



Morgan Lewis

NEW MARKET ENTRY AND THE ANACHRONISTIC US DISTRIBUTION SYSTEM: WHAT THE FUTURE PORTENDS

November 10, 2021

Brendan Fee | Daniel S. Savrin | Mark J. Fanelli | Caiti A. Zeytoonian

Presenters



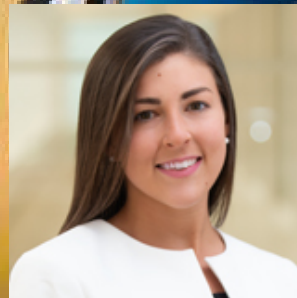
Brendan Fee
Partner, Philadelphia



Daniel S. Savrin
Partner, Boston



Mark J. Fanelli
Associate, Philadelphia



Caiti Zeytoonian
Associate, Boston

Morgan Lewis

Morgan Lewis Automotive Hour Webinar Series

A series of automotive industry focused webinars led by members of the Morgan Lewis global automotive team. The 11-part 2021 program is designed to provide a comprehensive overview on a variety of topics related to clients in the automotive industry. Upcoming sessions:

➤ **DECEMBER 8** | The IP Anatomy of the Automotive Nervous System

Roadmap

- | | |
|------------------|---|
| Section 1 | Origins of State Automotive Franchise Laws & Distribution Restraints |
| Section 2 | The Internet Age & the Evolving Automotive Buying Climate |
| Section 3 | A Look at Today's Playing Field: Limitations on Direct Sales |
| Section 4 | State Dealer Laws Embed Protections for Dealers with Competition & Consumer Protection Implications |
| Section 5 | The Road Ahead |

Morgan Lewis





Section 1

Origins of State Automotive Franchise Laws & Distribution Restraints

Morgan Lewis

The Changing Landscape

State automotive franchise laws were born in the era of mom-and-pop shops



“

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**.

”

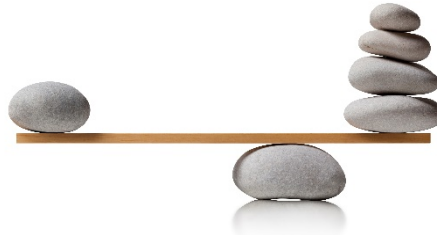
New Motor Vehicle Bd. v. Orrin W. Fox. Co.,
439 U.S. 76 (1978)

The Changing Landscape (cont'd.)

- Today's reality = sophisticated dealership groups
- Independent/small → medium/large
- Steady consolidation has led to concentrated ownership of dealerships, dominated by private ownership
- NADA's 2025 prediction: 16,500 dealerships across 6,500 owners

Auto Dealership Buy/Sell Market Sets Another Record in Q1 2021, as Dealership Earnings, Revenue, Blue Sky Values, and Market Caps Hit Unprecedented Highs

A perfect, and unique, combination of market factors - record auto sales and grosses, soaring valuations, waning pandemic crisis and potential new tax laws - fueled acquisition activity to 66 completed transactions in Q1, and an unprecedented 300 completed over the past 12 month period, according to the First Quarter 2021 Blue Sky Report® by Kerrigan Advisors



Car Dealerships Are Facing Consolidation And Change

By KEITH BRADSHAW

DETROIT, Jan. 14 — Auto dealerships are rapidly beginning to issue stock or to be

ECONOMY

Consolidation Sweeps Across Auto Dealerships During Pandemic

ships, the last big auto maker on the scene. "I don't think there's any question you're going to see more dealerships traded or markets," John F. Smith Jr., the chairman and chief executive of General Motors, said in an interview last week. The chains that have issued stock are using part of the proceeds to buy more dealerships, in what could be the early stages of a consolidation of the nation's 21,000 dealerships. Defenders of corporate ownership say

The Changing Landscape (cont'd.)

Three Major Changes in Bargaining Power

1

Increased competition among manufacturers both for retail sales and for good dealers

2

Shift in bargaining power due to increased dealer scale and scope

3

State laws impose substantial “dealer protection” measures

The Changing Landscape (cont'd.)

1965: "Big Three" accounted for more than **90%** of new motor vehicle unit sales in the U.S.; GM alone was close to 50%

2018: "Big Three" accounted for approximately **44%** of unit sales

2020: "Big Three" typically represented between **39% to 40%** of unit sales



The Changing Landscape (cont'd.)

New-Vehicle Sales and Market Share by Manufacturer, June YTD 2021

Ford	GM	Honda	Nissan	Stellantis	Toyota	Volkswagen	Other**	Total
955,609	1,323,360	833,510	583,701	946,294	1,291,879	369,534	1,990,220	8,294,107
11.5%	16.0%	10.0%	7.0%	11.4%	15.6%	4.5%	24.0%	

Source: NADA Data 2021: Midyear Report and Wards Intelligence

The Changing Landscape (cont'd.)

1960: Not a single dealer appeared on Fortune 500 list.

2021:

Company	Fortune 500 Ranking	Revenues (\$M)	US Dealerships
Penske Automotive Group	143	\$20,443.9	183 ¹
Lithia Motors	231	\$13,124.3	264 ²
Group 1 Automotive	286	\$10,851.8	133 ³
Sonic Automotive	308	\$9,767	105 ⁴
Asbury Automotive Group, Inc.	405	\$7,131.8	91 ⁵

¹ Per Penske's website (as of Nov. 4, 2021).

² Per Lithia's website (as of Nov. 4, 2021).

³ Per Group 1's website (as of Nov. 4, 2021).

⁴ Per Sonic's website (as of Nov. 4, 2021).

⁵ Per Ashbury's website (as of Nov. 4, 2021).



Section 2

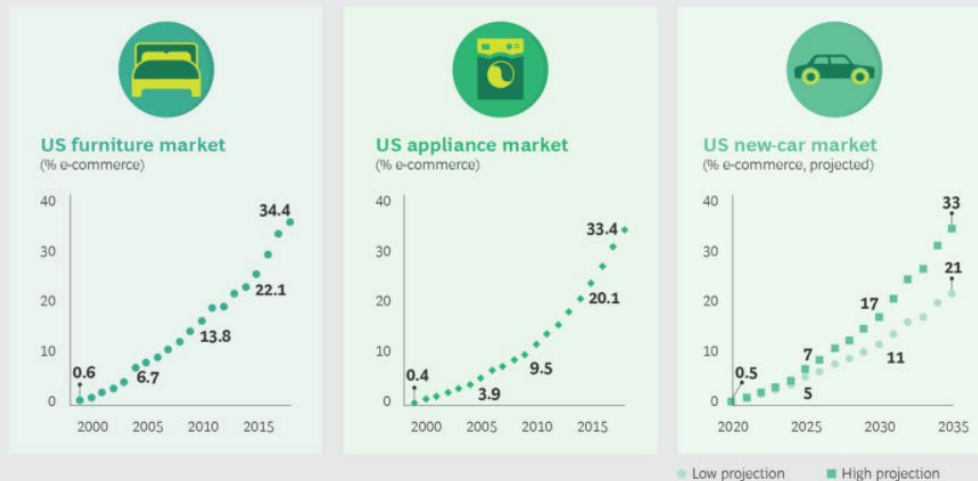
The Internet Age & the Evolving Automotive Buying Climate

Morgan Lewis

Digital Sales Channel – Pipe Dream or Reality?

Shift in consumer preferences over the past decade: in-person → e-commerce

EXHIBIT 1 | The Experience of Other Industries Shows the Growth Potential of Online Auto Sales



Source: US Census Bureau, "Estimated Annual U.S. Retail Trade Sales—Total and E-commerce, 1998-2018," in "Annual Retail Trade Survey: 2018," February 2020.

Note: The low projections assume that growth follows that of the appliance market, dampened owing to the greater complexity and higher price point of car purchases. The high projections assume that growth follows that of the furniture market, accelerated given greater Internet access and overall e-commerce adoption in 2020 versus 1998.

Digital Sales Channel – Pipe Dream or Reality?

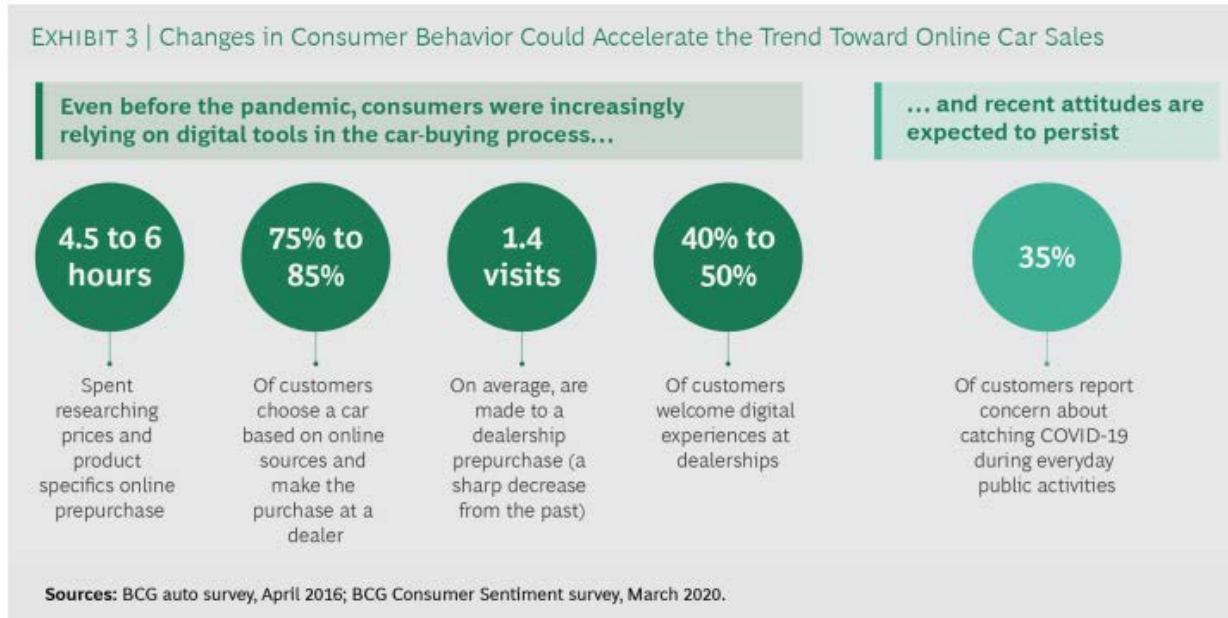
- Digital revolution of used-car retailing – delivery to your driveway
- Leading online buying platform for used cars saw over 100% year-to-year growth from 2014–2018
- Success of online sales for used vehicles validates and supports the transition from physical → digital sales for all vehicles



McKinsey & Company (June 6, 2019)

Digital Sales Channel – Pipe Dream or Reality?

Shift to digital accelerated by COVID-19



Will Consumers Finally Be Able to Buy New Cars Online?, Boston Consulting Group (Sep. 11, 2020), <https://www.bcg.com/publications/2020/impact-of-coronavirus-on-purchasing-new-cars-online>

Digital Sales Channel – Pipe Dream or Reality?

The future is digital!

- OEMs have already started experimenting with digitization of buying process for new cars
 - *Examples:* Virtual showrooms, contactless pickup, Honda “Shop Simple” initiative





Section 3

A Look at Today's Playing Field: Limitations on Direct Sales

Morgan Lewis

Why Do We Keep Buying New Cars at Dealerships?

- Long-established state franchise laws that largely prohibit direct sales by auto manufacturers.
- These restrictions typically take one of two forms (or both in some states):
 - 1. Express prohibitions on direct vehicle sales to consumers**
 - a. “A manufacturer shall not . . . [s]ell any new motor vehicle directly to a retail customer other than through franchised dealers”
Mich. Comp. Laws § 445.1574(1)(i) .
 - 2. Prohibitions on the ability of the manufacturer to operate a vehicle dealership**
 - a. “It shall be unlawful for any franchisor . . . To acquire any interest in any additional motor vehicle dealer in this state”
N.Y. Veh. & Traf. Law § 463(2)(bb).

Why Do We Keep Buying New Cars at Dealerships? (cont'd.)

- A minority of states permit (or do not expressly prohibit) manufacturers from owning a dealership.
 - *E.g.*, California, Florida, Illinois, Massachusetts, Ohio
- However, many of these states limit the right of manufacturers to own a dealership if there is an existing network of franchised dealerships in the state.
 - Fla. Stat. § 320.645(1) (“No . . . manufacturer . . . shall own or operate . . . a motor vehicle dealership in this state for the sale or service of motor vehicles which have been or are offered for sale under a franchise agreement with a motor vehicle dealer in this state.”).

Why Do We Keep Buying New Cars at Dealerships? (cont'd.)

- The protection afforded to dealerships under state franchise law allowed for the growth of large automotive dealership conglomerates.
- Total Vehicles Sold in 2020 in the U.S.:
 - Hyundai – 622,269 vehicles
 - Kia – 586,005 vehicles
 - **Penske Automotive Group, Inc. – 411,906 vehicles**
 - BMW – 278,732 vehicles
 - Audi – 186,625 vehicles

Why Do We Keep Buying New Cars at Dealerships? (cont'd.)

- State franchise laws are applicable to **new** vehicle sales; used car sales are typically not covered by these statutes.
 - Used cars are not subject to the same restrictions as new cars; as a result, consumers have been purchasing used cars online from dealers like Carvana and Vroom for years with a limited number of showrooms.
- Advocates have suggested that the success of online-only dealerships validate the shift in consumer buying preferences from a physical plant to a digital platform.

State Level Dealer Political Power

- Dealers are:
 - source of tax revenue for states.
 - typically owned by and/or employ residents who can vote for and contribute to campaigns of state legislatures.
- More than 90% of dealers in the U.S. belong to NADA.
- Dealers also belong to state and local 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.



Section 4

State Dealer Laws Embed Protections for Dealers with Competition & Consumer Protection Implications

Morgan Lewis

Justification for State Dealer Laws

- Unequal bargaining power between manufacturers and distributors.
- The importance of the industry to the local economy and consumers.
- Prevention of opportunistic conduct by manufacturers.
- Creation of a stable economic system that allowed dealerships to provide services.

Termination of the Franchise Relationship

- The establishment of a franchise relationship between a manufacturer and a dealer vests in the dealer substantial rights against termination.
- Many states permit termination of a dealership franchise solely for cause.
 - *E.g.*, New York, Oregon, Texas
- Other states permit termination without stated cause, but often with required notification periods.
 - *E.g.*, California (60 days); Florida (90 days)

Dealer Termination Litigation

- Dealer terminations (or failure to renew) frequently result in hotly contested and often expensive litigation over “cause” under state law:
 - Inadequate sales performance (Individual v. Comparable dealers)
 - Warranty or other fraud
 - Financial health of the dealer
 - Failure to comply with “reasonable and material” provisions of the dealer agreement
- The ADDICA also provides a cause of action for (1) a termination that is not in good faith, or (2) a dealer who is forced to terminate as a result of coercive tactics.

Dealer Protection Provisions

- Virtually all states have laws designed to protect dealers from alleged abuses by manufacturers.
- These laws vary from state to state, but they typically impose a broad range of restrictions on manufacturers.
- A total of 36 states prohibit discrimination or preferential treatment with respect to the distribution of vehicles among franchised dealerships.



Prohibition Against the Unfair Treatment of Dealers

- “Unfair conduct” conduct includes:
 - Coercion of dealerships to accept vehicles, parts, or other equipment that the dealership has not voluntarily ordered.
 - Requiring a dealership to participate in an advertising campaign.
 - Considering a dealership’s sales performance of new vehicles in determining the dealership’s eligibility to purchase program, certified, or other used vehicles.
 - Coercion of a dealership to undertake improvements to the dealership’s facilities.
 - Granting an additional franchise in the relevant market area of an existing dealership.
 - Unreasonably refusing to assent to a change of control of a dealership.

Prohibition Against the Unfair Treatment of Dealers

- Several states, prohibit manufacturers from inducing dealerships to use the service of an affiliated finance company.
- The prohibition against “unfair” conduct generally extends to affiliates of the manufacturer.



Prohibition Against the Unfair Treatment of Dealers

- Shift to direct-to-consumer sales is causing legal battles between dealers and electric vehicle companies.
 - **March 2021:** a group of Illinois dealers filed a lawsuit against a new entrant and the Illinois Secretary of State
 - **June 2021:** a dealership in Connecticut sued another new entrant
- Challenges to state franchise laws are opening the door for startups to sell directly to consumers in certain states.

Sales Incentive Programs – Restrictions

- In most states, manufacturers must adhere to strict regulation of sales incentive programs and promotions.

A manufacturer shall not offer "incentives, rebates, bonuses, promotional items, or other similar benefits" to a dealer "without making the same offer available to all other new motor vehicle dealers of the same line-make."

- Mich. Comp. Laws § 445.1574(1)(e)(ii)

"A performance standard, sales effectiveness standard, sales objective, or program for measuring dealership performance . . . shall be . . . uniformly applied to other similarly situated motor vehicle dealers."

- South Carolina Code, § 56-15-96

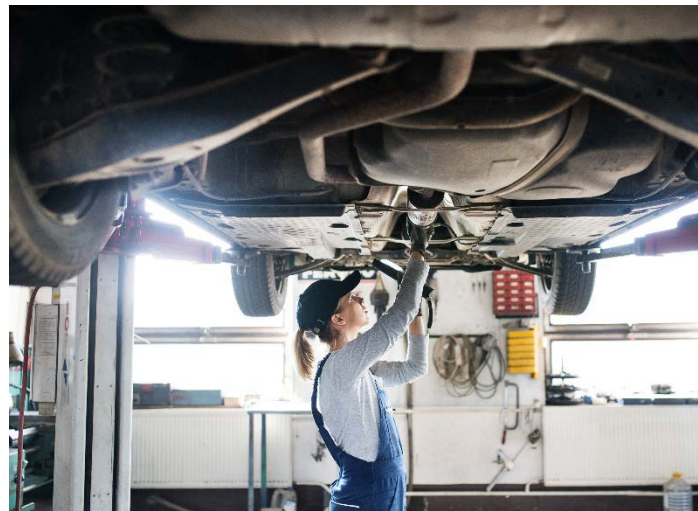
Warranty Reimbursements – Restrictions

- **Warranty reimbursement laws** = statutory obligations imposed on OEMs with respect to reimbursing dealers for warranty repairs.
- In the absence of these laws, OEMs typically reimburse dealers a percentage markup over cost or at MSRP for parts installed in a warranty repair and a markup over the hourly labor costs.



Warranty Reimbursements – Restrictions (cont'd.)

- In over 40 states, dealers are entitled to **reimbursement by manufacturers for warranty work at “retail” rates**.
 - In most states, “retail” is defined as the dealer’s customer “repair” rate
- Approximately 20 states **prohibit** manufacturers from raising prices to recover the increased costs imposed by the retail reimbursement regulation
 - *E.g.*, Fla. Stat. § 320.696; Va. Code Ann. § 46.2-1571; Me. Rev. Stat. Ann. Tit. 10, § 1176



Warranty Reimbursements – Restrictions (cont'd.)

Typically, these statutes:

- Require manufacturers to reimburse dealers for warranty repairs at dealer's retail labor rate *plus* markup on all parts (calculated by dealer)
- Authorize dealers to exclude specials or promotional discounts from calculation
- Outline procedures for manufacturer to rebut dealer's declared reimbursement rate



Section 5

The Road Ahead

Morgan Lewis

The Current State of Purchasing a New Car in the U.S.

- Two millennials walk into a car dealership...



Enter Tesla Motors

- Tesla has successfully sought to engage in direct-to-consumer car sales – largely through lobbying efforts at the state level.
- Tesla's pitch to state legislatures primarily focused on the argument that existing combustion engine dealers are not equipped to sell electric vehicles.
 - This strategy has been successful in several states and Tesla has sold directly to consumers.

Some State Laws Protect Dealers, But Do Not Prohibit Direct Sales

- California: The State does not expressly prohibit manufacturers from making direct sales; instead, it put protections in place for franchised dealerships.
 - Cal. Veh. Code § 11713.3(u)(1): “To unfairly discriminate in favor of a dealership owned or controlled, in whole or in part, by a manufacturer or distributor or an entity that controls or is controlled by the manufacturer or distributor.”

Some Other State Laws Were Amended in Limited Respects

- New Jersey: In 2014, the New Jersey passed a law that provides for zero emission-vehicle manufacturers to engage in direct-sales at up to four locations.
 - N.J.S.A. § 56:10-27.1 – “[A] motor vehicle franchisor licensed . . . on or prior to January 1, 2014, and exclusively manufacturing zero emission vehicles may buy from and sell, offer to sell, or deal to a consumer a zero-emission vehicle, provided that the franchisor owns or operates, directly or indirectly:
 - (1) No more than four places of business in the State; and
 - (2) At least one retail facility for the servicing, including warranty servicing, of zero emission vehicles sold, offered for sale, or otherwise distributed in this State. This facility shall be furnished with all the equipment required to service a zero-emission vehicle.
 - A franchisor shall not be required to establish or operate a place of business at a retail facility for the servicing of zero emission vehicles.”

Texas Is an Anomaly



- Current Texas laws make it illegal to buy a car directly from a manufacturer if the sale occurs in Texas. *See* Tex. Occ. Code § 2301.476; 43 Tex. Admin. Code § 215.261.
- All direct manufacturer sales orders in Texas are taken via the internet or over the phone.
- Texas residents can still buy a car from a manufacturer, but the purchase is handled as an out-of-state transaction and must be completed before the vehicle ships to Texas.
- As of 2020, most of the GOP delegates support direct sales, while Governor Abbott prefers the current system.

The Effect on OEMs

- State legislative efforts now treat OEMs competing in the ever-expanding EV marketplace differently.
- As a result, some OEMs have reconsidered their sales strategies.
- In 2021, Volvo announced that it will automate its buying process.
 - Dealers will largely just offer test drives, and handle service and repairs. Virtually everything else will go online.
 - Volvo dealers will also carry only a “handful of vehicles”

Source: NBC News, *Volvo to Sell All its Cars Online, in Latest Example of How the Pandemic Has Reshaped the Auto Industry*, Mar. 2, 2021, available at:

<https://www.nbcnews.com/business/autos/volvo-sell-all-its-cars-online-latest-example-how-pandemic-n1259337>

The Effect on OEMs (cont'd.)

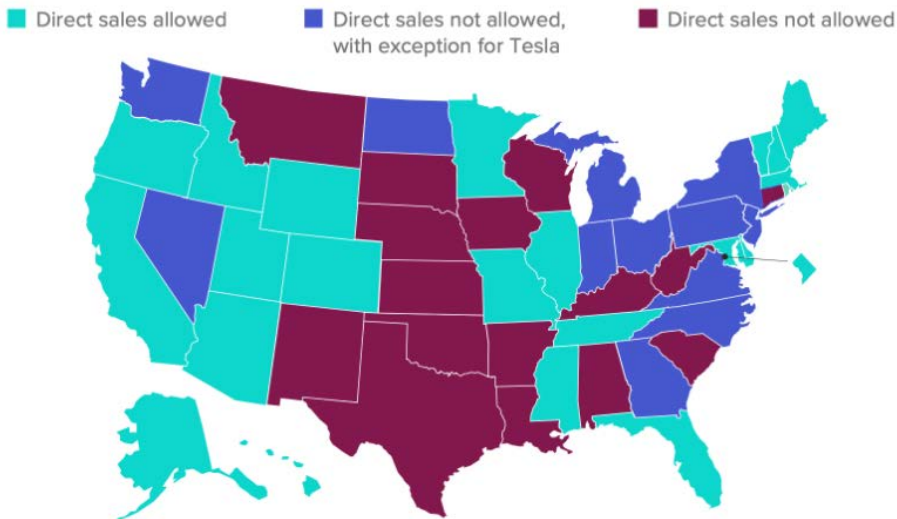
- The unlevel playing field has also motivated dealerships to drop line-makes or vice versa.
- At the conclusion of 2020, 150 General Motors dealerships dropped the Cadillac brand and accepted buyouts.
 - Cadillac required its dealerships to spend \$200,000 on upgrades to install charging stations, repair hardware, and other equipment needed to sell EVs.
 - Dealerships expressed concerns about consumers' demand for EVs in certain parts of the country and determined that the investment was not worth the risk.



Source: The Wall Street Journal, *About 150 U.S. Cadillac Dealers to Exit Brand, Rather Than Sell Electric Cars*, Dec. 4, 2020, available at: <https://www.wsj.com/articles/about-150-u-s-cadillac-dealers-to-exit-brand-rather-than-sell-electric-cars-11607111494>

Shifting Retail Sales Model

- Seeing a shift moving away from the traditional dealership model and towards direct-to-consumer sales.
 - 22 states generally permit some form of direct sales.
 - 11 states have a Tesla-only exemption.
 - Numerous state legislatures are considering bills that would allow direct sales by a variety of OEMs or others.



Source: Morning Consult & Atlas EV Hub via Natural Resources Defense Council
[As EV Startups Enter the Market, They Say Dealerships -- and a Decades-Old Legal Structure -- Stand in Their Way \(morningconsult.com\)](#)

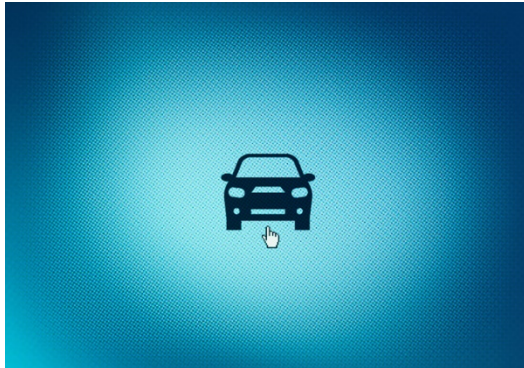
The Road Ahead

- Ideal Scenario: Level the playing field and allowing market entry by manufacturers, without existing franchise networks.
 - Allowing for this type of entry is technically outside of the scope of existing state laws.
- What distribution models will new entrants pursue?
 - How will they continue to impact state franchise laws?
- Will changing consumer preferences impact state franchise laws?
 - Millennials have demonstrated their desire to purchase goods instantly, online.
 - Rise in consumer interest in different and innovative leasing and subscriptions models is impeded by existing regulatory regimes.

The Road Ahead (cont'd.)

- Motor vehicles 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.
 - How will a declining need for consumers to take their motor vehicles to the dealership impact state franchise laws?

Where Do We Go From Here?



Questions?

Brendan Fee, Philadelphia | brendan.fee@morganlewis.com

Daniel S. Savrin, Boston | daniel.savrin@morganlewis.com

Mark J. Fanelli, Philadelphia | mark.fanelli@morganlewis.com

Caiti A. Zeytoonian, Boston | caiti.zeytoonian@morganlewis.com

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

Morgan Lewis

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.



Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington



Morgan Lewis

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU

© 2021 Morgan, Lewis & Bockius LLP
© 2021 Morgan Lewis Stamford LLC
© 2021 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.

Morgan Lewis