NADC
NATIONAL ASSOCIATION OF DEALER COUNSEL

DEFENDER

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In this Issue:

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President's Message

Rob Cohen

Some of you may have noticed that I've taken a short hiatus from writing a president's letter. Yes, I confess that I have passed on writing a letter for the last few issues of *Defender*. But, it was for good reason. I'm very, very busy. Why is this significant? Well, aside from the fact that my kids' college fund is actually growing again, it signifies a renewed interest in compliance.

For those of you who don't know, I am a compliance attorney. Over 90% of my work is compliance related. I don't do litigation; I don't do buy/sells; and I don't do windows (although I was seriously considering doing the latter when things got real ugly last year). My work largely consists of managing my team of 15 compliance auditors, refining and developing our audit methodology, and compliance training and consulting with dealer clients. My business dropped off precipitously over the last two years. Even long-standing clients were canceling our auditing service in order to cut costs. A common theme I heard was "Compliance is a luxury we just can't afford right now."

Fortunately for me (and my kids) it appears that dealers are starting to believe they can afford compliance again. We are signing up new clients and demand for training seminars hasn't been this good since the first time the Red Flags Rule was supposed to take effect (I think that was about 20 years ago). The things I see driving demand for compliance services are (1) a very active plaintiffs' bar here in California, (2) the two new federal notices that are required to be in place by January 1, 2011, and (3) a slight uptick in sales.

Active Plaintiffs' Bar

California is a strange place. The fact that our current governor is called "The Terminator" and our governor-elect is called "Moonbeam" should give you an idea of just how strange it really is. But, from a judicial perspective, our state is fertile ground for plaintiff attorneys looking to make a buck off the back of hard-working dealers. You see, our standard retail installment contracts are 27 ½ inches long. These contracts are not this long because Reynolds and Reynolds wants to kill more trees. The length is due to the fact that we have extensive (and strict) itemization and disclosure requirements.

Our contracts have three "Theft Deterrent Device" lines, two "Surface Protection Product" lines, and five "Service Contract" lines. This is not to mention separate lines for things like our Optional DMV Electronic Filing Fee and our Optional Used Vehicle Contract Cancellation Option Agreement. But wait, it gets worse. We also have to separately itemize our license and registration fees (they are different), tire fees, and smog exemption fees.

Some things to know about these requirements include:

- The license fee is 1.15% of the odd-hundred midpoint of a range of selling prices used by the DMV to establish what the fair market value of a vehicle is.

- Registration fees include things such as transfer fees, CHP fees, reflectorized plate fees, smog abatement fees, weight fees, county fees (which range from $0 to $14 depending upon the county in which you intend to garage your vehicle), and a bunch of other miscellaneous fees.
- The tire fee is $1.75 per new tire sold. For most new vehicles, the fee is $8.75. But, if a car doesn't have a spare tire (i.e., run flat tires), the fee is $7.00. On used cars, the fee just depends on how many new tires you put on the vehicle.
- Notwithstanding the detailed itemization requirements, all goods and services must be consented to by the customer prior to the presentation of the contract.
- All of the agreements with respect to the terms of payment and price of vehicle must be contained in a single document.

So why am I telling you all this? Because each of these issues is (or has been) the subject of several recent class action lawsuits against California dealers. There are a few plaintiff attorneys who have made an absolute killing by suing dealers across the state for technical (and typically unintentional) itemization errors.

Perhaps the most frightening development, though, is the recent appellate court decision of *Nelson v. Pearson Ford Co*. (186 Cal.App.4th 983 (2010)). This case involved a backdated contract. Meaning, a retail installment sale contract (RISC) was rewritten with different terms after the original spot delivery but the rewritten contract bore the date of the original delivery date rather than the subsequent delivery date. As you may recall, this practice was deemed to be a Truth in Lending Act violation in the case of *Rucker v. Sheehy Alexandria, Inc.* (244 F.Supp.2d 618, E.D.Va. (2003)). Unlike in *Rucker*, however, the Nelson case was filed as a class action and the court certified a class of 1,500 consumers. The Nelson court then proceeded to rule that backdating a RISC was not only a violation of TILA, but was also a violation of California's single document rule. This was a devastating blow for the dealer because California law permits rescission as a remedy for violations of the single document rule. If you've followed me this far, you realize that the court effectively ordered rescission of 1,500 deals.

The only silver lining in this case (actually, I think the lining is more dingy gray than silver) is that the dealer will be entitled to an offset for use of the vehicle. But, even so, the potential cost to the dealer is likely in the millions of dollars.

If you represent a client that is considering buying a franchise in California, you may want to warn them that compliance here needs to be taken a bit more seriously than in other states. And, if you represent dealers in California, I cannot overstate the importance of staying on top of all disclosure requirements.

New Federal Notices

I've been doing a lot of training on the new federal rules that take effect January 1, 2011. Beginning next year, dealers should be providing every finance and lease customer with a newly-formatted privacy notice and a "credit score disclosure" (a.k.a. "the exception notice" under the risk based pricing rule). As with most new federal rules, there is a lot of confusion out there. Fortunately for dealers, I don't see a whole lot of exposure under these new rules. Why? Because we are simply talking about two new forms and there is no private right of action for failure to provide either one.

The new privacy notice does have to be customized for the dealership. But, let's be honest. Most dealers are going to want to adopt the most basic version that does not require an opt-out. This form is easily created. Then, the attorney's job is to explain to their client what kind of sharing the dealer can and can't engage in. For dealer groups who want to share creditworthiness information for marketing purposes, it can get a bit more tricky. Nevertheless, I just don't see the FTC cracking down on a dealership group (or any other business for that matter) for failing to properly complete a privacy notice. If the notice was customized based upon the expected sharing practices of the group (and the notice looks like it should), that should be enough to avoid much scrutiny. Personally, I think the FTC will be too busy developing new regulations under their newly granted powers created by the Dodd-Frank Act to worry about whether a privacy notice adequately reflects the information sharing practices of a particular dealership.

With respect to the new credit score disclosure (CSD), I still see attorneys and others providing information about risk-based pricing and the formulas used to determine which customers get the notice. I really wish they would stop. The CSD should really be the only notice dealers should be considering. In fact, I think a dealer would have to be out of his/her bleeping mind to choose to issue risk-based pricing notices rather than the simplified CSD (or "exception") notice.

The credit aggregators will be providing the CSD when scores are pulled. In fact, Dealer Track has already stated they would provide the notice free of charge. Dealer personnel should give a CSD to every credit customer (and ideally maintain a signed or initialed copy) and that's it. Some say that it should be provided to every credit applicant regardless of whether the customer ultimately buys a car (and that's okay too). Either way, compliance

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Supreme Court Shows Continued Support for Arbitration

Feature Article

By Oren Tasini, Haile, Shaw & Pfaffenberger, P.A.

While much of the legal and political world remains hostile to arbitration as a means of dispute resolution, the United States Supreme Court continues to interpret the Federal Arbitration Act broadly in favor of arbitration.

In the Case of Rent-A-Center West, Inc. v. Jackson, 130 S.Ct. 2772 (2010), decided in June 2010, the Court held that the failure of a party to specifically attack the arbitration clause itself, as opposed to an attack on the agreement in its entirety, did not give the Court the right to rule on the issue of enforceability when the arbitration agreement delegated the issue of enforceability to the arbitrator.

The case involved an employment agreement which contained a broad arbitration provision and provided that the resolution of all "controversies" would be by arbitration. In addition, the arbitration clause contained a "delegation" clause, giving to the arbitrator the "exclusive" authority to determine enforceability of the agreement and any claim that all or any part of the Agreement was void. The employee challenged the Motion to Compel Arbitration by the employer, after the employee filed suit in federal court alleging discrimination. The employee asked the district court to deny the employer's Motion to Compel Arbitration on the basis that the entire agreement of the parties was both procedurally and substantively unconscionable. The employee claimed that the entire agreement was procedurally unconscionable because it was imposed as a condition of employment and was non-negotiable. Mr. Jackson argued that it was substantively unconscionable because it was one sided, imposed fee splitting on the parties, and limited discovery.

The Supreme Court quickly dispensed with Jackson's arguments, holding that as a matter of "substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract". Without a direct challenge to the agreement to arbitrate, the Court has no basis to intervene and find the agreement to arbitrate, such an agreement being "valid and irrevocable" save for the basis under the law where contracts can be deemed unenforceable.

What the holding in the Jackson case means, is that under the Federal Arbitration Act, a party must allege that, for example, she was fraudulently induced specifically to sign the arbitration clause, and not generally that she was fraudulently induced to sign the contract in which the arbitration agreement was contained; a tall order for even the most creative plaintiff's lawyer. Given the state court hostility to upholding arbitration clauses and the pending rules likely to come from the Frank Dodd Financial Reform Bill regarding arbitration in consumer cases (which we all assume will prohibit them), it seems advisable to provide for your arbitration agreements to be governed by the Federal Arbitration Act and to provide specifically that the arbitration agreement the arbitrator shall decide all issues related to enforceability. A number of federal and state courts have applied the Jackson case to compel arbitration against unconscionability claims.

Finally, it seems the next battle is going to be whether the new Reform Bill rules on arbitration can supersede the Federal Arbitration Act and the strong Supreme Court rulings favoring enforcing arbitration clauses under the Federal Arbitration Act. A provision that the Federal Arbitration Act applies to your contract, and not the state arbitration act, may help your cause. Stay tuned. ■

Oren Tasini is a Partner of the law firm of Haile, Shaw & Pfaffenberger, P.A. Mr. Tasini is one of the foremost authorities in Automotive Law in the United States, and assists automotive dealerships with legal compliance, regulatory and franchise matters, and in the purchase and sale of automotive franchises.

Can Amendments to Dealer Statutes Be Applied to Existing Agreements?

Feature Article

By Jeffrey Ingram, Galese & Ingram, P.C.

States have had in place for many years laws to protect motor vehicle dealers from arbitrary actions by manufacturers. In most situations, these laws have given dealers strong protections. The bankruptcies of General Motors and Chrysler exposed weaknesses in many of those laws. Those bankruptcies allowed General Motors and Chrysler to take actions against dealers that never could have occurred absent bankruptcy. In response, many states have taken actions to amend their dealer laws to extend additional protection to dealers. The question now is what effect, if any, do those laws have on existing dealer agreements?

Manufacturers have already claimed and will continue to argue that any application of these new laws to existing dealer agreements violates the Contracts Clause of the United States Constitution. The Contracts Clause provides that "No State shall...pass any...Law impairing the Obligation of Contracts." A recent Eleventh Circuit case, *Reliable Tractor, Inc. v. John Deere Constr. & Forestry Co.,* 376 Fed. Appx. 938 (11th Cir. 2010), although not involving motor vehicle manufacturers and dealers does give some comfort to manufacturers by holding that amendments to franchise statutes that substantially impair the franchisor's contract rights cannot be applied to franchise agreements that pre-date the statutory amendment without violating the Contracts Clause. This decision is subject to substantial criticism because the Circuit Court failed to follow its own precedent because it did not conduct a thorough analysis of the statute to determine whether it could be applied to existing agreements.

The genesis of *Reliable Tractor* was the company's execution of two dealer agreements with John Deere. The agreements allowed for no-cause termination. Subsequently, Maryland enacted and then amended the Equipment Dealer Contract Act. The amendment provided that equipment suppliers could not terminate a dealer agreement without good cause. The parties' relationship continued after this amendment. In 2007, John Deere notified Reliable that it was terminating the agreements based on the no-cause provisions. In response, Reliable filed suit for breach of contract and declaratory relief that the termination attempts were unlawful and void under the Maryland law.

The Eleventh Circuit, in an unpublished decision, held that application of the good cause provision to the parties' contracts violated the Contracts Clause of the United States Constitution. The court stated, quoting *General Motors Corp. v. Romein*, 503 U.S. 181, 186 (1992), that "in determining whether a state law violates the Contracts Clause it must ask 'whether there is a contractual relationship, whether a change in law impairs that contractual relationship, and whether the impairment is substantial.'" The Court held that the good cause provision at issue in *Reliable Tractor* was a substantial impairment to an existing contractual relationship and declared its application to be a violation of the Contracts Clause.

What is not clear from the *Reliable Tractor* decision is whether the parties raised and the court considered all factors that the court should have addressed before it declared the statute's application to be unconstitutional. The Supreme Court, in *Romein*, stated that the "substantial impairment" test was simply the "first" question to be answered. The decision in *Romein* court never addressed the remaining portions of the test because the first issue resolved that case, rendering any analysis of the remaining portions of the test unnecessary.

The complete analysis to be applied by courts is set forth in *Vesta Fire Ins. Corp. v. State of Florida*, 141 F.3d 1427 (11th Cir. 1998). *Vesta Fire* dealt with a Florida law passed after the devastation of Hurricane Andrew to prevent a total withdrawal of insurance companies from the residential Florida market. The Moratorium Phaseout required insurance companies to continue existing contracts they otherwise could have ended with a 45 day notice that the company was totally withdrawing from business in Florida. Insurance companies challenged this change to the law arguing that it violated the Constitution.

The Eleventh Circuit applied a three part test to determine if the new law violated the Contracts Clause. The court noted that the Contracts Clause is not absolute, and "its prohibition must be accommodated to the inherent police power of the State 'to safeguard the vital interests of its people.'" In making this accommodation, courts must consider "(1) whether the law substantially impairs a contractual relationship; (2) whether there is a significant and legitimate public purpose for the law; and (3) whether the adjustments of rights and responsibilities of the contracting parties are based upon reasonable conditions and are of an appropriate nature."

The Eleventh Circuit found that the statute did substantially impair the contractual relationships between the insurers and insureds because it forced the insurers to continue in relationships that they otherwise could have terminated. If this holding was sufficient, the *Vesta* court could have, as the *Reliable Tractor* court had, ended its inquiry at that point. Unlike the *Reliable Tractor* court, the *Vesta* court went on to the second portion of the test to determine if the State had "a significant and legitimate public purpose behind the regulation." The court found that the public purpose behind the statute was to protect and stabilize the Florida economy, in particular its real estate market. The court held that this was a legitimate public purpose.

Once it found a legitimate purpose for the regulation, the *Vesta* court looked "to whether the state's adjustments of the rights and responsibilities of the contracting parties [was] based upon reasonable conditions and are of an appropriate nature." Under this portion of the analysis, if the state is not a party to the contract, the Court is to defer to the legislature's judgment as to the necessity and reasonableness of a statute. The Eleventh Circuit then held that the statute did not violate the Commerce Clause even though its was a substantial impairment to existing contracts.

Most amendments to a Motor Vehicle Franchise Act will have a substantial impact on the relationship between manufacturers and dealers. This should not end the analysis. Once the second and third portions of the analysis are completed, a Court should apply statutory amendments to existing dealer agreements because Motor Vehicle Franchise Acts are usually expressly aimed at protecting and stabilizing a substantial business interest in a state, i.e. motor vehicle dealers and because states are not parties to these dealer agreements. Courts should therefore normally defer to the judgments of legislatures.

One illustrative case analyzing the Contracts Clause in the context of dealer agreements and changes to applicable statutes is *Equipment Manufacturer's Inst. v. Janklow*, 300 F.3d 842 (8th Cir. 2001). Although this case resulted in a manufacturer victory, it is still instructive in the proper method of analysis of a Contracts Clause question.

Janklow sets forth the same test as *Vesta Fire*: i.e. the existence of a substantial impairment on a pre-existing contractual relationship, whether the state had a significant and legitimate purpose behind the regulation, and whether the adjustments to that relationship are based on reasonable conditions and are appropriate to the public purpose of the regulation. *Janklow* is notable in its determination of whether there has been a substantial impairment because it states that the Court is to "consider the extent to which the parties' reasonable expectations have been disrupted" and "whether the industry the complaining party has entered has been regulated in the past." The provisions of the statute at issue in *Janklow* were held to be a substantial impairment because they were not reasonably foreseeable. This may also have been important in *Reliable Tractor* because, at the time the parties contracted, there was no statute governing their relationship.

Because the relationship between motor vehicle manufacturers and their dealers has been heavily regulated for decades, it is relatively easy to argue that changes to these statutes are foreseeable. If a dealership can show that a change was reasonably foreseeable, the dealership may be able to show that there is no substantial impairment at all, making it unnecessary for a court to even consider the second and third parts of Contracts Clause test.

Even if a significant impairment is found, courts must then move to the analysis of whether the statute has a significant and legitimate public interest. The regulation must protect a "broad societal interest rather than a narrow class." In *Janklow*, the State did not offer a statement of legislative intent to show the purpose of the Act in question. The State did offer a "post hoc" rationale for protecting rural communities and farmers, which would have been a significant interest, but the evidence offered contradicted this interest. The State did not produce any evidence of the harm to be avoided by passing the Act.

Many motor vehicle franchise acts include a very specific statement of purpose or legislative intent. For example, Alabama's statute provides that because "distribution and sale of motor vehicles within this state vitally affect the general economy of the state and the public interest and the public welfare...it is necessary to regulate motor vehicle manufacturers, distributors, dealers, and their representatives and to regulate the dealings between manufacturers and distributors or wholesalers and their dealers in order to prevent fraud and other abuses upon the citizens of this state and to protect and preserve the investments and properties of the citizens of this state." Statements such as this should help prove that any amendment to a motor vehicle franchise act has a significant and legitimate public purpose.

Finally, if a significant public purpose of the statute is found, the Court will determine if the adjustment of the rights of the contracting parties is appropriate to the public interest to be served. Because the Court in *Janklow* found that the statute at issue was to protect a narrow class of individuals and did not have a legitimate public purpose, it did not consider this final step of the analysis.

In *Alliance of Automobile Manufacturers v. Gwadosky*, 430F.3d 1237 (3rd Cir. 1987), the First Circuit applied the same test as used in *Vesta Fire* and *Janklow.* It is a good example of the application of the third portion of the test. In that case, manufacturers challenged a Maine law that prevented them from adding charges designed to "recoup the costs of their compliance with retail-rate reimbursement laws." The manufacturers claimed that the law violated the Contracts Clause of the Constitution. The Court stated that "when...the State is not a party to a contract, courts ordinarily defer, within broad limits, to the legislature's judgment about the reasonableness and necessity of a particular measure." Because the statute's purpose was to protect consumers and dealers and the legislature tailored the statute to fit that purpose, the Court held that the statute was constitutional.

Gwadowsky is also important because of the strong language used by the Court. The Court stated that because the state had been "heavily regulat[ing] the manufacturer-dealer relationship since 1975" ... "[t]hose franchise agreements were executed with the knowledge and expectation of pervasive state regulation." Thus, no agreements entered into after 1975 were substantially impaired by the new warranty regulations.

The Ninth Circuit also dealt with a similar issue in *Campanelli v. Allstate Life Ins. Co., 322 F.3d 1086 (9th Cir 2003).* In that case, the Court upheld the insurance regulation at issue because "[t]he severity of the impairment is significantly mitigated, however, by the fact that the California Insurance industry is heavily regulated" and the statute in question was passed "to bring needed relief to the victims of the Northridge earthquake." The Court held that this was a legitimate public purpose. Because the Court had to defer to the judgment of the legislature concerning the reasonableness of the measure and because the statute included several important limitations to its application, the Court found the impairments to the insurance contracts to be reasonable.

Dealer agreements have long been a source of litigation, often posing Contracts Clause issues. Despite the aberrant ruling in *Reliable Tractor*, Contracts Clause case law from many circuits and the Supreme Court offer a measure of comfort to existing dealers that they will be afforded the same level of protection as dealers whose agreements are signed following any beneficial amendment to a state's motor vehicle franchise law. ■

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is simple so long as the dealer uses a reputable vendor to generate the CSD.

The above discussions are, of course, oversimplifications but suffice it to say that these new requirements may be generating a lot of unnecessary stress for dealers.

An Uptick In Sales

A general sales manager told me the other day that he believed we are at the bottom of good. I agree. There is a proverbial light at the end of this cold, dark tunnel. But, what's more important than the actual sales numbers improving is the fact that dealer personnel are more optimistic than they have been in quite some time. Historically, optimism has not been a problem for people in our industry, but the bleak economic outlook posited by many pundits has taken its toll on even the most sanguine dealership personnel.

A more positive prognosis for the future can become a self-fulfilling prophecy (particularly in sales). This is why consumer confidence is such an important economic indicator. Who knows? Maybe Governor Moonbeam can generate enough positive energy that even California can avert its own economic apocalypse. Then again, I may be a bit too optimistic. ■

Rob Cohen, Esq., President of Auto Advisory Services, Inc., Tustin, CA, is President of NADC.

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