

The Benefits of the Franchised Dealer Network: The Economic and Statutory Framework

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More than 100 years ago, the automobile manufacturers established a dealer network comprised of independent entrepreneurs to outsource the costs associated with the distribution, sales, and servicing of their products. While the first automakers initially sold cars directly to the public, they soon outsourced the costs of retailing. Since its inception, the franchise system has provided an efficient and cost-effective method for selling and servicing vehicles. Without the investment of the independent owners who comprise the franchise network, the manufacturers would have to internalize the vast costs associated with creating and maintaining a retail sales and service network. Moreover, objective observers have called the U.S franchise system the most efficient motor vehicle distribution network in the world.

In Q & A form, this paper lays out the answers to some of the key questions that are currently being asked regarding the automobile manufacturer/dealer franchise relationship. In doing so, the paper seeks both to detail the economic benefits that the franchise network provides to the manufacturer and the consumer and to explain the rationale for the state franchise laws that were enacted to create a more level playing field to address the vast disparity in bargaining position between a dealer and its manufacturer.

Would relief from state franchise laws help stabilize the automobile industry in the United States?

No! To the contrary, the pre-emption or suspension of state franchise laws would further threaten the economic stability of Main Street and further erode the national infrastructure essential to the recovery of troubled manufacturers. If the manufacturers are empowered to ignore these statutes, they will act precipitously to the detriment of the dealers and the local communities they support. The consequences of wholesale dealer terminations would include closed businesses, terminated employees, increased foreclosures, and idle real estate. The adverse effects on Main Street would deepen the current recession and threaten even the dealerships that the manufacturers would designate arbitrarily for survival. The dealer network is part of the solution to the current crisis rather than part of the problem.

What is the nature of the contractual relationship between the automobile dealer and the manufacturer?

Dealers operate under a "Dealer Sales and Service Agreement" commonly referred to as a franchise agreement. The franchise agreement and related side agreements require the dealer to make investments in land, buildings, equipment, computers, tools, personnel, training, advertising and promotions, and good will. Additionally, dealers are required to maintain extensive inventories of new and used vehicles (and often manufacturer certified used cars), and parts. The manufacturer controls the only source of new vehicle inventory and may influence a large portion of the dealers' used inventory.

Also, the manufacturer sets labor rates and time constraints on warranty work, and the manufacturer has the right to conduct surprise warranty audits and bill a dealer for overcharges. Manufacturers increasingly rely on incentive programs to market vehicles. Such monies are also subject to audit and represent yet another cost shifting to dealers since dealer incentive monies are typically paid at the end of a program. Each dealer has an open account with the manufacturer which can be used to assess charges against the dealer. Increasingly, manufacturers are using the multiple points of leverage in this relationship to force dealers to make multi-million dollar facilities upgrades or take vehicles into inventory regardless of local demand.

Most significantly, no individual dealer, regardless of size, has the opportunity to negotiate any of the terms and/or conditions of the agreement. All of these factors, combined with the limited opportunity to switch manufacturers, the high cost of making any such change, and the difficulty of converting expensive facilities to another use make the franchise agreement a classic “take it or leave it” contract of adhesion.

How does the franchise dealer network benefit the manufacturers?

Simply put, the goal of the manufacturer is to use the dealer body to externalize all of the costs associated with selling and servicing vehicles. Absent the franchised dealers, a manufacturer would have to invest billions of dollars to replicate the existing facilities, employees, and retail presence. No manufacturer, much less an automaker in extremis, could possibly assume this burden and hope to remain competitive.

Moreover, no manufacturer would want to assume the risk involved with retailing. For example, if the manufacturers make an unappealing vehicle, the dealers bear the brunt of that mistake, because the dealers buy the vehicles from the manufacturers and suffer the consequences of unsold inventory. Similarly, the dealers also bear the risk of the deterioration of a prime real estate location and the risk of a local economic downturn.

Dealers also add value to the manufacturer brand by creating good will in their communities, not only by directly promoting the brand but also through their support for charitable and community causes.

What is the annual operational cost to the manufacturer to maintain the dealer network?

Since the principal purpose of the franchised dealer network is to outsource costs, the manufacturers incur very little direct costs related to the dealer network. Several years ago, a General Motors executive observed that the sale of 10 cars per year by a dealer would cover the automaker’s operational expenses (field personnel, etc.) associated with that dealer. That number is likely to be lower today because all manufacturers (including the Detroit 3) have utilized advances in technology and organizational efficiency to steadily reduce dealer support personnel over the years.

Moreover, because the manufacturers control large streams of payments to the dealer body – all of which are non-interest bearing payments made in arrears for products already delivered or services already performed – the manufacturers can simply use cash management techniques to achieve “cost of money” savings that would easily offset these minimal operational expenses. In the aggregate, the manufacturers

can use this “float” to earn millions of dollars. And there are a number of purchases that dealers are required to make – including signs and specialized tools – on which the manufacturers actually make a profit.

How does the dealer network benefit the consumer?

An extensive retail network provides consumers a convenient opportunity to purchase vehicles and service vehicles. Because the dealer has made the investment in inventory, a consumer can examine the texture of the upholstery and take a test drive before making a purchase decision.

More important, the dealer network fosters competition – both inter-brand and intra-brand. In fact, the most intense competition is intra-brand. For example, the strongest competitor to a Ford dealer is the nearest Ford dealer. Also, the dealer network enables consumers to respond to safety recalls easily, and the dealer can pay a customer for a trade in, which facilitates the purchase of new car. If the manufacturers had relied on a company store model to begin with, their sales market penetration would never have reached current levels, especially in rural areas.

Why were Federal and State laws enacted to govern the specific relationship between automakers and the dealers?

There is an economic power imbalance between the manufacturer and the dealer that has persisted from the early days of the franchise system to the present. Prior to the enactment of statutory provisions that provide a safety net of equity, existing dealers faced several types of pressure from the manufacturers: the threat of a unilateral termination without cause; the threat that the manufacturer would unilaterally establish additional competing dealerships with the same brand on every corner; and demands from manufacturers to purchase unneeded vehicles and products. In the 1930s, dealers sought relief in the courts and before the Federal Trade Commission with respect to these threats, but were unsuccessful because the agency and the courts refused to imply a duty of good faith or good cause on the part of the manufacturer.

In response, dealers turned to the state and federal legislatures. The first state franchise law, passed in Wisconsin in 1937, contained the requirement that a manufacturer would have to have “cause” to cancel a franchise agreement. In the 1950s, Congress enacted the Dealer Day in Court Act. However, that latter statute was weakened during the legislative process and has been eroded to the point of ineffectiveness during judicial interpretation.

Outside of the legislative process, can the dealers work together to achieve a collective result in negotiations with the manufacturers?

Absolutely not. The United States Justice Department, the Federal Trade Commission, and the various state Attorneys General would view any attempt by a dealer body to exercise collective economic power with respect to its manufacturer as a classic violation of antitrust law. (This is to be contrasted with labor unions which are expressly exempted from the application of the antitrust laws by the national labor laws that establish the rules for collective bargaining and the like. Thus, unlike the UAW, Ford dealers, for example, cannot collectively refuse to deal with Ford (i.e., strike) if the dealers believe that Ford is establishing too many Ford dealerships or feel that Ford is

otherwise treating them unfairly.) In the face of (1) years of arbitrary treatment, (2) the failure of the judicial branch, at the time, to recognize a distinct cause of action, and (3) the limitations imposed by the antitrust laws, the dealers sought the only other relief available – the legislative process.

What is the public policy rationale for the state franchise laws that have been enacted in some form in all 50 states?

Because each state has enacted some form of a motor vehicle franchise law and these state statutes govern exclusively the unique relationship between a motor vehicle manufacturer and dealer, there is an extensive body of legislative history demonstrating the public policy imperative of these laws. A good articulation of the purposes for which these laws were enacted is found in Georgia where the legislature made the following findings in connection with the adoption of that state's franchise statute:

- (1) The distribution and sale of motor vehicles within this state are vital to the general economy of this state and to the public interest and public welfare;
- (2) The provision of warranty service and the repair of pre-delivery transportation damages to motor vehicles is of substantial concern to the people of this state;
- (3) The maintenance of full and fair competition among dealers and others is in the public interest; and
- (4) The maintenance of strong and sound dealerships is essential to provide continuing and necessary reliable services to the consuming public in this state and to provide stable employment to the citizens of this state.

(Georgia Motor Vehicle Franchise Practices Act, Code 1981, sec. 10-1-621, enacted by Ga. L. 1993, p. 1585, sec 2).

What are the typical provisions of a state franchise law that affect the dealer-manufacturer relationship?

While many of these state laws also provide consumer benefits by providing for the licensing and regulation of dealerships, the provisions governing the dealer and manufacturer relationship reflect the fact that the franchise agreement is a contract of adhesion.

A typical state franchise law requires a manufacturer to show good cause in order to terminate a dealer agreement, provides a framework for determining a fair value of the franchise terminated, establishes basic rights of succession from generation to generation, and sets out a definition of relevant market area to preclude unfair proliferation of dealerships.

Why do state franchise laws contain relevant market area (RMA) provisions?

The RMA provisions permit a dealer to file a protest, typically with a state administrative agency, when a manufacturer proposes to add an additional dealer within

a specified radius of an existing dealer with the same brand. A California appellate court concluded that the legislative intent of these provisions was to balance the dealers' interest in maintaining viable businesses, the manufacturers' interest in promoting sales, and the public's interest in adequate competition and convenient service.¹ The impact of an RMA provision is frequently overstated. The provision does not allow an incumbent dealer to veto the addition of another dealer; rather the RMA requires a manufacturer to demonstrate, on the record in an administrative hearing, that an additional dealer makes economic sense to the consumers and dealers in a specific market.

Have state franchise laws been tested in the courts?

The courts have scrutinized these laws since their enactment, and the statutes have withstood numerous constitutional challenges.² The United States Supreme Court upheld the constitutionality of California's state franchise law based on the following rationale:

"The disparity in bargaining power between automobile manufacturers and their dealers prompted Congress and some 25 states [now all 50] to enact legislation to protect retail car dealers from perceived abusive and oppressive acts by the manufacturers. California's version is its Automobile Franchising Act. Among its other safeguards, the Act protects the equities of existing dealers by prohibiting manufacturers from adding dealerships to the market areas of its existing franchises where the effect of such intrabrand competition would be injurious to the existing franchisees and to the public interest."³

What is the rationale for the continued existence of state franchise laws?

The same interests of the dealers and the broader public that the United States Supreme Court recognized in 1978 still exist today. Similarly, the same inherent disparity between dealers and manufacturers that the Court identified still exists today. Manufacturers still reserve the contractual right to unilaterally amend dealer agreements. In fact, due to the dramatically higher costs of entry and the dramatically higher risk factors inherent in operating a dealership, the continued need for such statutes is even greater today.

Given the 100-year track record of the manufacturers, who would invest in a dealership today without the prospect of fundamental fairness provided by the state franchise laws? Similarly, what lender, even in a booming economy, would lend to a potential dealer facing such uncertainty?

Have the state franchise laws prevented individual dealer terminations or dealer consolidation?

¹ Piano v. State of California ex rel New Motor Vehicle Board, 103 Cal.App.3d 413 (1980), cited in Franchise Law Protection: Laws Against Termination the Establishment of Additional Franchises. American Bar Association, ABA Monograph 17, pp.90-91. 1990.

² See, e.g., American Motor Sales Corp. v. Division of Motor Vehicles, 592 F.2d 219 (4th Cir. 1979); Tober Foreign Motors Inc. v. Reiter Oldsmobile, Inc., 381 N.E.2d 908 (Mass. 1978); Ford Motor Co. v. Pace, 335 S.W.2d 360 (Tenn. 1960); Forest Home Dodge, Inc. v. Karns, 138 N.W.2d 214 (Wis. 1965).

³ New Motor Vehicle Board v. Orrin W. Fox Co., 439 U.S. 96, 100-102 (1978) (emphasis added).

For more than 50 years, the number of dealerships has been shrinking at a consistent, orderly pace, dictated by market conditions. In 1949, there were almost 50,000 dealerships and by 1970 that number was 30,800. During that timeframe, the vast majority of the dealers were domestic-only franchisees. In 1987, there were 25,150 new-car dealerships; by the end of 2008 there will only be 19,700. Of the remaining dealerships, only about 14,200 are domestic only.

This steady, market-driven rationalization of the dealer population has occurred while state franchise laws were in effect and while the U.S. vehicle population that these dealers sell and service has increased from 125 million vehicles in 1976 to approximately 250 million vehicles today. Rather than prevent dealer termination or consolidation, the franchise laws have limited the unnecessary proliferation sought by the manufacturers and have provided a rational framework for consolidation and reduction of dealerships.

Have state franchise laws prevented the automakers from reorganizing brands?

No, under the existing laws the domestic manufacturers have instituted “channeling” arrangements which involve the combination of multiple brands within one dealership. This process, often implemented at the expense of the dealers involved, has enabled the domestic manufacturers to package several brands under one dealership roof.

Do the state franchise laws prevent a manufacturer from terminating a brand?

The state franchise laws have not prevented the termination of brand. Those individuals who used to have an Oldsmobile franchise or a Plymouth franchise will attest to that fact. The state franchise law does not give the dealer veto authority over such a decision or prevent the manufacturers from restructuring, but rather such decisions are subject to administrative or judicial review. From the dealer’s viewpoint, the manufacturer cannot have unfettered rights because the dealer has assumed all of the risks associated with establishing and maintaining the manufacturer’s retailing network.

What were the costs associated with the termination of the Oldsmobile brand?

According to General Motors, the cost of discontinuing the Olds brand was approximately \$1 billion, which is the estimated amount that General Motors paid to the dealer network. That was the total payment to the dealers who lost their Olds franchises, but these termination payments did not make these dealers whole. In fact, the affected dealers suffered losses far in excess of amount of these payments. Some lost their entire business, while others faced reductions in the size of their business model. The typical franchise agreement contains totally one-sided provisions, so the dealer looks to the state franchise law as an inducement to enter the arrangement.