

Auto Dealers Unambiguously Increase Competition

By
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The auto dealer franchise system was originally developed by manufacturers, on the belief that franchised dealers would have greater knowledge about local markets to sell cars in those markets, and strong incentives to invest their own resources in developing their dealership franchise and marketing their dealer brand to their own local customer base. Manufacturers learned through experience that this was the most cost-effective way to expand their presence into local markets.

Today, auto dealers have invested more than \$200 billion in land, buildings, software and infrastructure to sell cars. That is a great deal for carmakers – given that the combined market caps of the big three auto manufacturers barely half that at \$110 billion.

The dealer network enables manufacturers to focus their business and resources on designing, engineering, and nationally marketing cars, rather than the low margin selling of cars. Dealers only make between 2-3% profit on the sale of new cars. GM President Mary Barra said at the recent Consumer Electronics Show, “We believe strongly in the dealer model and the tremendous value our customers derive from neighborhood dealer relationships.”

But the dealers learned over time that despite their large investments in the infrastructure to sell cars, they were at the mercy of the manufacturers, who could replace them, or start up nearby competitors, if they were displeased. With the U.S. economy in deep recession in 1920, Ford kept its plants operating at full capacity by mandating dealers to continue to take their full shares of that auto production, even though they could not sell those volumes during the downturn.

Individual dealers quickly realized they would be displaced if they resisted, rendering their investments worthless. Both GM and Ford maintained this practice during the Great Depression. The dealers became a cushion for carmakers, forced to absorb any losses during economic hard times.

Why didn't dealers just negotiate better contracts with manufacturers to create a safer environment for doing business? Because of the huge imbalance between major multinational manufacturing companies and small business auto dealerships. Why didn't dealers band together to negotiate their contracts? The Sherman Anti-trust Act prohibits dealers from banding together to negotiate their contracts with carmakers, to match the market power of the manufacturers. The last time dealers joined up to confront manufacturers over abusive practices in the mid-1990s, the U.S. Justice Department opened an antitrust investigation, and intimidated them into backing off.

Prevented by the government from organizing to better negotiate their contracts with manufacturers, the dealers turned to their local states to win countervailing regulation in dealer

franchise laws, which restrict unfair dealer terminations, and generally require auto sales to be conducted through independent, franchised dealers with licenses, to prevent undercutting by manufacturers.

The FTC is now investigating whether the independent dealer franchise model, regulated by state dealer franchise laws, reduces or increases competition. Currently, there are about 30 auto manufacturers producing cars for the general public, the every-day automobile driver. In the retail auto market nationwide, these 30 manufacturers are represented by tens of thousands of dealers through the auto dealer franchise model, which unambiguously increases competition and reduces prices for consumers. Because franchise laws protect the dealers' investments – as a contract would do, were dealers able to collectively negotiate – the result is a vast increase in the number of retail competitors. For these and other reasons, the U.S. Supreme Court upheld dealer franchise laws almost 40 years ago. *See New Motor Vehicle Board of California v. Orrin W. Co.* 439 U.S. 96 (1978).

The Phoenix Center for Advanced Legal and Economic Public Policy Studies published a study of hundreds of thousands of car sales demonstrating that, in fact, increased local dealer competition drives down car prices by hundreds of dollars. If you take away the dealers, you take away the competition, and prices will go up.

The question is why – given this data and lack of any countervailing studies – the FTC is questioning the competitiveness of auto retail. Tens of thousands of dealers compete across the country on sales and service, and this competition demonstrably drives down prices, as the Phoenix study shows. This is clearly a competitive marketplace.

If, in fact, the FTC is concerned about competition in the auto retail market and the impact of auto dealer franchise laws, the agency should consider a different, deregulatory policy. They should grant auto dealers an exemption from antitrust laws in their contract negotiations with the auto manufacturers. The auto dealers would then be liberated to combine for countervailing power that can protect their investment in their independent dealerships.

The auto manufacturers are really big boys, with substantial market power to defend and advance their own interests. Experience shows that the big auto manufacturers can abuse that power to the great detriment of dealers and their substantial investment in their dealerships. The auto manufacturers are not individual consumers with no significant market power or even knowledge of the auto retail market. Unchecked market power of these manufacturers is what would threaten competition in the auto dealer marketplace.

With an exemption from the antitrust laws, auto dealers would then not need the countervailing power of state franchise laws. They too could then defend their own interests combining as they thought best to be most effective. Market competition would then be the most effective regulator of the auto dealer markets, a more effective and efficient regulator than central planning bureaucrats in Washington – but only if the government first removed its hand from the scale in harming dealers through antitrust.

Professor David Sappington spoke at the public FTC workshop on the competitiveness of the auto dealer franchise model as regulated by state dealer franchise laws, saying that "teams of dealers" could negotiate their terms with manufacturers. He said, "in my view, it is not apparent that we really need government intervention here to force these manufacturer and dealer teams to agree upon warranty terms that will serve consumers. It's competition that will do that itself, and, in fact, that's the better way in general to run an industry when possible."

But if the FTC is truly going to examine the effects of government intervention in the auto dealer retail market, it must examine the effects of all the "government intervention" or regulation in the market. That would include both antitrust regulation, as well as the auto dealer franchise laws – whose *raison d'être* is to balance out the federal government first tipping the scales against dealers with anti-trust prohibitions. As a matter of basic logic, we would need to remove both sets of regulation if we are going to be able to rely on competition to "regulate" the auto retail sales market.

Professor Sappington's comment about "teams of dealers" negotiating shows a misunderstanding of the law and regulation that applies in that market. Because of the unequal bargaining power that a manufacturer has over an individual dealer, in the absence of franchise laws, the only way that dealers can protect their massive investments in facilities, equipment, personnel, training, and marketing, which are required by their franchise agreements, would be through collective bargaining. But the federal antitrust laws limit the collective action that dealers can undertake to protect their franchise investments in the absence of franchise protection laws. *Big Apple BMW, Inc. v. BMW of North America, Inc.*, 974 F. 2d 1358 (3rd Cir. 1992); *Arnold Pontiac-GMC, Inc. v. General Motors Corp.*, 786 F. 2d 364 (3rd 1986). See also, *Aunyx Corporation v. Canon U.S.A.*, 1990-2 Trade Cas. (CCH), P69,201 (D. Mass. 1990).

In fact, Sappington's comment at the workshop actually acknowledges that there is an imbalance that must be addressed to create a competitive marketplace – that can be addressed by either explicitly allowing dealers to collectively negotiate their contracts, or other regulatory action (i.e. state franchise laws) that balance out the parties' negotiations.

Dealers of the same brand are buyers of the products that their manufacturer sells. Collusion among buyers of the same product have been found to violate the antitrust laws. See, e.g., *Mandeville Island Farms v. Am. Crystal Sugar Co.*, 334 U.S. 219 (1948). While not every collective action by dealers directed toward their manufacturer may theoretically constitute an antitrust violation, the severe penalties attached to antitrust violations make collective efforts by dealers to achieve fair treatment from the manufacturer a high risk undertaking.

As real world evidence of this reality, witness the non-existence of dealer associations aligned by manufacturer or make. There is no General Motors Dealers Association, or Toyota Dealers Association, or BMW Dealers Association that negotiates franchise contracts with GM, Toyota or BMW. Indeed, the "teams of dealers" referred to by Professor Sappington literally do not exist – except at the state legislative level. The antitrust risks for such an enterprise are so high that dealers clearly do not believe they can, in fact, negotiate in the way that Professor Sappington described.

For these reasons, dealers have been forced to turn to the legislatures to protect their franchise investments from unfair, arbitrary or capricious acts of the manufacturer whose interests are not always aligned with those of its dealers.

The FTC should issue an antitrust exemption for dealers combining together for purposes of collective bargaining with auto manufacturers if it wants to follow Professor Sappington's suggestion that markets should be regulating the retail auto dealer market, not government intervention. The FTC would have the power to do that, at least in regard to its own antitrust enforcement, which influence all antitrust enforcement.

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