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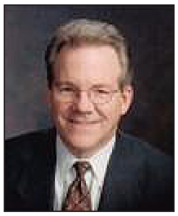
NATIONAL ASSOCIATION OF DEALER COUNSEL

DEFENDER

The National Association of Dealer Counsel Newsletter APRIL 2011



Why Your Dealership Client's Sales Effectiveness Score Should be on Your Radar Screen

By Michael McKean, MBA, AVA, CMAP, President, OCD Consulting, LLC

Under the terms of their Sales and Service Agreements, all dealers are required to be one hundred percent sales effective. Forgetting for a moment that it is impossible for all scores in a data set to be above average, the mathematics of the sales effectiveness score are quite simple; the dealer's actual retail sales are divided by an expected sales number. The expected sales number is derived by applying the manufacturers' segmented market share in a particular geography to the dealer's area of responsibility (AOR). If the result is one hundred percent or higher (as in above average), then the dealer is said to be sales effective and in compliance with his Sales and Service Agreement.

Manufacturers would have you believe this is a straight forward, bullet proof method for measuring a dealer's sales performance. In practice, however, it is not and the system is prone to producing false negatives, meaning the system is capable of assigning low scores to dealers who are actually performing well.

Manufacturers regularly notify dealers of their sales effectiveness scores and of course underperforming dealers receive the usual dunning notices. In the pre-bankruptcy era, except in the most egregious cases, manufacturers would leave it at that. In the post-bankruptcy era however, I believe we will see manufacturers become more aggressive in their actions against poor performing dealers primarily because they have become emboldened by the success of both GM and Chrysler in the arbitration process.

For those dealers who have low sales effectiveness scores there are only two possibilities. Either the dealer is a poor performer, in which case the system worked or the dealer is actually a good performer in which case the system has failed. In the latter instance, whereas in the old days the dealer might just take a pass on the issue, today, I believe it is of the utmost importance that all dealers respond directly and vigorously to any notice or report of poor sales performance.

This of course is where your services become required and why I believe you should be fully aware of your dealership clients' sales effectiveness scores. If the dealer is really underperforming; then work with him to fix his business, but if it truly appears that he is being wrongfully identified as a poor performer, then he needs your help.

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Contact Us:

NADC
1155 15th Street, NW
Suite 500
Washington, DC 20005
Phone: 202-293-1454
Fax: 202-530-0659
www.dealercounsel.com

President's Message

Patricia E.M. Covington
Hudson Cook, LLP
NADC President

Lucky me! I am entering the presidency of NADC at a time when the federal regulatory framework affecting dealers is undergoing tremendous change. With that comes uncertainty and apprehension.

A trade association can play a valuable role in these times; not only by keeping its members abreast of developments, but by impacting the course of events. That's the role the NADC has played in the past—we saw that in the 2009+ manufacturer crisis, point closures and bankruptcies—and the role I expect it to play now, during this intense period of regulatory restructuring.

Even as we are just entering this period of restructuring, the NADC is at the forefront. At our April Annual Meeting, we had Joel Winston, the Federal Trade Commission's Associate Director of the Division of Financial Practices, do a Q&A with me. Mr. Winston heads the FTC's unit that regulates dealers. He answered some pretty pointed questions about how the FTC intends to use its new Dodd-Frank rulemaking power over dealers. He was challenged on how pejorative the questions the FTC published in a recent notice were with respect to dealers; leaving an impression that the FTC had already staked out a negative stance against dealers. Mr. Winston responded that the FTC was indeed neutral on the issues and in fact-finding mode, with no predisposition. He also assured the audience that the FTC was not looking to write regulations based on anecdotal evidence; they want hard facts, empirical data that shows a problem requiring regulation. He also talked about the Roundtables the FTC is holding to understand whether there are unfair or deceptive dealer practices, and if so, the extent of such practices.

We provide a platform to exchange ideas, keep each other informed on developments and strategize about how to best represent the interests of our clients.

And, speaking of the Roundtables, the NADC participated in full force at the first of these, held in Detroit on April 12th. We had no less than seven members participate as panelists, in addition to many others in attendance. We had a fantastic showing! Members ably responded to questions and attacks on dealer practices, and pointed to existing state and federal regulation that would address the alleged misconduct.

These are just a couple of examples of the impact the NADC has and can have. We provide a platform to exchange ideas, keep each other informed on developments and strategize about how to best represent the interests of our clients. We are only able to do this because of the wide breadth of practice areas represented, and members who have deep knowledge and practical experience of the law and the business of dealers.

The crucial ingredient, however, is how generously we share. I am proud and thrilled to become the President of such a group.

So, hooray to us! I encourage members to get involved, if they are not already. NADC conferences are a great opportunity to network and learn what your colleagues are doing. The NADC Listserv provides a ready tool to ask questions and share experiences, and the much improved NADC website is a repository for lots of great information we've shared in the past.

The NADC is now seven years old. I was in that very first meeting when Jonathon Harvey described his vision of an association of lawyers that represent dealers. It is rewarding to see how the NADC has grown from one man's idea to a fully developed and thriving association.

Best to all,

Patty

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Michael Charapp, Editor
mike.charapp@cwattorneys.com

Trudy Boulia, Assistant Editor
tboulia@jpharveylaw.com

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1155 15th Street, NW
Suite 500
Washington, DC 20005
Phone: 202-293-1454
Fax: 202-530-0659
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Buying Dealerships in Tough Times

Part 3: Staying Out of Litigation

By Erin Tenner, TennerJohnson LLP

Feature Article

How many of you can honestly say your clients love paying you loads of money to litigate on their behalf? Would you agree that win or lose, litigation is a losing proposition? I know you make money from it, but do you keep the client coming back or do they leave and say things about you that you wish they wouldn't? If you could keep your clients out of litigation, would that make you more valuable to them? Litigation is a costly proposition. A well drafted purchase agreement will keep your client out of litigation, rather than leading them into it.

What causes litigation? Is it something you have any control over? Economic downturns increase litigation dramatically, and that is something you cannot control. But there are aspects of it that you can control, or at least influence. More often than not, litigation arises out of ambiguities in purchase agreements, which result from taking on more than you can handle, lack of skill, or just plain old laziness. How often have you gone back and read an agreement you drafted for a client and gasped at the mistakes because they already signed it? Do you succumb to pressure from your client to keep costs down, or the pressures of getting all your work done, and forego reading your draft after it is completed to make sure you haven't made mistakes? It is often the mistakes that cause ambiguities. Getting busy is great, but compromising the quality of your work to get it all done or shortcutting to save money will end up costing your client, and you, in the end.

What else causes litigation? Is it warranties and representations? Is it conditions that fail? Is it failure to conduct thorough due diligence? Is it just an unreasonable party? It can be any or all of the above, but there are many ways to deal with these issues to reduce the chances they will land your client in litigation.

At the same time, how do you keep the deal simple enough so your draft agreement does not kill the deal? How can warranties and representations make or break your deal? Where do you draw the line between too much and not enough? Purchase agreements have gotten more complex over the years and longer because attorneys can always think of new things they didn't include in their last agreement. Is it necessary to list every possible thing that could go wrong? When is less more? We have all heard the old adage "keep it simple stupid." Maybe you have even heard some variation of it from your client.

There are ways to draft warranties and representations that are comprehensive, but short and to the point. Which of the paragraph below do you like better, paragraph 1 or paragraph 2?

> Paragraph 1: Seller has no knowledge of any plan by the manufacturer to establish a new point in the Seller's relevant market area. Seller has no knowledge of any plan or intent by the manufacturer to relocate another dealer into the Seller's relevant market area. Seller has no knowledge of any plan or intent by the manufacturer to change the Seller's relevant market area. Seller has no knowledge of any plan or intent by the manufacturer to discontinue any vehicle line make.
>
> Paragraph 2: Seller has no knowledge of any plan or intent by the manufacturer to take any action now, or in the future, that would adversely affect the Buyer after closing.

Which paragraph would you be more likely to use? Not only is the Paragraph 2 shorter, it covers more.

What about conditions to closing? How do you create conditions to closing without giving the opposing party the right to walk at a whim? How do you make sure your conditions do not create an illusory agreement? One condition that is often a bone of contention, at least in California, is a warranty and representation that the buyer will have obtained a license to operate the new point from the Department of Motor Vehicles ("DMV") prior to Closing. This condition not only gives the Buyer an absolute out, since they can come up with any number of reasons why they didn't get the license, but it can also have the effect of creating an illusory agreement because the DMV will not issue a new dealer license without an OL-124 and the factory usually will not typically issue an OL-124 until after the deal has closed. It isn't necessary to include a condition for obtaining DMV approval in the purchase agreement. All that is needed is a condition providing that the Buyer does not know of any reason, outside of the Buyer's control, why the Buyer would not be able to obtain any licenses or permits it may need to operate the business after closing. This, coupled with a few warranties and representations regarding the Buyer's qualifications to be a dealer, will not only prevent the problem of an illusory agreement, it will protect the Seller from the Buyer using failure to get a DMV license as an excuse to walk. The Buyer can usually obtain a temporary license prior to Closing, pending receipt of the OL-124 so the Buyer will know prior to Closing if there are going to be any problems. Similar situations can exist with all kinds of conditions. Our job as lawyers is to provide the client with the maximum protection possible, preventing the buyer or seller, depending on who we are representing, from being able to walk while at the same time not killing the deal with unreasonable demands.

One of the conditions to closing that will always have to provide the buyer with some latitude is buyer's right to due diligence. However, due diligence rights can and should be spelled out, so the seller knows exactly what to expect and so the buyer does not use the due diligence condition as an absolute out. The buyer should be required to share findings and reports with the seller, especially if the buyer is going to use one of those findings or reports as the basis for terminating the deal. Clear parameters need to be set forth in the agreement so that if the buyer does decide to walk based on a finding in its due diligence, the seller has the right to address the concern and proceed to closing. Without this kind of clarity the parties can easily get into a dispute over what the rights of the seller and buyer are if the buyer elects to walk based on its due diligence.

The purchase agreement also needs to provide protections for a buyer and seller for discoveries made during due diligence. An experienced transactional attorney will know how to provide consequences to the buyer for walking based on a whim, something buyer's often think they can do, by attributing their change of heart to any failed condition, whether the condition actually failed or not. A well drafted purchase agreement will not only prevent this kind of folly, but will prevent the litigation that will arise out of it, by making clear to the purchaser that their decision to walk must be based on well documented evidence of a failed condition that is not within the control of the buyer. The same holds true for seller's conditions.

Drafting can be an art. Have you ever had a client call you with a problem after closing and been able to make one phone call to make the problem go away? That is the way it should be. Keeping your client out of litigation should be a priority. Right? You know you have done a good job drafting an agreement when opposing counsel makes an argument at closing that you can shoot down by pointing to one sentence in your agreement. ***What causes litigation? You tell me.*** ■

Erin K. Tenner is a partner at TennerJohnson LLP and a member of NADC. She has handled hundreds of buy/sell transactions for auto dealers. In addition to her transactional practice she has also served as a private mediator and expert witness. She can be reached at 818-707-8410 or toll free at 888-501-0040.

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Are Your Clients Prepared for an IRS Audit?

TAX TIP Part II

With proper planning and a clear understanding of what to expect, your client can emerge relatively unscathed.

By Andrew J. Weill, Benjamin, Weil & Mazer

Last time we looked at some astounding statistics surrounding the increased audit potential for our clients. We talked about having an internal audit plan, useful resources to consult, and understanding the audit notice. We continue now by looking at basic guidelines on preparing for, conducting, and appealing the results of an audit. While no guidance can guarantee a favorable outcome, these guidelines can minimize the problems and risks associated with an audit.

4. Preparing for the Audit.

Decide who will handle the audit. The correct answer usually is: anyone but the client. The client cannot be expected to understand how to respond to IRS requests to be sure that they stay within limits. All too often, the client brings the agent some papers in a misguided effort to be helpful, only to find that the IRS response is to widen the audit. A representative acts as a buffer between the IRS and your client, since the rep can more easily remain detached, levelheaded and stick to the facts and issues. Ideally, a tax attorney or CPA well versed in dealing with the IRS should act as the sole interface with the IRS. A non-attorney can also do the job, as long as the representative is unflappable, familiar with the tax return in question, can speak to the issues in its preparation and filing, and is grounded in the audit basics. However, if at any time things are not going well or there is an indication of fraud, the representative can and should demand a recess to consult a tax attorney.

Get Acquainted with the Return Under Review. After you and your client have decided who will handle the audit, that representative should get a thorough understanding of the contents of the return in question, paying close attention to records that would support the items questioned by the IRS. The goal is to be prepared to the extent that relevant questions can be honestly and succinctly answered. If your client is involved in a field audit, consider hiring a tax professional (such as a CPA experienced in audits) to conduct a pre-audit review of all books and records to identify tax compliance issues and other areas of exposure.

Organize Your Client's Documents. The examination process can proceed more smoothly if documents and records are gathered and organized before any interviews. Always make copies of the requested documentation. Do not relinquish original documents. If any requested documents are missing, your clients are allowed and encouraged to reconstruct them before the audit (i.e., contact bank and credit card companies to get copies of statements or receipts). Never mail copies of, or bring to an office audit, or have on the premises during a field audit, any documents that do not pertain to the specific year under audit or that were not specifically requested by the audit notice. This is a surefire way to expand the audit into other tax years. Lastly, keep track of all correspondences from the IRS and always keep an exact copy of any documents your clients produce.

Request the IRS File. Consider requesting any information or documents accumulated by the agent during the pre-audit investigation. This information could help you assess the basis for the audit, as well as help prepare your client's defense.

Request a Transfer of Location. Because the average adjustment for a field audit is $17,000, compared to the $4,000 average for office audits, it is in your client's best interest to keep the IRS from holding the audit at the dealership. Field audits will generally be conducted where the books and records are located, but a request to transfer the audit to another location will be considered (see Treasury Regulation 301.7605-1(e)). Try offering to bring all books and records to the IRS office or to an agreeable offsite location like your firm's conference room. Prepare Others. If the audit occurs on your client's premises, instruct all employees not to talk about the business or the audit with the IRS agent, unless told otherwise. Inquiries from the IRS agent should be referred strictly to you (or to whomever was designated to handle the audit).

5. Conducting the Audit.

Slowing Down an Audit. More than likely your client's audit notice will be dated somewhere between 12 and 18 months after he or she filed the return, because the Internal Revenue Manual directs auditors to complete audits within 28 months of when the return was filed. Keep in mind that the IRS must not only begin an audit but must also complete the audit within three years of the filing date (assuming your clients are not being accused of understating their income by 25% or more or of fraud). With this in mind, you can see how slowing down the audit process may work in your client's favor. Request more time whenever your client needs it, perhaps to get records in order or for any other business reason.

Office Audit Etiquette. During the office audit, stay calm and try to keep casual conversation to a minimum. This is especially important if your client is handling or is present during the audit. Only bring the requested documentation and do not leave the originals with the IRS.

Field Audit Etiquette. If the location cannot be transferred to the IRS's office, determine which of your client's facilities the examining agent(s) will use during the audit. Make sure agents have adequate space without giving them unrestricted access to other records, your client or the client's employees. In this situation, it is best to establish a working relationship with the auditor early, in an effort to get them out of your client's space as soon as possible. To this end, determine the agenda, timeline and which employees will need to participate in the audit, if any. Remember that inquiries from the IRS agent should be referred only to you (or to whomever was designated to handle the audit).Avoiding Common Audit Mistakes. (1) Do not allow unrestricted access to information during any type of audit, but especially during a field audit. (2) If computer-based records are requested (i.e., QuickBooks backup files), make sure the files do not contain data for tax years outside of that being audited, or any other valuable and confidential business information. (3) Prior to allowing the IRS to interview your client, consider asking why an interview is necessary or consider going in his/her place, since initial interviews are not mandatory under current policy. I usually decline to produce the client, and I tell the IRS that's because I can provide accurate responses to their inquiries much faster than any client interview. (4) While a little negotiation never hurts, negotiating and bickering over every aspect of the audit should be avoided. (5) Always inquire whether interest or penalties can be abated or waived.Closing the Audit. Never allow your client to sign anything before you or his/her representative have had a chance to review it. Signing certain documents, such as Form 4549, could forfeit your client's right to an appeal. Your clients should not feel pressured to accept the auditor's findings, because they are well within their rights to request more time to review any proposed changes for discrepancies or questionable issues.

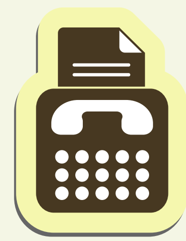
6. Appealing the Results.

If your clients have been prepared and grounded in these audit basics, hopefully they have emerged relatively unscathed from the audit. If, on the other hand, a client is unable to live with results, you should discuss with your client whether an appeal is necessary. But before considering such measures, decide whether you should set up a meeting with the auditor or the auditor's manager to see if a compromise can be reached. If an appeal is necessary, consider working with a tax attorney to determine the best approach. If your client lodges an appeal with the IRS appeals division, the appeals officer will likely consider factors such as the time and expense of trying your case in court. Because of this, your client may have leverage to reach a favorable settlement agreement. If this is not possible, and your client still disagrees with the decision of the appeals officer, he or she may file a petition to the U.S. Tax Court. As an alternative, your client can pay the amount of tax due and file a suit for refund with either the U.S. District Court or the U.S. Claims Court.The foregoing is of course just a general guide. Hopefully it has given you enough background to help your client understand the nature of a typical audit and to consider his or her state of preparedness. Intelligent foresight can make the difference between a mildly annoying audit and a devastating one. ■

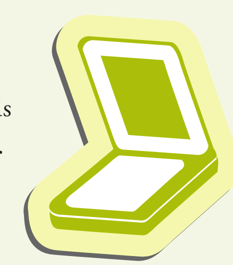
Andrew J. Weill is a Principal of Benjamin, Weill & Mazer, APC, in San Francisco. His practice includes complex business tax and estate disputes across the nation. He is Treasurer of the NADC Board of Directors.

Information Safeguards Sometimes Overlooked

You have worked hard with your dealer clients to address their customers' concerns about protection of their private information. They have put in place safeguards to protect that information as required by federal law, and they notify customers of the policy through a privacy notice. They have locked file rooms, locked F&I offices, and put in any number of physical and electronic protections have against information breaches. But here are some things they may have overlooked.



- **Equipment with a memory.** Hopefully, when your client disposes of a computer it takes steps to reformat the hard drive to wipe out all information. However, today's copiers, faxes, printers, and scanners keep an electronic copy of any documents one is processing through them in an internal memory. Unless one wipes out that memory when it trades in the equipment, sends it to the dump, or gives it to the local school, pages and pages of material containing confidential information will still be in the machine. Before disposing of electronic equipment with memory, a dealer must make sure to wipe the equipment clear of any stored information. It should discuss this with the vendor selling the replacement equipment to make sure that you get it right.



- **Portable Devices.** You have counseled your client to have safeguards on its computer system. It protects against external and internal intrusions. It has

Continued on next page.

adopted a password protocol, and it makes sure that employees only have access to customer files for the purposes of doing their jobs. However, to what types of devices can employees with access download the information? If they can download it to portable PCs, workpads, and smartphones, it may wind up with some substantial confidential information on these personnel devices. What happens if an employee terminates with this information? What happens if an employee loses his or her PC, workpad, or smartphone? Make sure that your client controls the ability to download to personal devices.

- **Invoices and Deal Documents.** Dealers want salespeople to follow up with customers to whom they sell vehicles. So they give them "invoices" or other deal documents to keep track. Is the employee keeping those documents under lock and key to protect them? And what happens to them when the employee leaves? The company's deal documents belong to the company. A dealer should be sure that deal documents are safeguarded by the company's system and that they are not in the personal files of salespeople. ■

Why Your Dealership Client's Sales Effectiveness Score Should be on Your Radar Screen

Continued from page 1.

Here are just three of the many pitfalls that can be found when trying to measure sales performance.

(1) A dealer's AOR is a collection of census tracts that are more proximate to his location than his facing same make competitors; the assumption being distance equates to convenience. But there are many other facets of convenience this system cannot account for and there are numerous reasons why a person living close to one dealership may travel to a different location to purchase a new car.

(2) The system does not account for differences in demographics between the dealer's AOR and the comparative geography. Manufacturers claim segmentation analysis accounts for all differences in demographics but this simply is not true. Boston Metro GMC dealers perform only forty percent as well as their rural Massachusetts brethren because Yukons just don't work that well in downtown Boston. When compared to the state average, a Boston GMC dealer had a sales effectiveness score of only seventy percent. When compared to just the Boston Metro area however his score was above one hundred and fifty percent, nevertheless, GM sought to terminate him in the bankruptcy.

(3) The system is incapable of discerning socio-economic differences between the dealer's AOR and the comparative geography. An import dealer in Montgomery, Alabama is being threatened with an add point in his market because when compared to the Southeast Region he is just ninety-three percent effective. It so happens that Hyundai Motor Manufacturing has a huge assembly plant in Montgomery, and Kia, a division of Hyundai has an even larger facility just across the border in Georgia. It is no wonder that the Hyundai dealer in this market when compared to the Southeast Region is two hundred percent effective. But when you take Hyundai out of both sides of the equation the threatened dealer is one hundred percent effective meaning there is not an economic need for another dealer in this market. When the manufacturer reps are presented with these facts they just shrug and say "we'll see you in court."

In the battle between manufacturers' demands and dealers' rights, I believe dealers are losing ground. Here is an area however where dealers can and should fight back. The systems used by manufacturers to measure sales performance can be arbitrary and irrational. If every dealer who is wrongfully pegged as a poor performer proactively and with your assistance raises convincing objections then perhaps manufacturers will be compelled adopt performance metrics that are more thoughtful and fair. In doing so, you and your client will be providing an important service to automobile dealers everywhere. ■

Michael McKean is a lifelong participant and observer of the retail automotive business. He is the President and founder of OCD Consulting, a joint venture partner of O'Connor and Drew, CPA's.

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Questions:

Erin K. Hussey
email: ehussey@dealercounsel.com

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