

2015's Top Twenty Legal Trends for Automobile Dealers

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NOTE: 2014 Rankings are in parentheses; NR (Not Rated in 2014).

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DealersEdge

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The good news! The year ahead will likely be a profitable one – very profitable – for most of America’s franchised auto dealers. There’s every sign that new retail auto sales, building on the strength of a soaring 2014 marketplace, may turn 2015 into a record year. The downer: At the same time, legal minefields and issues need close attention, and for too many dealers, one or two of the year’s trends could be all-consuming.

For 2015, the regulatory storm for car dealers (as well as for other businesses) will continue unchecked; the stunning 2014 mid-term Republican wins will offer negligible, if any, headwinds against this runaway trend. The vast overreaching sweep and universal applicability of regulatory growth keep this trend in first place.

The retail automotive market’s sales have boomed in spite of the bureaucratic maelstrom – great news for dealers. It would be even better for bottom lines, and more sustainable, if government impediments were reversed or lessened. Even though many Republicans, and some Democrats, vow to make genuine headway, the outcomes of 2014 mid-term federal elections are not likely to convert to any discernable relaxation of the regulatory explosion of dealer obligations and associated costs. Nor will state regulatory activity abate. Sadly, this trend is bipartisan.

In May 2014, the Center for Automotive Research (“CAR”) completed its study for NADA – “The Impact of Federal Regulations on Franchised Automobile Dealerships.” In a nutshell, the findings are not pretty. Data from 2012 showed that “the average federal regulatory compliance annual expenditure was \$182,754 per rooftop.” That number helped trigger a total loss of “\$441,332 per rooftop,” a cost of “\$245 for every new and used vehicle sold, or nearly \$8,035 for every dealership employee.” Nationwide, auto dealer loss to the U.S. economy was \$10.5 billion, and “76,000 fewer jobs across all sectors.” And these numbers do not include the negative cost impact of state and local regulations.

Anecdotal evidence from individual dealers strongly suggests that costs have risen each year since 2012, and that 2015 will continue the upward trend. In some years, for some dealers, wasteful and unnecessary bureaucratic compliance can spell the difference between profitability and loss.

No one contends, of course, that U.S. dealers or businesses generally should be free of all regulations. Some regulations are necessary and good. No one, for example, advocates dirty air or water, or unchecked consumer scams, unsafe vehicles, racial discrimination, or sexual harassment. The growing alarm, however, is that a virtual sea of over-regulation, ideological pressure, and mini-enforcement is stifling and drowning small

businesses and start-ups generally, and franchised dealers in particular. Unnecessary paper drills, redundancies, time devoted to a host of trivial tasks, and retention of compliance professionals have become commonplace. The CAR study focused only upon federal regulatory costs. But like all U.S. businesses, dealers must comply with state and local laws and rules as well.

The year's #2 trend is the ongoing and growing body of challenges to the formidable state laws that enforce fairness in the automotive franchise system, laws premised conceptually upon branded networks of independent dealers, tethered to franchisors who manufacture and wholesale products to dealers. Enter Tesla with direct retail sales and no independent franchised dealers. The Tesla phenomenon is on something of a roll, with abundant public and government support. The traditional franchisors are also starting to test the possibilities of direct sales.

There is much to digest in this year's twenty trends. All dealers should take care to address the specific trends that affect them.

The ranking of the top twenty legal issues/trends is based on three factors: 1) the likely number of dealers affected; 2) the probability of change from the current situation; and 3) the seriousness of a trend/issue impact on the lives of dealers.

1. *The Regulatory Tsunami Continues (1)*

No one – literally no one – applauds the U.S. regulatory explosion. A comprehensive search shows unanimity in bipartisan political rhetoric decrying the waste and cost of over-regulation. This was a regular topic in 2014's mid-term campaign.

To be sure, there's much finger-pointing, and plenty of blame to go around. But there are some obvious culprits in the over-regulation monster for 2015. It's been many years in the making. Dodd-Frank, now five years old, is especially vulnerable to criticism, with the CFPB leading the charge. *See, e.g.,* Peter J. Wallington, "Four Years of Dodd-Frank Damage," *Wall Street Journal*, July 20, 2014. Other super-sized regulation generators include The Affordable Care Act ("Obamacare"), the EPA, the FTC, and a host of privacy protection mandates. And, despite the supposed immunity of franchised car dealers from CFPB regulatory reach, watch for its imposition of arbitration rules, lending mandates (pushing flat fees for dealers on loan work), and other possible reaches.

The CFPB, in my opinion, has turned out to be more of an anti-business ideological force than a neutral regulatory body faithfully carrying out its duties. It conceals methodologies and announces conclusions without rationale. This observation is especially insidious in the CFPB obsession with asserting racial discrimination in lending practices, with conclusions of "disparate impact" on minorities. *But see American Insurance Association v. HUD*, Civil Case No. 13-00966 (D.D.C. Nov. 3, 2014) (The government exceeded its delegated authority in recognizing disparate impact claims.).

One noted scholar sees the regulatory mess as part of a larger systemic trend that will be hard to cure. Francis Fukuyama, "America in Decay: The Sources of Political Dysfunction," *Foreign Affairs*, October 2014.

For over half a century, George P. Shultz has been one of the most astute observers of the American economy (as well as having served as Secretary of

Labor, Treasury and State, and Director of the Office of Management and Budget). Criticizing unwarranted regulatory burdens, Shultz commented in his *Wall Street Journal* article of August 9, 2014, "How to get America Moving Again":

We all know that the maze and uncertainty of the regulatory octopus is stifling the economy. Regulations are needed, but they can be made simpler and designed to work better. Overhaul the current complexity so that even small businesses can see how to comply without having to hire compliance advocates they can't afford.

Although the Shultz recipe for economic improvement covers multiple ways to heal an underperforming economy, the regulatory burdens loom especially large for car dealers. That's because the business of car retailing implicates so many discrete areas of federal, state, and local governance. Dealers are popular targets for officials who want to be perceived as protectors of public welfare. See Trend #5 (Consumerism). Unfortunately, the regulatory albatross is here to stay – irrespective of 2014's election results.

In the post-midterm phase of political promises, Republican congressional leaders have targeted "excessive regulations" as one of several early priorities. John Boehner and Mitch McConnell, "Now We Can Get Congress Going," *Wall Street Journal* (Nov. 6, 2014). We'll see. Despite all good intentions, this kind of promise is among the most difficult to fulfill, because an embedded bureaucracy holds critical trump cards.

Dealers should avail themselves of the excellent annual NADA publication, "The Regulatory Maze,"

which keeps current a list of major federal laws and regulations as they apply to dealerships – overall and also on a department-by-department basis.

Dealer advertising and sales practices are now targeted by a regulatory blizzard of competing mandates and standards – including federal, state, and local laws, ordinances, and regulations. A helpful guide to federal ad regulations will soon be available from the NADA. Advertising is an area of particular concern, as it attracts much of the state and local enforcement against car dealers.

For a frame of reference, consider this glimpse at just one aspect of my own business: My law firm consists of about 130 attorneys in four offices in as many states. In the main kitchen of our New Jersey office, there is a bulletin board with fourteen required federal or state posters – all to inform/remind employees of their vast array of rights and protections vis-à-vis their employer. Not only do these posters enumerate a catalogue of rights; but they also refer to a host of record keeping and other affirmative obligations of employers.

As every franchised dealer knows, such workplace requirements as these posters and the obligations published in them are but the tip of an iceberg. The redundancies in workplace requirement publications are mindboggling, confusing, and at times, seemingly contradictory. Yet this example is just one of many in the regulatory arena. There are now so many agencies, public officials, and lawmakers with so many overlapping, redundant, and competing agendas that "regulatory creep" is really more accurately described as a regulatory avalanche.

Of course, friends on the franchisor side sometimes express a sense of irony in dealers' success in lobbying for decades to normalize the franchise relationship with laws and regulations that benefit franchised dealers. We plead guilty to this effort. But the comparison to dealer initiatives underscores the difference between gratuitous, redundant, competing, and wasteful laws and regulations, and those that have an express salutary purpose to promote fairness. Because of historical overreaches, it was necessary, for example, for state laws to protect costly franchised businesses from arbitrary franchise terminations or nonrenewals. Such laws are focused and available in singular legislation or regulation. By contrast, the infinite busywork required to satisfy regulatory whims across numerous agencies cannot begin to establish meaningful justification for the waste and costs involved. See "The Regulatory Maze," cited above.

Outlook: The regulatory train wreck won't stop, or even slow down, anytime soon, despite the growing outcry and political pledges. Too many federal, state and local bureaucrats believe their impositions on business and the economy serve noble ends, and they think that a grateful public applauds the invasion. The CFPB, in particular, will continue aggressive overreach to impact dealers, especially on lending issues. The pushback against CFPB overreach, however, is growing. In November 2014, a report commissioned by the American Financial Services Association ("Implications for the Indirect Auto Finance Market") found that the CFPB's methodology and conclusions were "conceptually flawed in their application and subject to significant bias and estimation error.") The CFPB's blatant ideological slant has been exposed, but it remains to be seen whether it can or will be reined in anytime soon. See Investor's Business Daily Editorial, Dec. 17, 2014, "Study Rips CFPB's Anti-Bias Probes as Biased."

The Affordable Care Act, a/k/a Obamacare, continues to be unpopular, according to national polls. A case pending before the U.S. Supreme Court has the potential in 2015 of throwing that law into chaos. The challenge is to subsidies paid in states opting not to have exchanges. Watch for a decision by June.

2. Challenges to the Fundamentals of State Franchise Laws: Tesla; the Alliance of Automobile Manufacturers (6)

For years, there has been a simmering debate over the efficiency and fairness of state franchise laws that mainly arose out of an intent to "level the playing field" for automotive franchisees. All 50 states now have laws protecting franchised auto dealers from arbitrary franchisor conduct. Every year, amendments are enacted in many states.

The Alliance of Automobile Manufacturers, comprised of twelve major auto franchisors, contends that the power disparity no longer applies, and that state franchise laws are inequitable anachronisms. The Alliance points to, for example, publicly held dealer companies and mega-dealers to illustrate the growth of dealers' economic power. But the Alliance protests too much. Most dealers are relatively small – certainly, when compared with the major franchisor behemoths. Without reasonably protective laws, dealers and the consuming public would foreseeably suffer in a variety of ways, including arbitrary terminations and overly aggressive sales requirements.

For the most part, attacks by the Alliance and others on franchise laws have been overwhelmed by successful state legislative efforts, led by state associations and buttressed by the backing of the National Automobile Dealers Association. Recently, however, the challenges by Tesla Motors to overcome

state laws banning direct retail sales by automakers have seen much success. But Tesla's success may also signal a backdoor channel to challenge franchise laws generally. See, for example, John Kerr, "Tesla breaks the auto dealer cartel," *Wall Street Journal*, Sept. 16, 2014. And see an especially partisan editorial rant against Michigan Governor Rick Snyder for signing legislation prohibiting direct Tesla sales. "Rick Snyder Drives Off the Road," *Wall Street Journal*, Oct. 24, 2014. (Despite the hit piece, Mr. Snyder handily won his reelection bid on November 4, 2014.)

Of course, Tesla accurately points out a major difference between it and the venerable franchised dealer networks of domestic and import brands. All of Tesla's retail operations are company-owned. There are no Tesla franchisees at all. Therefore, company-owned Tesla sales outlets cannot, by definition, unfairly compete with franchised Tesla dealers – of which there are zero.

Will the Tesla phenomenon be the catalyst that opens the door to direct sales by franchisors with existing franchised dealer networks? The question is raised, and opinion writers across the country seem to favor the Tesla approach by huge margins. Simplistically, they assume that "competition" from the factories would be good for consumers and good for the economy. Such commentators ignore the arguments by many in the business that the franchise system spawns numerous well-established consumer protections in the retail automotive industry and intra-brand competition among same-brand dealers.

Tesla's relative success in the direct-sales arena has no doubt encouraged traditional franchisors to try to follow suit. GM is pushing its "Shop-Click-

Drive" initiative, and is overtly seeking approval of direct sales in Tesla fashion in some states.

There is also the Alliance's larger question as they lobby across the country and nationally for rollbacks of state relationship laws that they argue unfairly favor dealers, and restrain trade and basic contract rights.

Outlook: For now, the Tesla phenomenon will continue its (mostly) winning streak. At some point, I predict there will be Tesla franchises, and the "competition" controversy will fade away. In the meantime, expect more of the one-sided, and frankly mindless, Tesla cheerleading from editorial pages. It seems unlikely that the direct sales invasion will spill into other kinds of franchise protection areas.

That is, the Alliance's broader attack on laws that protect dealers against unreasonable demands or requirements, or arbitrary terminations, from their franchisors will not gain any traction.

Dealers, through state associations and NADA, are reacting with comprehensive and well-presented public campaigns to demonstrate the high consumer value of the franchise system. The fight is surely on, but dealers, I believe, have the winning argument.

3. The Phenomenon of Clearly Unreasonable Factory Demands, Standards, and Practices (2)

Many dealers have recently seen an uptick of threats and demands about, especially, retail sales. The most aggressive carmakers these days appear to be Nissan, Kia, and VW, but others, too, send unfriendly put-downs to dealers who, by factory measuring standards, fall below "average" sales penetration, when compared to a factory-selected benchmark. These franchisors label "below-average" or "below-benchmark" sales penetration as a breach of the dealer agreement.

Use of a statistical sales comparison methodology to discipline, punish or even terminate franchised

dealers is remarkably flawed. In any dealer network, using any measurement criteria, there will always be those who rank high or first, and there will always be those that rank low or last. A legitimate franchise network, however, needs to accommodate the entirety of that network, so long as the dealers are properly running their dealerships and carrying out their responsibilities.

The statistical certainty that there will always be a dealer ranked "last" in any numerical measurement system does not automatically mean that the dealer at the bottom of that statistical ranking is a "bad" dealer. Rather, the legitimate interests of franchisors can and should be furthered only by assessments of how the dealer is operating, the competence and sufficiency of staffs, training rigor, and describable professionalism. Franchisors should reject the purely statistical approach, and if they do not, courts, commissions, and boards should do it for them.

But fair and realistic assessments of dealers are difficult and time-consuming efforts. It's much easier for an automaker to establish a statistical benchmark. Never mind that it's inherently unfair and arbitrary.

Outlook: The "above average" (or above benchmark) standard will continue to be a key battle line. On this one, franchisors have a losing case, but the battle may continue past 2015. In other areas, auto franchisors will continue their creativity as they try to ride hard on their dealers.

4. Buy-Sell Activity in a Bull Market for Dealerships; Rights of First Refusal (8)

For many car brands in the turnaround years since the Great Recession of 2007-2009, it's now profitable – often very profitable – to be a dealer. This trend translates to higher multiples with surging

blue sky values and a boom in buy-sells, at transactional prices that now are, in some instances, above pre-recession records.

When there's more transactional activity, there's also the greater prospect of factory exercises of the right of first refusal (ROFR). A few franchisors have tried in recent times to "cherry pick" their franchises in complex deals, so that they don't have to buy other branded operations, even when the buy-sell agreement unifies a single transaction with multiple brands. Some have put cherry picking rights into the ROFR language of dealer agreements. This is wrong, because the exercise of an ROFR should require the exerciser to step 100% into the shoes of the contract buyer.

Outlook: 2015 will see lots of buy-sells with still growing transactional values. The end of the growth stream is not yet in sight. There may be an uptick in exercises of the factory ROFR. Watch out for franchisors who try to "cherry pick."

5. Consumerism (3)

This old chestnut keeps a lot of people busy. It's a field that brings out the kind of political correctness that frequently tramples fairness and accuracy. These days, "consumers" are sacrosanct, whereas businesses are marginalized, even vilified. Auto dealers, especially, are prime targets. State AG offices, consumer affairs divisions, and federal regulators prospect for dealer abuses of consumers. To be sure, there are abuses that no honest person would support. All dealers should implement stringent standards of honesty, fairness, and compliance with laws. As I see them, the problems for dealers come when regulators creatively invent overreaching "violations" that cannot withstand scrutiny. For

example, detailed font size requirements or statistically unsupportable "disparate impact" discrimination assertions (CFPB) tend to discourage and frustrate honest dealers. More subtle – and worse – is the public animosity displayed by both regulators and elected officials.

Outlook: Dealers need to acknowledge the old axiom that "the customer is always right," or at least recognize that dealers are underdogs in disputes with customers or with agencies with "consumer" in their names. Every dealer should have no-nonsense, zero tolerance policies to ensure store integrity.

6. Involuntary Termination (5)

These days, the arena of involuntary termination notices is dominated by factory assessments of poor sales performance. Almost exclusively, such assessments are purely based on statistics/numerical measurements and comparisons to benchmarks of what the franchisor deems to be the minimal acceptable market penetration percentage.

Outlook: Over the next few years, dealers (and, perhaps, courts) will push back on the inherent wrong of using "average" sales performance (based solely on market penetration comparisons) as a hammer to, first, threaten termination, and, second, to issue termination notices. A few judges in a few cases have caught on, and they have supported dealers against purely statistical rationales for termination.

7. Warranty Reimbursement (12)

Thanks to the steadfast stamina of many state dealer associations, the NADA, and stalwart dealers, reimbursement at retail to dealers for warranty labor and parts may be heading toward a successful end game. The Alliance of Automobile Manufacturers, composed of 12 major automotive franchisors, has for years led the factory fight against proper warranty reimbursement at retail (mainly for parts), but legal

results in the states of Maine, Connecticut, and Florida have rocked the Alliance's efforts. At this writing, the Alliance is continuing to appeal an adverse decision in Connecticut, and if the dealers' victory there holds up, there will be even more cause for considerable optimism in this long-contested area.

In Maine, the Alliance lost its battle years ago, and it gave up in Florida in 2014, after the court there remained steadfast in requiring reasonable discovery from automakers about their costs.

Outlook: The battles over reasonable reimbursement for warranty parts and labor are narrowing. More and more franchisors are surrendering. The Alliance is in retreat. Dealers should see less factory resistance in 2015 and beyond.

8. Privacy and Identity Theft (13)

This trend has jumped up five spots in a year, partly because some franchisors want to invade dealer files where private customer information is stored. Such demands conflict with statutory privacy laws and rules (federal and/or state) imposed upon dealer record holders. See, e.g., Graham, Leach, Bliley; Safeguards and Privacy Rules. Dealers and their associations need to continue to push back against such unwarranted factory efforts.

There are about two hundred federal agency regulations that regulate issues pertaining to consumer data and privacy! As one lawyer in the field says, "there's no clear solution." So-called "data aggregators" are in the business of obtaining electronically stored information. Dealer controls, including password secrecy, are sometimes not adequate to prevent third party access to customer information.

Outlook: This field becomes more complex as time passes because internet thievery and hacking attract