boardman & clark llp
LAW FIRM

Paul R. Norman, Attorney

1 SOUTH PINCKNEY STREET, STE. 410, P.O. BOX 927, MADISON, WI 53701-0927
Telephone 608-283-1766
Facsimile 608-283-1709
pnorman@boardmanclark.com

February 24, 2016

Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue NW, Suite CC-5610 (Annex B)
Washington, DC 20580

Re: Comments regarding workshop on state automobile distribution regulation

Dear Commission Members:

Please include the following comments in the record for the workshop on state automobile distribution regulation conducted by the Federal Trade Commission on January 19, 2016. I served on the Direct Distribution panel at the January 19 workshop and want to supplement the comments I delivered on that topic and present comments on issues addressed by other workshop panels.

I am a partner with the Madison, Wisconsin law firm of Boardman & Clark LLP. I am chair of the Litigation Practice Group for that firm. I have practiced law since 1973 and have been involved with the retail automotive industry throughout my legal career. I have represented franchised automobile dealers extensively in disputes with their franchising manufacturers. These disputes have included franchise terminations, the establishment of other same brand dealers (sometimes referred to as "add point" or "RMA" disputes), dealership relocations, additions of other franchises (commonly referred to as "dualing"), changes in dealership ownership and management, unilateral dealership agreement changes by the manufacturer, and warranty reimbursement.

BACKGROUND OF STATE AUTOMOBILE DISTRIBUTION REGULATION

Soon after mass production of automobiles commenced in the U.S., automobile manufacturers recognized the advantages of distributing their products through franchised independent dealers. The primary advantage was the cost savings to the manufacturers of having independent dealers make the investments in facilities, equipment, personnel, training, marketing and inventory needed to successfully sell and service the automobiles covered by the franchise. Stewart Macaulay, *Law and the Balance of Power: The Automobile Manufacturers and Their Dealers* (1966), page 6. The secondary advantage was that manufacturers retained almost total control over the retail distribution of their automobiles because, once the dealers had made the substantial investments of their personal assets to become a franchised dealer, they were wholly dependent on the manufacturer to build and supply them with the vehicles they needed to sell and service in order to maintain and earn a return on that investment. *Id.* at 11-12. This economic power gave manufacturers the ability to control how their vehicles were marketed, sold and serviced at retail without the risk of investing in the assets needed to perform these functions.

Manufacturers exploited this control by drafting dealership agreements that gave themselves virtually all of the rights and the dealers virtually all of the obligations in the relationship. *Id.* at 9. For example, the early dealer agreements allowed the manufacturer to terminate the relationship at will at any time and did not even obligate the manufacturer to provide the dealer with any vehicles. *Id.* at 11. These agreements were offered to each dealer individually on a take it or leave it basis. Early on, the dealers did not have trade associations and, even if they did, the antitrust laws prevented them from attempting to collectively negotiate reasonable contract terms with the manufacturers.

Manufacturers exploited these one-sided contract terms to force most of the risk of the automobile supply chain onto their dealers. If a manufacturer overestimated demand and produced an excess number of vehicles of a particular model, dealers were forced to accept and pay for vehicles that would remain in their inventories and subject them to floor plan interest charges for extensive periods of time. If a dealer refused to accept vehicles in excess of the demand for them in its market, the dealer faced being terminated and the loss of its entire investment.

This unequal bargaining power inevitably led to dealers forming trade associations and using their *Noerr-Pennington* rights to collectively petition the legislative branch of government for statutes protecting them and their investments from egregious conduct by manufacturers. State legislatures responded by initially enacting laws that prevented automobile manufacturers from terminating dealers without cause and from coercing dealers to accept unwanted vehicles and parts or entering into other agreements unfair to the dealers by threatening to cancel them. The first state automobile dealer franchise law was enacted here in Wisconsin in 1937, but the momentum toward enacting these laws did not really begin until the 1950s and 60s.

During the 1950s, Congress enacted the Automobile Dealer Day in Court Act that provides dealers with the right to recover damages from manufacturers who do not act in good faith in enforcing the terms of the dealer agreement. The federal courts soon made the ADDICA a pyric victory for franchised automobile dealers by requiring a plaintiff suing under that statute to establish that they had been coerced by (1) the manufacturer making an unjustified demand (2) enforced by an illegal threat of sanctions. *See, e.g., Autohaus Brugger, Inc. v. Saab Motors, Inc.*, 567 F.2d 901, 911 (9th Cir. 1978). Since dealer agreements largely justified any demand that a manufacturer made on a dealer and made almost any threat legitimate, dealers achieved very few victories under the ADDICA.

Dealers experienced more success in the state legislatures. Although some states were slow to act, by the early 2000s, every state had a law that prohibited automobile franchise cancellations (and, in most cases, nonrenewals) without good cause. In addition, several states have enacted other statutes aimed at protecting dealers from various "unfair practices" by manufacturers. These practices include: (1) coercing dealers to accept unwanted vehicles, parts and other commodities; (2) establishing or relocating another same brand dealer into an existing dealer's "relevant market area" ("RMA") without notice and an opportunity for a hearing before a court or state agency on whether there is good cause for the proposed action; (3) unreasonably refusing to approve a change in a dealership's ownership or management; (4) unreasonably refusing to allow a dealer to relocate, or add a franchise for another brand to, the dealership facility; (5) failing to reasonably compensate dealers for work performed to repair defects covered by the manufacturer's vehicle warranty; (6) unilaterally changing the terms of the dealer agreement in a way that injures the dealer's rights or investment without advance notice and an opportunity for a hearing on whether there is good cause for the change; (7) refusing to indemnify and defend dealers against third party claims caused by the manufacturer's design and manufacture of the vehicles the dealers sell; (8) imposing unreasonable performance standards on dealers; (9) competing against their dealers in the selling of vehicles to the public; (10) failing to allocate vehicles among their dealers in a fair and equitable manner; and (11) failing to buy back new vehicles, current parts and special tools from terminated dealers.

The prohibitions of manufacturer conduct under state statutes are enforced in various ways. Many states have enacted a licensing regime under which both manufacturers and dealers doing business in the state are required to be licensed. A manufacturer's violation of a franchised dealer protection provision in these states can be grounds for suspension or denial of the manufacturer's license to do business in the state (just as a dealer's violation of a consumer protection provision can be grounds for suspension or revocation of the dealer's license to continue doing business); however, for obvious reasons, this sanction is rarely sought by the dealers or imposed by the state. More commonly used enforcement mechanisms are laws that allow dealers to file complaints with an administrative agency that has the authority to enjoin a manufacturer from continuing a prohibited practice against the complaining dealer and that allow dealers to sue in court to recover damages for economic losses caused by a prohibited practice of the defendant manufacturer.

PUBLIC POLICY JUSTIFICATIONS FOR STATE REGULATION OF AUTOMOBILE DISTRIBUTION

Many commentators, including some serving on the Workshop panels, describe state regulation of automobile distribution as resulting from "crony capitalism" whereby the "powerful" automobile dealer lobby somehow influences state legislatures to enact laws that do nothing but harm the constituents who elect them by diminishing competition and adding unnecessary distribution costs that consumers must pay in higher prices for vehicles and service. These commentators ignore the public benefits that state regulation of automobile distribution provides through the preservation of robust intrabrand competition and efficiencies, maintaining the stability of automobile retailing and service, avoiding the shifting of manufacturer warranty repair costs to consumers and promoting localized control of retail automobile sales and service outlets.

The claim is sometimes made that state automobile franchise laws are no longer needed due to growth in the number of manufacturer participants in the market and in the size of some of the independent franchised dealers. This claim ignores the fact that, once a substantial and specialized investment is made in a particular brand, the manufacturer which controls the supply of that brand gains economic power over the dealer making the investment that allows it to engage in opportunistic behavior, regardless of the relative sizes of the parties. It also ignores that the independent franchised automobile dealer network is still dominated by individual investors whose assets are primarily invested in the automobile brands that they represent and who will be economically devastated if those assets are lost due to arbitrary or unfair actions by manufacturers. This claim also ignores the beneficial impact these laws have on consumers by regulating the distribution and service of motor vehicles.

Because the FTC's focus is on competition and economic issues, these comments will similarly focus on the competitive and economic benefits that state regulation of automobile distribution provides with emphasis on the three categories of state laws that were subject to the first three Workshop panels: franchise termination and RMA laws; warranty reimbursement; and laws prohibiting direct retail sales by manufacturers.

Franchise Terminations and RMA Laws

To be clear, none of the state automobile franchise laws prohibit a manufacturer from terminating an underperforming dealer or prohibit a manufacturer from establishing or relocating a dealership where the interests of the manufacturer, the dealers involved and the public justify the establishment or relocation. Rather, where the proposed action is disputed, these laws allow an independent agency or court to review the facts of the case and decide whether it is in the overall interests of those concerned. Some commentators oppose these laws for two primary reasons: (1) they interfere with manufacturer decision-making; and (2) they delay the implementation of the manufacturer decisions.

As to the first reason, some commentators phrase the argument against these laws in terms of their preventing the "market" to decide the makeup of a dealership network. However, in these cases, it is the manufacturer who would make the sole decision absent any regulation. The manufacturer's decisions are, in turn, made by individuals who are often only in the positions that vest them with the decision-making power a short time before they move on to other positions within the same or a different manufacturer or in another industry entirely. Unlike dealers who, by virtue of their personal investments in their dealerships, are required to think long-term, the manufacturer decision-makers are focused on short-term results that may make them look good, but are not in the best long-term interests of the affected dealers or the public or even the manufacturer itself.

For example, after the Wisconsin RMA law was enacted in the late 1970s, Chrysler Corporation attempted to establish new dealerships in the Milwaukee, Wisconsin, Sales Locality on two separate occasions. Both establishments were protested under the RMA law. In the first case, the state agency upheld the protest. In the second case, the new dealership was allowed to be established. A few years after the second case, Chrysler Corporation filed for bankruptcy, a decision which it and the federal government claimed was driven, in part, from Chrysler having too many dealers in its network. Relying on its ability to reject dealership agreements in the bankruptcy proceeding, Chrysler reduced its dealer count by approximately 790 dealers before its assets were sold to the present manufacturer, FCA USA LLC. Two of these rejected dealers were in Milwaukee, Wisconsin. But for the RMA law, there would probably have been at least one other rejected Chrysler dealer in Milwaukee with the resulting disruption of a vacant dealership facility, laid off employees, customer confusion and tax-base reduction for the community.

In my experience, the state agencies that apply the RMA laws make the public interest the primary factor in their decisions. For example, in one of the Chrysler RMA cases referred to above, the Wisconsin Division of Hearings and Appeals explained the standard it applied to its decision as follows:

> An additional dealer will increase competition in the [relevant market]. Increased competition, as a rule is beneficial to the public. However, larger dealers enjoy economies of scale and achieve lower costs per unit. Assuming sufficient competition, this will ultimately mean lower prices to consumers. The required balancing involves the benefits to consumers of more dealers which, to a point, will increase competition and result in lower prices versus the efficiencies resulting from larger volume dealers.

Dodge City of Milwaukee, Inc. v. Chrysler Corporation, Division of Hearings and Appeals, State of Wisconsin, Docket No. 94-H-852, Final Decision at 17 (1995).

A statute that makes the public interest its primary goal cannot fairly be labeled as the result of "crony capitalism." And the presumption that manufacturers are more likely than an independent state agency to make decisions that are in the public interest ignores the manufacturer decision-making that has led to the consumer disruptions caused by the several manufacturer bankruptcies, product withdrawals, recalls and deceptive practices that have plagued the automobile industry in the United States in recent years. Given these disruptions, the states have an even larger reason to regulate automobile distribution in their states than ever before.

Warranty Reimbursement Statutes

Automobile dealers perform two types of motor vehicle service and repair functions. One is for owners of vehicles that are out of warranty and for which the owners must pay themselves (frequently referred to as "customer pay" or "nonwarranty" work). Dealers compete for customer pay work in a highly competitive market that includes franchised dealers of both the same and other brands and independent repair facilities (which, by virtue of agreements between their associations and the motor vehicle manufacturers, have access to the technology and tools needed to make the same repairs as do the manufacturers' own dealers). As a result, the prices that dealers can charge for customer pay work are truly competitive.

The other type of service and repair function performed by franchised automobile dealers is warranty work for which they are paid by the manufacturer. If requested by the owner, dealers are required by their dealer agreements to perform warranty work on any vehicle of the brand they are franchised to represent, regardless of where the vehicle was purchased. Unlike for customer pay work, the prices that dealers are paid for warranty work are not set by a competitive market. Instead, they are set by the manufacturer which has monopsony power as the sole buyer of warranty work from each of its dealers and whose dealer agreement has left each dealer with no choice but to perform the work.

Dealers make a large investment in the service facilities, equipment, tools and personnel needed to perform both customer pay and warranty work. It is a given in the auto industry that new vehicle retail prices do not provide dealers with sufficient margin to cover this investment. Instead, the profits generated by the dealers' service and parts departments need to cover not just the investments in those departments' assets, but in other departments as well, if a dealer is to remain viable.

The aim of the state warranty reimbursement laws is to ensure that these costs are equitably covered by the revenues generated by both the warranty and the customer pay work that dealers perform. Absent these laws, the manufacturers would be free to exercise their monopsony power to force dealers to accept artificially low compensation for warranty work. In other words, the state warranty reimbursement laws are needed to prevent manufacturers from having the legitimate costs of their warranties subsidized by the dealership's nonwarranty service customers.

Because dealer customer pay prices are set in a highly competitive market, the state warranty reimbursement laws generally use these prices as the standard for what the manufacturer should pay for warranty work. This insures that the amounts paid for all service and repairs performed by a dealer are set in a competitive market, regardless of who pays for the work. Accordingly, these laws promote the public interest of reducing the monopsony power over the warranty work payments made to dealers, preventing forced subsidization of the manufacturer's warranty costs by nonwarranty repair customers and ensuring that warranty repairs are properly made.

That the compensation which warrantors pay third parties for fulfilling the warrantors' warranty obligations is a legitimate subject for government regulation is reflected by Congress's decision to address this subject in adopting the Magnuson-Moss Consumer Warranty Act, which the FTC enforces. Under this Act, warrantors of consumer products who designate representatives to correct warranty defects must make "reasonable arrangements of compensation" of those representatives. 15 U.S.C. § 2307. This reflects Congress's concern that warranty repairs may not be made properly if third party representatives are not reasonably compensated by the warrantor. The same concerns justify the warranty compensation provisions in state automobile franchise laws.

Direct Sales Bans

It is axiomatic that vertical integration of the distribution of a vehicle brand will eliminate intrabrand competition for that brand. Even the opponents of direct sales bans who spoke at the workshop conceded that intrabrand competition, all else being equal, is pro-competitive and will result in lower prices and enhanced customer service. There is also empirical evidence, which was cited during the workshop, which establishes this fact.

This indisputable fact justifies the direct sale bans enacted by some states, particularly given the absence of any credible evidence that vertical integration has other pro-competitive benefits that could possibly outweigh the anti-competitive effects from the elimination of intrabrand competition that vertical integration would have. Some commentators attempted to assert that such pro-competitive benefits would result from cost savings that can be achieved only through vertical integration of an automobile brand's distribution. In addition to the complete absence of any empirical evidence reflecting those cost savings, these assertions have no logical underpinnings.

Whatever distribution costs are needed to effectively market, sale and service a vehicle brand, these costs must be borne by someone regardless of whether the distribution is achieved through independent franchised dealers or the manufacturer itself. Whoever makes the investment needed to cover these distribution costs is also going to require a reasonable return on that investment; otherwise, there would be no inducement to make the investment in the first place. This includes the manufacturer. The commentators who assert that there are cost savings from vertical integration seem to presume that, if a manufacturer invests in the distribution, in addition to the design and manufacturing, of its own vehicles, it will not seek any additional return on its overall investment, even though that investment would significantly increase. This presumption is obviously incorrect. If a manufacturer makes an additional investment in the assets needed to sale and service its vehicles at the retail level, it and its shareholders will require a return on this additional investment that equals or exceeds the return on investment received by independent franchised dealers.

From its previous statements to state legislatures and the way that the workshop was conducted, it is clear that the FTC has already made up its mind to oppose direct sales bans at the state level. This is unfortunate and disappointing given the dearth of any credible economic evidence that vertical integration of automobile distribution would result in cost savings or other pro-competitive benefits that would offset the clear anti-competitive impact of eliminating intrabrand competition which has historically served the retail buying public so well.

I urge the FTC to stay its opposition to these laws until it has at least conducted a true economic analysis to determine if there are, in fact, any offsetting benefits from vertical integration that merit the condemnation of these laws, rather than relying on outdated and refuted analyses and illogical opinions asserted by those with limited experience with the industry.

CONCLUSION

In conclusion, as an observer and participant, I was very disappointed in the clear bias against state automobile franchise laws displayed in the uneven balance of the panels and selection of the keynote speakers for the January 19, 2016 workshop. This imbalance left the clear impression that the FTC has already made up its mind to oppose these laws regardless of the economic and other justifications for them. I hope this is not the case. As a federal agency, the FTC should support, rather than oppose, state regulation of automobile distribution. There is no credible evidence that such regulation has harmed the public in any way. On the contrary, the public currently benefits from a retail automotive market characterized by low prices and a high level of customer service and satisfaction. The primary cause of these benefits is the aggressive interbrand and intrabrand competition created by the historic distribution of automobiles through independent franchised dealers. By protecting this network from irrational or opportunistic manufacturer decision-making, the state automobile franchise laws help to ensure that the public will continue to enjoy the benefits of a strong, competitive retail automotive market in the future.

Sincerely,

Paul R. Norman

PRN:cp