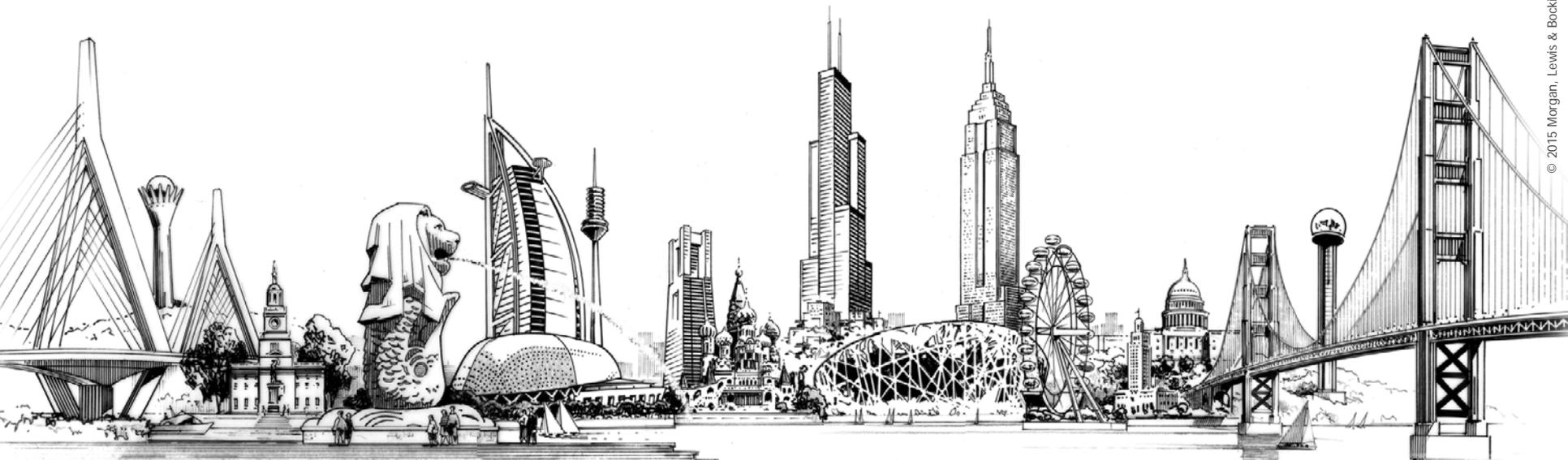


STATE REGULATION OF MOTOR VEHICLE WARRANTY PAYMENTS: SPECIAL INTEREST LEGISLATION RUN AMOK

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Although the authors have a long history of representing motor vehicle manufacturers and distributors, this presentation is not submitted on behalf of any client.

Historical Disparity in Bargaining Power: The "Rationale" of State Motor Vehicle Franchise Regulation

- **State regulation gained impetus in the mid-twentieth century on the heels of federal legislation.**
- **Then a few large manufacturers with considerable financial 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.**

1978: SCOTUS Upholds Cal Law in NMV Board v. Fox

- **“The disparity in bargaining power between automobile manufacturers and their dealers prompted Congress and some 25 States to enact legislation to protect retail car dealers from perceived abusive and oppressive acts by the manufacturers....”**
- **Purported bargaining power disparity continues to serve as support for dealers’ claim that they need statutory protections from the conduct of manufacturers – despite significant changes in the industry.**

The Relative Bargaining Power Has Changed Dramatically

➤ Changes are primarily threefold:

- ❖ Increased competition among manufacturers both for retail sales and for good dealers – competition that requires manufacturers to develop strong dealers to compete with other brands for retail sales. Interbrand competition among manufacturers, and reliance on dealers to sell their vehicles at retail, provides market incentives to ensure dealers are properly incentivized.
- ❖ Increased dealer scale and scope has significantly changed relative bargaining power; large dealer groups, not mom-and-pop businesses, are the entities with whom manufacturers must negotiate.
- ❖ Dealer protection legislation, developed and supported by politically powerful dealers and dealer associations, provide broad protection against bad faith and unreasonable conduct.

The OEM Landscape Has Changed Dramatically: Increased Competition

- **1965: “Big Three” accounted for more than 90% of new motor vehicle unit sales in the U.S.; GM alone was close to 50%**
- **2014: “Big Three” accounted for only 45% of unit sales**
 - ❖ **Toyota, Honda, and Nissan accounted for 32% of sales, with other imports accounting for 20%**
 - ❖ **2009: GM and Chrysler bankruptcies**

Source: WardsAuto Group Report: U.S. Vehicle Sales Market Share by Company, 1961-2012; NADA Data Reports, Market Share 2005-2014, nada.org

The Landscape Has Changed Dramatically

Table 1
New-Vehicle Market Share by Manufacturer
1961 - 2014

Year	Chrysler	Ford	GM	Toyota	Honda	Nissan	Other Imports	VW	Big Three
1961	10.4%	29.3%	45.7%	-	-	-	-	3.0%	85.3%
1965	14.3%	26.8%	49.6%	0.1%	-	0.2%	-	3.0%	90.6%
1970	14.9%	28.3%	38.9%	2.0%	0.0%	1.5%	-	5.6%	82.2%
1975	12.9%	25.4%	43.1%	3.0%	0.9%	3.0%	-	2.9%	81.4%
1980	9.1%	20.5%	44.2%	6.2%	3.3%	5.5%	-	3.0%	73.7%
1985	11.8%	21.3%	40.4%	6.0%	3.5%	5.3%	-	1.9%	73.4%
1990	12.0%	23.8%	35.2%	7.6%	6.0%	4.4%	-	1.1%	71.0%
1995	14.3%	25.5%	32.2%	7.2%	5.3%	5.1%	-	0.9%	72.1%
2000	14.2%	22.6%	28.0%	9.1%	6.5%	4.2%	-	2.5%	64.7%
2005	13.2%	17.0%	25.6%	13.0%	8.4%	6.2%	11.6%	1.8%	55.8%
2010	9.2%	16.4%	18.8%	15.0%	10.5%	7.7%	18.2%	3.0%	44.5%
2012	11.2%	15.2%	17.6%	14.1%	9.6%	7.7%	20.2%	3.0%	44.0%
2013	11.5%	15.7%	17.9%	14.4%	9.8%	8.0%	19.9%	2.6%	45.1%
2014	12.6%	14.7%	17.8%	14.4%	9.4%	8.4%	20.3%	2.2%	45.1%

Note: Market share based on total units sold

Source: U.S. Vehicle Sales Market Share by Company, 1961-2012, WardsAuto.com; NADA Data Report 2014, nada.org

The Dealer Landscape Has Changed Dramatically

- **1986: Average dealership sold 649 new vehicles; generated \$10.8 million in revenue; secured less than \$250K in pre-tax profit**
- **2011: Average dealership sold 793 new vehicles; generated \$38 million in revenue; secured \$870K in pre-tax profit**
- **2014: Average dealership sold 1,003 new vehicles; generated more than \$49 million in revenue; secured nearly \$1.1 million in pre-tax profit**

Source: NADA Data Reports; available at NADA.org

The Dealer Landscape Has Changed Dramatically

Table 2
Average U.S. Dealership
Sale, Revenue, and Profit

	1986	2011	2014	% Increase (1986 - 2014)
New-Vehicle Sales	649	793	1,003	55%
Total Sales Revenue	\$10,821,331	\$38,387,875	\$49,165,223	454%
Net Pre-Tax Profit	\$233,741	\$868,251	\$1,093,805	468%

Notes: New-Vehicle Sales are in units. Net pre-tax profit is the difference between gross profit and operating expense.

Sources: "NADA Data" Reports from NADA Industry Analysis Division at NADA.org; Wards AutoGroup Report "U.S. Car and Truck Sales, 1931-2012" from WardAuto.com

The Dealer Landscape Has Changed Dramatically

- **1960: No dealer appeared on Fortune 500 list.**
- **2015: AutoNation, Penske, Group 1, Sonic, Asbury, and Lithia rank in the Fortune 500, each generating billions in revenue, with hundreds of dealerships in the U.S.**
- **Bargaining power of the large dealer groups benefits all dealers because manufacturers generally adopt uniform dealer policies.**

The Dealer Landscape Has Changed Dramatically

Table 3
Automobile Dealer Firms in the Fortune 500

Firm	Fortune 500 Rank	Gross U.S. Revenues	Number of U.S. New Vehicle Dealerships
AutoNation	156	\$19,108,800,000	276
Penske Automotive Group	177	\$17,177,200,000	179
Group 1 Automotive	291	\$9,937,889,000	116
Sonic Automotive	315	\$9,197,079,000	118
Asbury Automotive Group, Inc.	450	\$5,867,700,000	104
Lithia Motors, Inc.	482	\$5,390,326,000	130

In sum, six dealer groups account for 923 dealerships and over \$66 billion in revenues.

Source: Company SEC Form 10-K filings for the fiscal year ended 12-31-2014; www.hoovers.com

The State Regulatory Landscape Has Changed Dramatically

- Today, nearly every facet of the manufacturer-dealer relationship is subject to varying degrees of state regulation across all 50 states.
- ❖ Wide ranging protections against bad faith, arbitrary and/or unconscionable OEM treatment of dealers.
- ❖ Among other statutory protections, dealers are protected from (i) competition by direct sales; (ii) termination, (iii) appointment of same-line make competitive dealers, and (iv) all variety of “unreasonable” activities by OEMs, and . . .
- ❖ *Dealers enjoy a legislative monopoly on providing warranty service.*

State Level Dealer Political Power

- **Dealers are:**
 - ❖ **an important source of tax revenue for states**
 - ❖ **typically owned by and/or employ local residents who can vote for and contribute to campaigns of state legislatures**
- **More than 90% of dealers in the U.S. are members of NADA**
- **Dealers also belong to state and local dealer associations too**
 - ❖ **For example:**
 - **In Florida, 70% belong to FADA**
 - **In addition to FADA, Florida has four other independently operated, regionally based dealer associations**

State Level Dealer Political Power

“It is hardly surprising that car dealers have been able to lock down state legislatures across the nation in maintaining anticompetitive laws: After all, some of the richest people in nearly every town across the country are the owners of car dealerships. ... [T]he car dealers dominate local business (especially in smaller towns), with economic power that translates directly into political might.”

- **Neil Buchanan, “Political Power in the Auto Industry: Why Did Congress Protect Car Dealers?”**
FindLaw, December 17, 2009

State Level Dealer Political Power

“The net result of all these laws is to raise profits for car dealers. State legislatures may be willing to do this because dealers represent an identifiable source of state employment and tax revenue, while even large manufacturers can site manufacturing plants only in a limited number of states. The result is that new car dealers have an advantage over auto manufacturers when it comes to political leverage in state legislatures, and thus states enact laws that extract rent from manufacturers and redistribute it to franchise dealers.”

- **Francine Lafontaine and Fiona Scott Morton, “Markets: State Franchise Laws, Dealer Terminations, and the Auto Crisis,” *Journal of Economic Perspectives*, Volume 24, Number 3, Summer 2010, at 241**

State Level Dealer Political Power

“Florida politicians fear the powerful car dealer lobbies in Tallahassee. The most powerful lobby is the Florida Automobile Dealers Association, FADA, and there are other lobbying car dealer associations in Tampa, South Florida, and Jacksonville. A long time ago I was a director for the FADA and for the South Florida Auto Dealers Association, SFADA This is when I became aware of how much money and influence we car dealers had through our associations. Car dealer associations contribute huge sums of money to candidates of both parties.”

➤ Source: Earl Stewart, <http://oncars.blogspot.com/2012/08/florida-car-dealers-win-triple-crown.html>

Dealers Enjoy Substantial Benefits from Their Legislative Monopoly Over Warranty Work

- **Warranties are offered by every OEM as part of the competition for retail sales.**
- **Warranties help dealers to market the sale of new vehicles to consumers.**
- **Warranty work is immune from competition from manufacturers or independent repair shops. Dealers do not need to advertise, but have a captive customer base.**
- **Competition and product improvements have increased the average length of warranties in recent years, benefitting consumers and extending the period for which dealers enjoy the legislative monopoly on providing warranty repairs.**
- **Warranties bring customers to the dealership, expose them to new vehicles on the showroom floor, and attract customer-paid work in conjunction with or after warranty coverage ends. Warranty work gives dealers a captive customer base to impress with the quality of the dealer's service, thus providing a competitive advantage for post-warranty repair work not enjoyed by independent repair shops.**

Table 5
Changes in OEM Warranty Terms

Manufacturer	Original Warranty Terms			Updated Warranty Terms		
	Model Years	Basic Warranty	Powertrain Warranty	Model Years	Basic Warranty	Powertrain Warranty
Chrysler - Original Warranty	10/31/01 and earlier	3 years/36,000 miles	3 years/36,000 miles	11/1/01-7/8/02	3 years/36,000 miles	7 years/100,000 miles
Chrysler - 2nd Update				7/9/02 and later	3 years/36,000 miles	7 years/70,000 miles
Dodge	10/31/01 and earlier	3 years/36,000 miles	3 years/36,000 miles	11/1/01-7/8/02	3 years/36,000 miles	7 years/100,000 miles
Dodge - 2nd Update				7/9/02 and later	3 years/36,000 miles	7 years/70,000 miles
Hyundai	1998 and earlier	3 years/36,000 miles	5 years/60,000 miles	1999 and later	5 years/60,000 miles	10 years/100,000 miles
Isuzu	1999 and earlier	3 years/50,000 miles	5 years/60,000 miles	2000-2002	3 years/50,000 miles	10 years/120,000 miles
Isuzu - 2nd Update				2003 and later	3 years/50,000 miles	7 years/75,000 miles
Jeep	10/31/01 and earlier	3 years/36,000 miles	3 years/36,000 miles	11/1/01 - 7/8/02	3 years/36,000 miles	7 years/100,000 miles
Jeep - 2nd Update				7/9/02 and later	3 years/36,000 miles	7 years/70,000 miles
Kia	7/2000 and earlier	3 years/36,000 miles	5 years/60,000 miles	7/2000 and later	5 years/60,000 miles	10 years/100,000 miles
Mazda	2003 and earlier	3 years/50,000 miles	3 years/50,000 miles	2004 and later	4 years/50,000 miles	4 years/50,000 miles
Mitsubishi	2003 and earlier	3 years/36,000 miles	5 years/60,000 miles	2004 and later	5 years/60,000 miles	10 years/100,000 miles
Porsche	1998 and earlier	2 years/unlimited	2 years/unlimited	1999 and later	4 years/50,000 miles	4 years/50,000 miles
Suzuki	Prior to 8/1/02	3 years/36,000 miles	3 years/36,000 miles	8/1/02 and later	3 years/36,000 miles	7 years/100,000 miles
Volkswagon	2001 and earlier	2 years/24,000 miles	10 years/100,000 miles	2002 and later	4 years/50,000 miles	5 years/60,000 miles

Source: Car Lemon online "Vehicle Warranties" Report at <http://www.carlemon.com/vehicle-warranty.html>

Dealers Enjoy Substantial Benefits from Their Legislative Monopoly Over Warranty Work

- **Warranty work has historically generated substantial profits for dealers.**
- **In the absence of retail reimbursement laws, manufacturers generally pay dealers a markup of 40% (some pay MSRP, or roughly 67%) on parts used in a warranty repair, and a mark-up of more than 250% for labor services.***

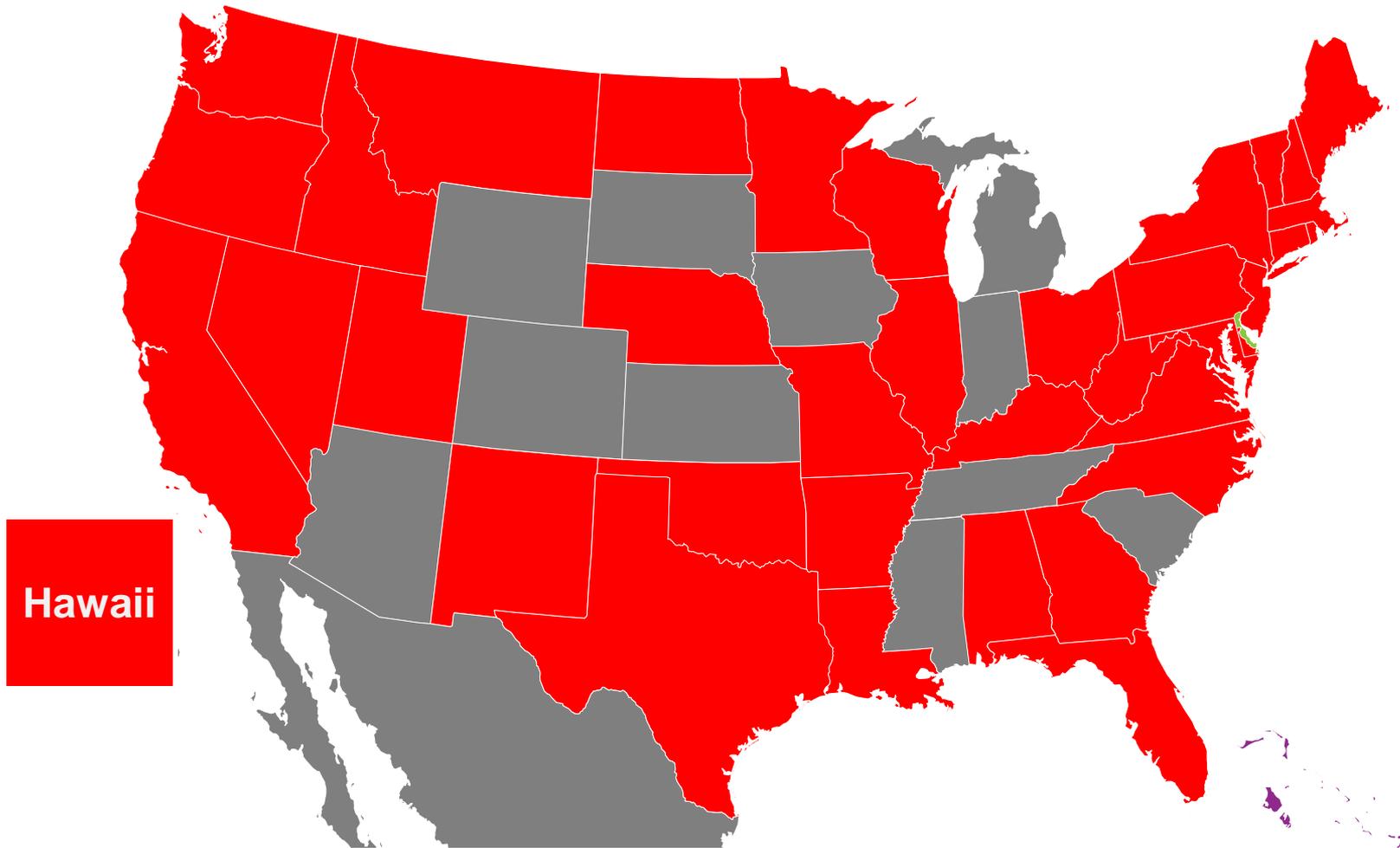
***Figures derived from analysis of dealer financial statements conducted for an expert report disclosed in litigation challenging the constitutionality of Florida's warranty reimbursement scheme.**

Dealer Protection Legislation: Warranty Reimbursements

- **Warranty reimbursements are the one payment stream that goes from the OEM to the dealer. Despite the history of profits that resulted from contractually agreed upon reimbursement rates, dealers have coaxed state legislators to remove reimbursements from the realm of contractual negotiation.**
- **Particularly over the last ten years, and despite historical profits derived from warranty work, dealers have sought to increase their profits through warranty reimbursement legislation.**
- **Today nearly 40 states have enacted warranty reimbursement legislation, which removes warranty reimbursement from the realm of contract between OEMs and their dealers, and ties reimbursement to rates that are actually above the retail pricing unilaterally determined by a dealer.**

Dealer Protection Legislation: Warranty Reimbursements

States in Red: Require Retail Reimbursement for Parts and Labor



Dealer Protection Legislation: Warranty Reimbursements

Retail Reimbursements Laws:

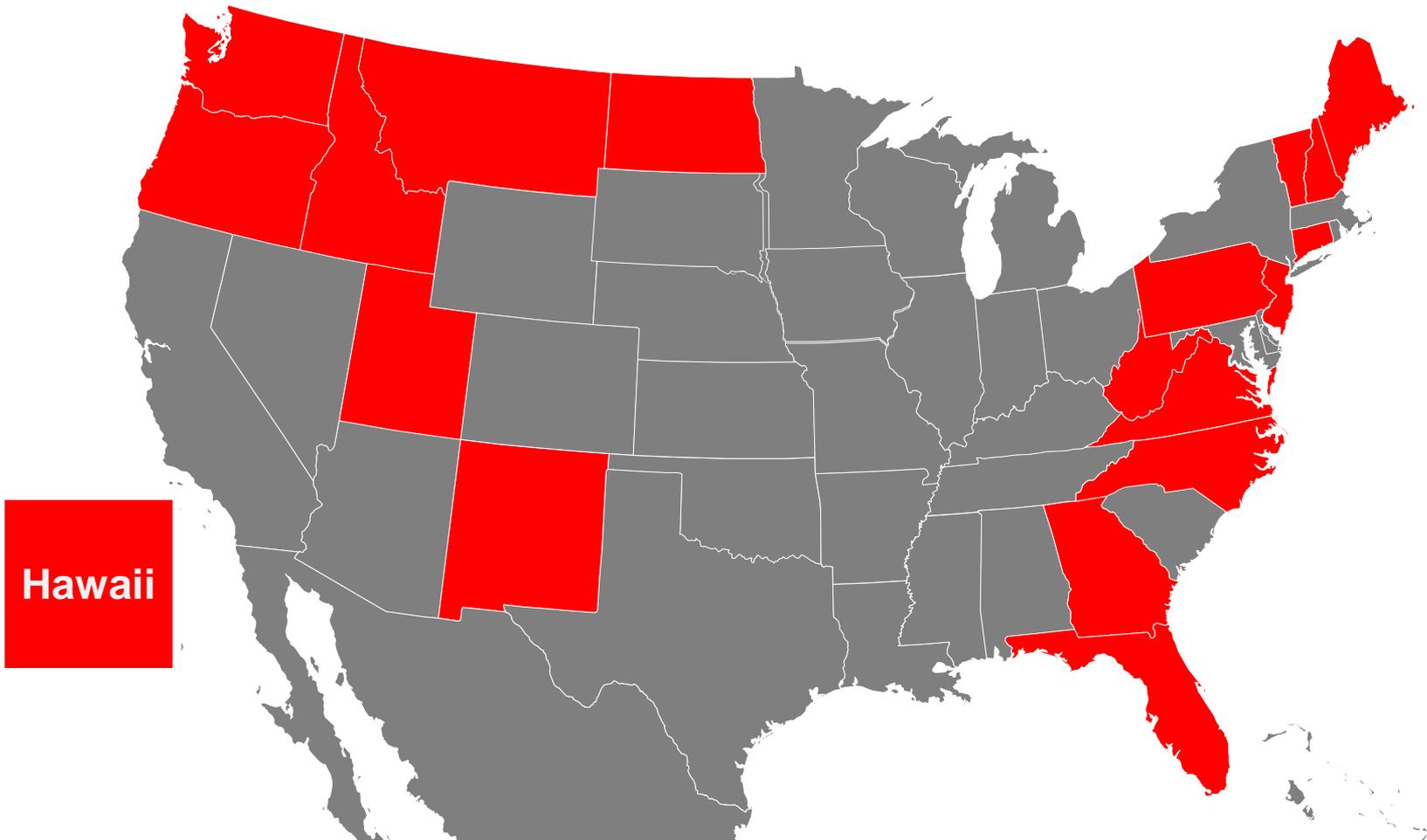
- allow dealers to unilaterally set the mark-up manufacturers must pay based on 50 or 100 consecutive customer-paid repair orders
- allow the dealer to *exclude* specials or promotional discounts from its calculation of the mark-up for parts and labor, boosting warranty reimbursement rates *above* retail rates and thereby providing economic incentive for a dealer to raise its retail rates
- often preclude the manufacturer from any realistic challenge of the dealer's declared rate

Dealer Protection Legislation: Warranty Reimbursements

- **The clear purpose (and result) of the reimbursement regulation is to increase the amounts that dealers will receive. But after some OEM efforts to recover these increased costs in the state that imposed them – which would let consumers know they were paying more for their vehicles due to the reimbursement legislation – dealers have begun to induce states to forbid OEMs from recovering those costs from within the state.**
- **In some form, 19 states now prohibit manufacturers from raising prices within the state to recover the increased costs imposed by the retail reimbursement regulation. Shifting the cost of regulation away from the citizens of the state that imposes those costs interferes with an essential element of democracy, where voters can assess the cost/benefit of regulation.**

Dealer Protection Legislation: Warranty Reimbursements

States in Red: Prohibit OEMs from Recovering Increased Costs of Warranty Reimbursement Legislation (in some form)



Dealer Protection Legislation: Warranty Reimbursements

Warranty Reimbursement Laws Have Also Imposed Unique Statutes of Limitations Inapplicable to Any Other Industry

- While state laws generally give dealers a full year to submit warranty reimbursement claims, manufacturers often are required to approve and pay claims within 30 days of receipt or approval.
- States are increasingly constraining a manufacturer's ability to audit dealers for warranty reimbursement errors or fraud by:
 - reducing the time from within which the manufacturer may audit unsubstantiated, incorrect, or false claims – in many cases, manufacturers now have only 6-12 months following payment (or submission of the claim by the dealer) to conduct an audit and issue a chargeback. Contrast that period with the statutes of limitations for contract and fraud claims that govern other businesses.

Dealer Protection Legislation: Warranty Reimbursements

- **These provisions require prompt, pre-audit payment, and they restrict the ability to audit and to determine and act on trends that might reflect fraud.**
- **They also insulate dealers from the consequences of their own poor warranty claims management practices.**
- **Excessive and unjustified warranty payments further increase costs that must ultimately be borne by consumers – and the enhanced warranty reimbursements mandated by legislators mean that dealers are benefitting from warranty errors or fraud to the detriment of consumers.**

The Reach of Retail Reimbursement Legislation

- **Of the 13,565,569 new motor vehicles sold nationwide to retail customers in 2014:**
 - ❖ **10,960,950 were sold in states with parts and/or labor reimbursement laws that tie reimbursements to retail**
 - ❖ **4,336,592 of those vehicles were sold in states with some form of recovery ban**

Source of new motor vehicle sales: IHS Automotive; figures exclude sales of approximately 3 million new motor vehicles nationwide to fleet customers in 2014

The Reach of Retail Reimbursement Legislation

The Financial Burden

- In Florida alone, between 2008 and 2012, the retail reimbursement statute imposed on just four manufacturers (which together accounted for just under 50% of new vehicle unit sales in Florida) more than \$80 million in increased costs.
- In other words, between 2008 and 2012, four manufacturers (of the more than a dozen major manufacturers) transferred more than \$80 million to Florida's dealers *in addition to the hundreds of millions paid to dealers in the absence of the reimbursement statute.*
- The financial burden, if extrapolated to all manufacturers and to all 40 states with retail reimbursement requirements, is enormous and will continue to mount.

Who Pays in the End?

- **Higher warranty costs place upward pressure on the price of new motor vehicles. Consumers are harmed whether the higher legislated warranty reimbursements result in higher prices for new motor vehicles, reduced warranty coverage, or other steps economics will dictate must be taken to deal with significantly increased costs.**
- **End Result: Retail reimbursement laws are significant, unwarranted wealth transfers that benefit dealers at the ultimate expense of consumers.**

What is a Better Alternative?

- **Return warranty reimbursement issues to the realm of contract and competition. Let the marketplace, with its vigorous interbrand competition for the sale of motor vehicles, determine warranties and warranty reimbursements.**
- **Remove the legislative monopoly over warranty now granted to dealers and allow competition for warranty sales and for good dealers to develop cost-effective warranty systems. Some OEMs may want to continue to rely exclusively on their dealers to provide warranty; others may experiment with other alternatives.**
- **Contractual negotiations that pre-dated retail reimbursement legislation provided for significant dealer profits; allow for a return to the negotiating table, where smaller dealers will continue to ride the coattails of the larger dealers.**
- **Remove timing constraints on warranty audits and charge-backs. Allow contractual negotiations and the statutes of limitations applicable to every other industry to apply to motor vehicle distribution and warranty.**

What Lies Ahead?

- **Cars and trucks 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.**
- **There will be no the need to take your vehicle to the dealer for such over-the-air updates and repairs.**
- **As over-the-air updates and repairs increase, be wary of legislative efforts to require that dealers be paid whenever such an update or repair is made – and assess whether existing legislative monopolies on warranty will be argued to apply to over-the-air updates and repairs.**
- **Third party add-ons – like computers and navigation systems – will be inhibited if manufacturers must pay dealers for over-the-air updates and repairs.**
- **Car sharing and different vehicle ownership models are developing. Who will own the car of the future? Warranty regulations ought not inhibit such developments.**

Selected Further Reading

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