AUTO ALLIANCE
DRIVING INNOVATION®

803 7th Street N.W., Suite 300 | Washington, DC 20001
202.326.5500 | www.autoalliance.org

Auto Alliance Analysis of the Problematic Issues in House Bill 136

The following is a discussion of the many problems in House Bill 136. The Auto Alliance does not intend this document to be an exhaustive list of every problematic detail in the bill. Instead, the document is meant to provide context for anyone unfamiliar with the issues so that they can more easily see the problems with the bill.

Section 1: Legislative Findings

HB 136 asks the Alaska State Legislature to find that this sweeping franchise law is necessary "to prevent the infliction of fraud and other abuses on people in the state." That is offensive.

Section 3: Terminations

This section would prohibit a manufacturer from terminating a dealer in certain situations. For example, dealers would be free to move their current dealership into any existing store in the market area. Manufacturers have an interest in where their franchises are located, but this would give the dealer complete authority to move that location.

Sections 4: Terminations

This section seeks to make it harder for a manufacturer to terminate a poorly performing dealer. It is important that manufacturers be able to terminate a poorly performing dealer because state law effectively prevents manufacturers from adding another store within an existing dealer's market area. Manufacturers and consumers rely on every dealer to be effective representatives of the brand because the next dealer could be far away. Consumers rely on the dealer as a place to shop and get their vehicle serviced. It should not be the legislature's role to protect underperforming businesses from the consequences of poor performance.

Section 4 allows the dealer to challenge a performance termination by relying on market analysis based upon not only that dealer's vehicle allocation, but also the allocation of that dealer's competitors. That data is confidential yet the bill would force the manufacturer to disclose it. It is not in the interest of manufacturers or dealers to have a law that would make competing dealers' confidential information so readily obtainable during litigation that they are not even a party to.

These sections create a system of rules that is ripe for contentious litigation and encourage application of 20/20 hindsight to business decisions. For example, Section 4 requires the manufacturer to have provided an adequate supply of vehicles. First, this idea does not fit well with the allocation system that most manufacturers use which is to send vehicles to the dealers who are selling them the fastest. But what if the dealer refused the vehicles? Or what if the manufacturer is terminating the dealer for terrible customer satisfaction scores and the allocation is irrelevant? This section would apparently allow a dealer to force an Alaska court to consider arguments about a highly technical and fact-intensive product distribution issue even though it is totally irrelevant.

Sections 6 to 9: Termination Assistance

These sections spell out a manufacturer's obligations to pay a dealer various forms of severance fees upon termination. Many of these obligations are simply forms of "risk shifting." When a franchisee in any industry goes into business, he or she is accepting a certain amount of risk that the business will either succeed or fail. HB 136

seeks to shift that risk of doing business from the dealer to the manufacturer. Indeed a poor performing, ineffective dealer would receive very generous compensation under the bill. It requires the manufacturer to repurchase inventory, demonstrator cars, signage, furnishings, tools, etc. The bill also requires payment for early lease terminations and payment for remodeling or relocation costs from the previous three years. In an instance where a dealer owns the property, the manufacturer would have to pay two years of the rental value of the property. The list of required payments is long and excessively generous. This section also ignores the value that the dealer got out of these items as part of running the business.

These are not an exhaustive list of the ideas in the statutorily-defined golden parachute that HB 136 seeks to create. This list illustrates the dramatic risk shifting that the bill seeks to accomplish. Such risk shifting is entirely unreasonable in light of the incredible long term profitability that car dealers have shown.

Even more astounding is that HB 136 would require the manufacturer to pay these generous benefits to a dealer even if it was the *dealer* that decided to terminate the franchise agreement and quit the business. The Alliance has agreed in other states that manufacturers should have some obligations towards a terminated dealer (although certainly nothing as generous as the windfall contemplated in this bill). But there is certainly no reason that a dealer who voluntarily quits the business should receive the same severance benefits as a dealer who was terminated by the manufacturer. Dealers should not be rewarded for quitting.

Section 10: Sale or Transfer of the Dealership

Current law makes it very difficult for a manufacturer to establish a new location for a dealership. In fact, Section 13 of this bill makes it even harder to do so. This means that every point is critical for serving the local population and effectively representing the brand.

In light of these facts, it is very important for manufacturers to be able to exercise a "right of first refusal" when a dealer wants to sell his or her franchise to someone else. That means that a manufacturer has the option to match the buyer's price and then assign the dealership to someone that the manufacturer thinks would be a better dealer. That way a manufacturer can avoid an underqualified candidate from taking the franchise. Right of first refusal provisions are very common in all sorts of commercial contracts. HB 136 would nullify the right of first refusal clause in a franchise contract. There is nothing unique about the automobile industry in this context. There is no reason that a right of first refusal provision in a contract between a manufacturer and a dealer should be unenforceable while a similar provision in another commercial contract should be acceptable.

The drafting of this section creates additional problems through the use of the disjunctive "or" in subsection (a)'s list of instances when a manufacturer may not withhold consent to a sale of the dealership. It means that simply being "capable of being licensed as a new motor vehicle dealer" is enough to prevent a manufacturer from withholding consent. The subsection also means that a manufacturer may not withhold consent if the buyer "already holds a franchise from the manufacturer." That gives the manufacturer no way to prevent a single dealer from consolidating control of area franchises and harming or eliminating intra-brand competition.

Sections 13: Adding or Relocating Dealerships

Situations may arise when a manufacturer may seek to add new dealerships to meet consumer demand, or the manufacturer may seek to relocate an existing dealership. Oftentimes, a relocation is at the request of the existing dealer because its location has become less desirable over the years for reasons such as changing traffic patterns or some kind of long term nuisance. Section 13 of HB 136 would add extremely high hurdles for a manufacturer that seeks to add or relocate a dealership. The result will be less competition and underserved consumers.

Section 13 would require a manufacturer to establish "good cause" before it can create or move a dealership. Section 13 then goes on to list 11 factors that determine whether there is good cause.

The first of the two flawed criteria is (c)(10), which would count against good cause if the manufacturer denied the protesting dealer the opportunity to expand and create a satellite location. Yet manufacturers and consumers may have a legitimate reason to want a different dealer in the market. Car dealers often argue that intra-brand competition amongst dealers that sell the same brand of vehicles keeps prices low for consumers. A pre-requisite to intra-brand competition is of course multiple dealerships that are not controlled by the same person. Diverse ownership should be a factor in favor of good cause, yet (c)(10) would cause it to be scored against a finding of good cause. This section clearly does not have the public interest in mind when it allows a dealer to argue, "There should be no new store at that location unless I can have it."

Determination of good cause is fact specific matter for courts to decide. This bill actually creates a constitutional separation of powers issue because it asks the legislature to encroach on the judiciary's decision making ability. These sections create a long list of factors that are presumed to be relevant and required to be met. Equally as troublesome is that HB 136 does not allow the court to weigh these considerations against each other. This is another example of the bill overstepping its bounds.

Finally, Section 13 could strangely require the manufacturer to bear the burden of proof for relocating a dealership when it was the dealer instead of the manufacturer that suggested the move. It would be very unusual to see a manufacturer arguing the case in what would essentially be a dealer v. dealer dispute.

The result of all of these provisions would be that Alaska's dealer network would become more rigid and less able to respond to consumers.

Section 14: Court Actions

Section 14 also creates "automatic stays" when a protest is filed in a case involving closing, opening, or relocating a dealership. Rule 65 of the Alaska Rules of Civil Procedure already covers preliminary injunctions and courts have a wealth of experience in applying it. There is no reason to depart from Rule 65 and give special treatment to dealer lawsuits about closing, opening, and relocating dealerships. Departing from Rule 65 would incentivize filing complaints that only delay a manufacturer while wasting court resources in the process.

Section 15: Warranty Reimbursement

Manufacturers fulfill their warranty obligations to consumers by relying on dealers to perform the warranty work. This allows the manufacturer to know that qualified technicians are doing the warranty work. It also allows the manufacturer to know that the customer's needs are being met conveniently and with high quality.

The question that arises in this model is how much a manufacturer should pay a dealer to perform this work. Manufacturers and dealers already have agreements in place that provides compensation for both parts and labor. This bill would allow dealers to ignore those agreements and require the manufacturer to pay the dealer the same retail rates that it charges to public. The bill ignores the fact that manufacturers are almost always a dealer's biggest customer for service work. The manufacturer provides a steady stream of work that does not have any advertising or customer retention costs that an ordinary repair shop would have. Section 15 disregards the value of being a bulk purchaser of service work.

It is difficult to see how any regulatory system that sets *minimum* prices could be good for consumers. Indeed, the concept of mandatory retail reimbursement rates creates a threat to Alaska consumers. If a dealer knows that the manufacturer is its largest customer, cannot take its business elsewhere, and that the manufacturer must pay the dealer's retail price, then the dealer will have an incentive to raise the retail prices that it charges consumers. The

dealer will know that the lost revenue from the customers that take their business elsewhere will be more than made up by the increased revenue that the dealer gets from the manufacturer. The consumers that keep going back to the dealer will suffer because of the incentive to raise prices that this bill creates.

Section 15 also limits a manufacturer's ability to claim that a dealer's retail rates are unreasonable. 45.25.210(h) says that a manufacturer would need to demonstrate that a dealer's proposed retail rate "unreasonably exceed[s] the rates and charges of all other franchised new motor vehicle dealers in the same relevant market area offering the same motor vehicle line or a competitive motor vehicle line." That means that a dealer's rate is unreasonable only if it is the highest rate of any dealer in the area. That is a needlessly difficult threshold to meet, and it should not be used as a necessary standard to show unreasonableness.

The bill seeks to establish a higher cost for the manufacturer in doing business in Alaska. But it then goes on to say that despite an Alaska-specific law that raises costs, the manufacturer must distribute that cost across the country rather than having the option to have a surcharge for cars sold into Alaska. States should not pass laws that benefit in-state interests and then pass the costs for them onto other states. The Alliance would ask other states not to do that to Alaska consumers, and the Alliance would also ask Alaska not to do that to consumers in other states.

Section 15's problems do not end there. As previously stated, manufacturers rely on the dealers to perform warranty work and then the manufacturer compensates the dealer. Manufacturers will naturally need some ability to audit to make sure that claims that were paid should have been paid, and to make sure that the repairs were appropriate and performed properly. The ability to audit for warranty is simply a matter of good financial controls. Section 15 would limit a manufacturer's ability to audit to only the previous 6 months, which is too short for an effective and efficient audit program. The large majority of states in the country allow manufacturers 12 months, and only a small minority have adopted the 6 month standard. This bill is even worse however, because in addition to limiting audits to only the last 6 months, the bill would illogically only allow a single audit per calendar year. That means that for a least half of the year, a manufacturer would have no ability to audit a dealer's claims. That idea is an invitation for abuse and sloppiness.

Section 15 incentivizes abuse and sloppiness in other ways as well. For example, 45.25.200(h) would require manufacturers to pay dealers' warranty claims even if the dealer did not follow not follow prescribed procedures. It would allow a dealer to repair a vehicle by doing a different repair than what the warranty manual calls for. Warranties are still the manufacturer's warranty and the manufacturer's obligation. Manufacturers should be able to insist that their procedures are followed.

Finally, Section 15 gives a manufacturer only 15 days to approve or deny a dealer's request for compensation for warranty work. This is half of what most if not all other states allow for.

<u>Section 16: "Unfair Practices"</u>

Section 16 creates a list of 24 actions that manufacturers would be prohibited from doing. Most of these are either completely objectionable or have some form of problem in their scope.

(1-3): These subsections seek prohibit a manufacturer from selling to dealers at different prices. The problem is that this prohibits various incentive programs such as those for sales performance or inventory. These three subsections harm good dealers.

(4): This subsection seeks to allow dealers to know more about a manufacturer's method for allocating vehicles. The state should be concerned that this language could be used to force disclosure of confidential business information simply because the dealer would like to know more about the manufacturer's allocation strategy.

(5): Manufacturers often run programs that offer discounts to members of the military, employees, or recent college graduates. These programs are a way to say “thank you” and build brand loyalty. Dealers are not required to participate in these programs. It is not uncommon for these programs to include a provision that sets a maximum document preparation fee that a dealer can charge to someone who is eligible for the discount. The reason is that the manufacturer wants to make sure that the discount goes to the consumer rather than eaten away in fees that the dealer charges. This subsection would prohibit manufacturers from limiting document preparation fees in these programs. It would allow dealers to charge higher fees to members of the military, employees, and recent graduates. The subsection is inappropriate.

(6): This subsection requires manufacturers to deliver parts of vehicles to the dealer if other dealers are receiving the same item. The subsection is more inflexible than it should be. It does not account for situations beyond the manufacturer’s control. It does not account for reasonable technology capabilities to sell or service certain vehicles (e.g. a dealer needs to be able to charge and service an electric vehicle in order to sell it).

(9): This subsection would require manufacturers to offer all models to the dealer. This subsection is also too broad. Some manufacturers do produce exotic or rare models, however it would be impractical to provide one to every dealer because there is not enough consumer demand to justify it.

(12): This subsection would prohibit manufacturers from allowing anyone other than a dealer to do warranty repairs without the local dealer’s consent. It is not uncommon for large fleet customers such as rental car companies to have agreements with manufacturers to do their own warranty work if the fleets have the capability to do it. Those agreements save fleet customers by having vehicles repaired faster and without the need to spend labor hours delivering vehicles to a dealer and picking them up later. Subsection (10) could raise costs for fleet customers if the local dealer did not consent to the fleet doing its own work.

(14): These subsections seeks to allow dealers to sell more than one brand at a location. However, the language is once again too broad. It is not uncommon for manufacturers to incentivize dealers to only sell that manufacturer’s brands out of a location. Subsection (14) should make sure that it does not prohibit those types of agreements that have been beneficial to both manufacturers and dealers.

(15): This subsection seeks to protect dealers from manufacturer requirements to upgrade their facilities unless the same requirement is imposed on all dealers. Once again, this approach is too broad. It unreasonably assumes that every store in Alaska is in the same condition. Subsection (15) should focus on unreasonable requirements rather than all requirements. It should also allow the manufacturer to incentivize dealers to upgrade facilities, and it should also allow manufacturers to incentivize dealers to use a manufacturer’s preferred vendors.

(17): This subsection seeks to protect dealers from being forced to join an advertising association. While the goal is reasonable, the language is again overbroad and could needlessly prevent manufacturers from offering valuable incentives to dealers.

(21): This subsection seeks to limit manufacturer’s ability to change the capital structure of dealerships. Manufacturers must rely on their dealerships being stable and able to borrow effectively. Manufacturers should have input into the capital structure and financing in their dealer network.

(24): This subsection seeks to define when manufacturers must indemnify dealers. This is unnecessary because franchise contracts already have well-defined indemnification clauses. The concern with codifying the indemnification concept is that it could lead to an unreasonable expansion of what dealers should be indemnified for—particularly for suits arising from the dealer’s actions or omissions.

Sections 17: Definition of "Terminate"

The proposed definition would conflate terminations of a specific dealer with a discontinuation of an entire line make. These are two distinct actions with distinct justifications and distinct compensation for dealers. There is no reason to add confusion.

Section 18: Definition of "Line Make" and "Relevant Market Area"

"Line Make" is an industry term of art that has proven very difficult to define in state statutes.

Section 19 seeks to make the terms "relevant market area" and "area of responsibility" mean the same thing. It is a mistake to do this. The former term refers to an area within a set distance around an existing dealer. The purpose of the relevant market area is to decide what dealers would have standing to protest a plan to create or relocate a dealer. "Area of responsibility" is entirely different. A dealer's area of responsibility is the geographic area (typically census tracts) that the dealer's sales performance will be measured on. The area of responsibility may include more, less, or different geographic areas than the simple "ring" around that the dealer that makes up the relevant market area.

The two terms are entirely distinct. An important negative consequence of making these terms mean the same thing is that a dealer could get standing to protest new or relocating dealerships in a much larger area than its relevant market area. It is not in the best interest of Alaska consumers to have a single dealer be able to block changes in the locations of other dealerships.

Section 20: Retroactive Application

This section would make not just this bill retroactive to previously existing contracts, it would make the entire existing franchise code retroactive as well. That is extraordinary. When two parties enter into a contract, they do so based on the law as it is when they sign the contract. HB 136 is a request by car dealers for the Alaska Legislature to rewrite contracts that the dealers signed, and give the dealers an amazing deal in the process. Any business should have confidence that when it signs a contract, that the government will not step in and rewrite it later to advantage a preferred interest group.

The Supreme Court of Alaska recently addressed a similar circumstance involving a bill that retroactively rewrote existing contracts to favor one party over the other. The case is *Hageland Aviation Services v. Harms*, 210 P.3d 444 (Alaska 2009). The Court examined whether a law that retroactively exempted pilots from state overtime laws was constitutional. The Court found that the retroactive law violated the Alaska Constitution's Takings Clause and its Contracts Clause. HB 136 would raise many of the same concerns as the law at the center of the *Hageland* case. Every section of HB 136 is written to benefit dealers at the expense of manufacturers--both financially and in the manufacturer's freedom to make business decisions.

Section 21: Schedule of Compensation

This section sets a price floor in perpetuity for the dealer's compensation. It says that the schedule of compensation may not be less than it was on the day before the effective date of this bill. That means that if a dealer's costs go down in the future, then the manufacturer cannot decrease the schedule of compensation accordingly. There is no reason to codify a perpetual price floor into Alaska law.

For more information, please contact David Bright at dbright@autoalliance.org or (202) 326-5533.