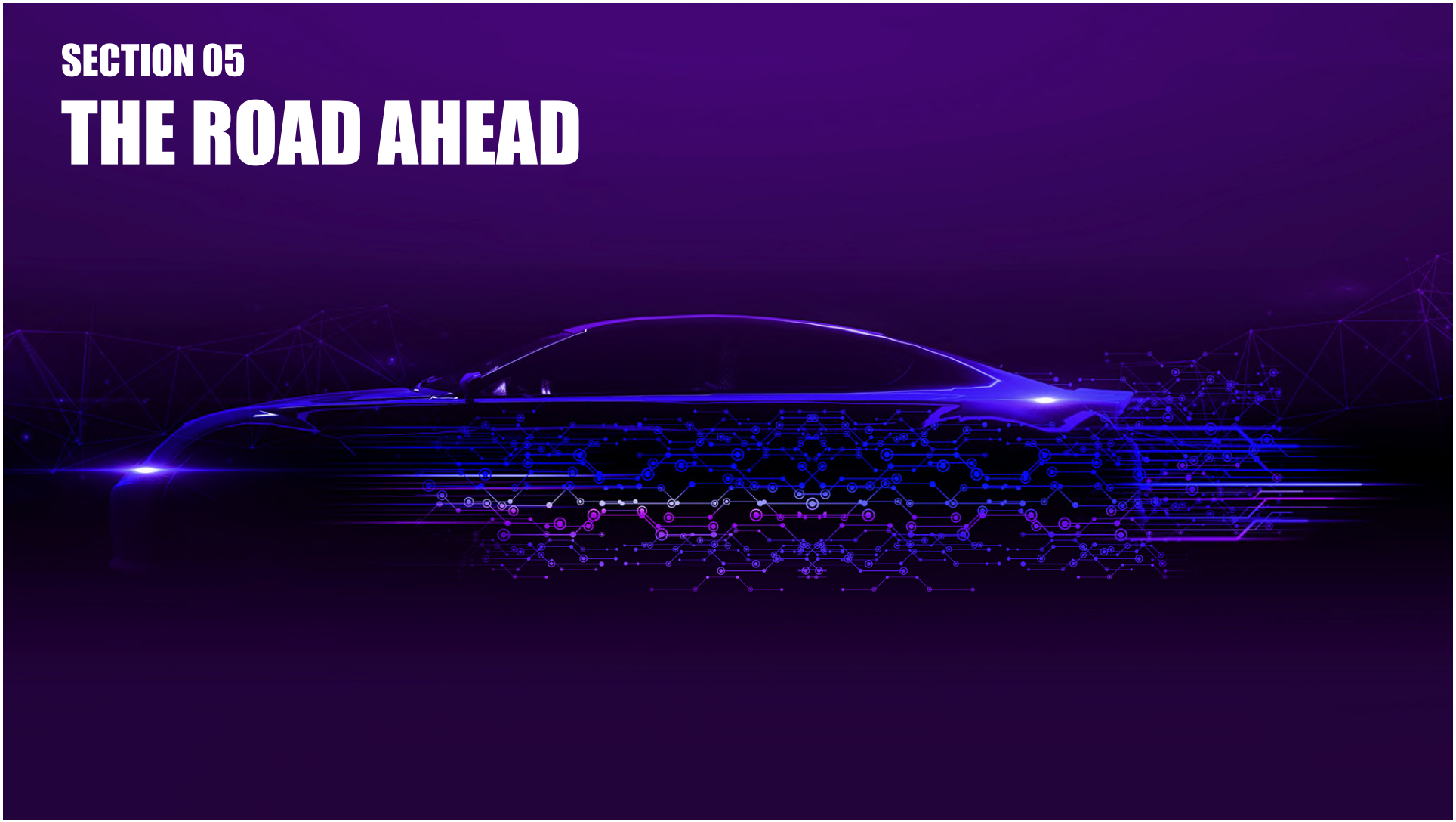
- Virtually all states impose prohibitions on manufacturers from treating franchised dealerships in a manner this is unfair, discriminatory, or unreasonable.
- The form of the prohibitions vary from state to state, but they typically encompass a broad range of conduct.
  - 17 N.Y. Veh. & Traf. Law § 463 (setting forth a non-exclusive list of 37 distinct "unfair" business practices, including termination of the franchise relationship without cause and establishing or attempting to establish the resale price of a vehicle).
- A total of 36 states prohibit discrimination or preferential treatment with respect to the distribution of vehicles among franchised dealerships.
  - Cal. Veh. Code Ann. § 11713.3(a) (making it unlawful for a manufacturer to "refuse or fail to deliver in reasonable quantities and within a reasonable time . . . a new vehicle or parts or accessories . . . if the vehicle, parts, or accessories are publicly advertised as being available for delivery or actually being delivered").

- Other common examples of "unfair" conduct include:
  - Coercion of dealerships to accept vehicles, parts, or other equipment that the dealership has not voluntarily ordered.
  - Requiring a dealership to participate in an advertising campaign.
  - Considering a dealership's sales performance of new vehicles in determining the dealership's eligibility to purchase program, certified, or other used vehicles.
  - Coercion of a dealership to undertake improvements to the dealership's facilities.
  - Granting an additional franchise in the relevant market area of an existing dealership.
  - Unreasonably refusing to assent to a change of control of a dealership.

- A number of states, including California and Florida, prohibit manufacturers from inducing dealerships to use the service of an affiliated finance company.
  - Cal. Bus. & Prof. Code § 18403 ("It is unlawful for a [manufacturer] to sell . . . motor vehicles to a retailer on the condition or with an agreement or understanding . . . that the retailer shall finance the purchase or sale . . . only with or through a designated person . . .").
- The prohibition against "unfair" conduct generally extends to affiliates of the manufacturer.
  - N.C. Gen. Stat. § 20-308.2(d) (declaring it "unlawful for a [manufacturer] to use any subsidiary corporation, affiliated corporation, or any other controlled corporation, partnership, association or person to accomplish what would otherwise be illegal conduct . . . on the part of the [manufacturer]").

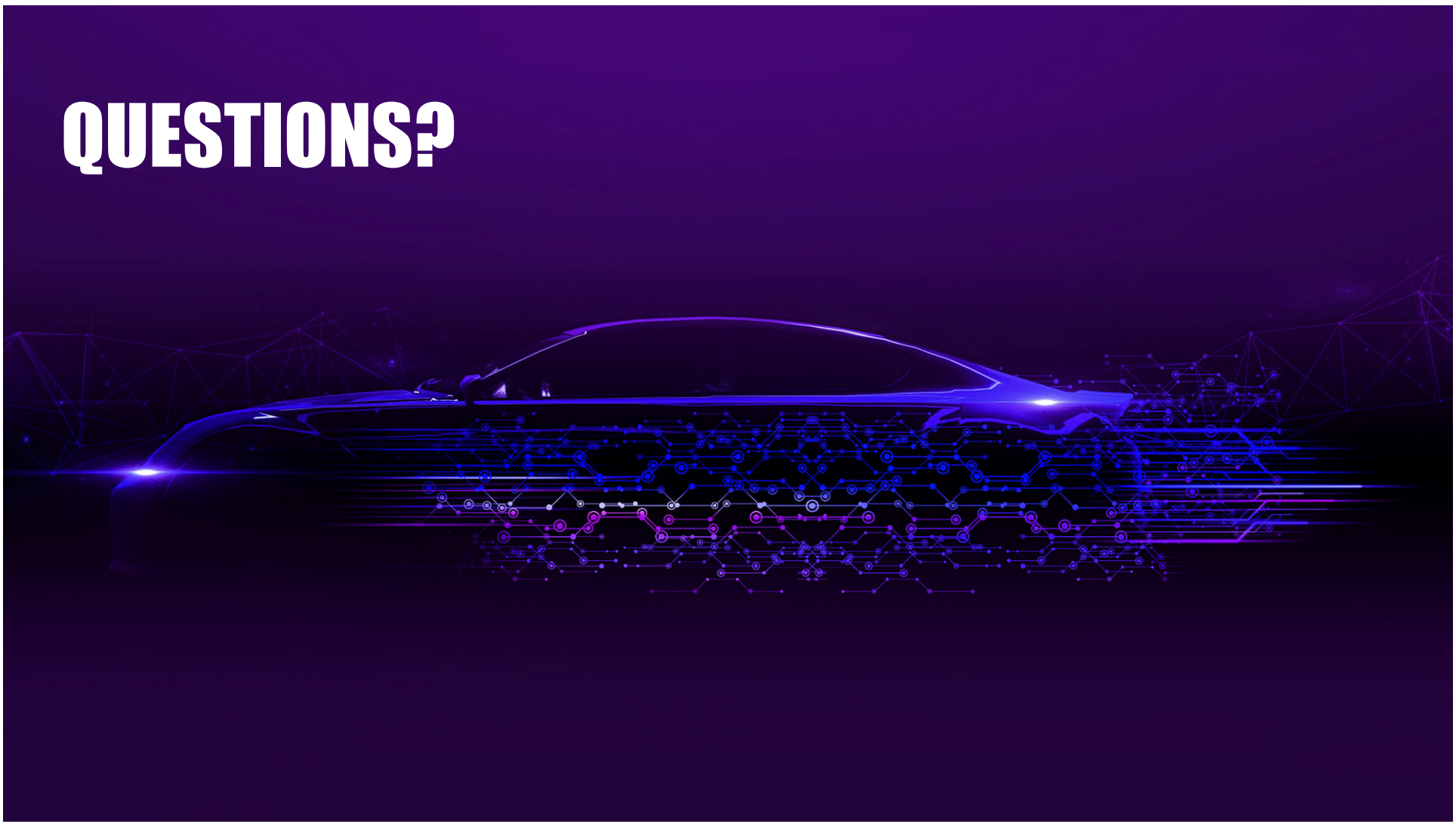
SECTION 05

THE ROAD AHEAD



- Market entry by manufacturers without existing franchise networks and therefore outside the scope of existing state laws
- What distribution models will new entrants pursue, and how will they impact state franchise laws?
- Will changing consumer preferences impact state franchise laws?
  - Rise in consumer interest in different and innovative leasing and subscriptions models is impeded by existing regulatory regimes
- Motor vehicles are increasingly becoming "computers on wheels."
  - Manufacturers will increasingly be able to perform software updates and many warranty repairs remotely – whether via the Internet, by satellite, or by mailing a thumb drive directly to the consumer to download.
  - How will a declining need for consumers to take their motor vehicles to the dealership impact state franchise laws?

QUESTIONS?



THANK YOU

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