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DEFENDER

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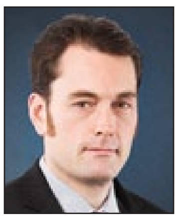
Stop the Bleeding: Challenging The Manufacturers' Control of Dealers Through Incentives

By James Westerlind and Michael McMahan, *Arent Fox LLP*


Westerlind


McMahan

Audi has its "Margin and Bonus Program." BMW calls theirs the "Added Value Program." Maserati landed on the "Commercial Bonus Policy." Whatever you call it, virtually every major car manufacturer has instituted an incentive program that ties substantial profit margin on new car sales to the attainment of a litany of artificially-created standards and goals. Not true "bonuses," these programs often replace regular trading margin and holdback that dealers once enjoyed automatically. The consequences are clear: meet the manufacturer's demands or lose up to several thousand dollars of profit per car. Meeting those demands, however, may be just as costly, as manufacturers require multi-million dollar investments in new facilities, set often unobtainable sales goals, or insist upon the purchase of unneeded parts or the buyback of off-lease vehicles. Dealers face an impossible choice—lose money if you comply or lose even more money if you don't.

Thankfully, dealers have a third option—fight. These incentive programs can be (and are being) challenged in both state administrative proceedings and federal court. Particular prongs of these incentive programs violate several provisions of state dealer acts, and dealers can (and should) challenge those prongs. As a recent New York administrative decision, [*Wide World of Cars, LLC d/b/a Wide World Maserati v. Maserati North America, Inc.*, Case No. FMD 2017-03], demonstrates, dealers have begun to find success challenging the manufacturers' paradigm shift to incentive programs as the way to coerce their dealers. Many state dealer acts, such as New York's and Florida's, contain a modification provision that prevents a manufacturer from undertaking any "change or replacement of any franchise" that may "substantially and adversely affect the new motor vehicle dealer's rights, obligations, investment or return on investment," unless the manufacturer is acting in "good faith" and with "good cause." N.Y. Veh. & Traf. Law § 463(2)(ff); *see also* Fla. Stat. Ann. § 320.641. While proving that a manufacturer acted in bad faith

Disclaimer: The *Defender* articles do not constitute legal advice and are not independently verified. Any opinions or statements contained in articles do not reflect the views of NADC. Cases cited in articles should be researched and analyzed before use.

and without good cause will be a fact-specific inquiry, the initial battle is to demonstrate that the incentive program itself is indeed a modification of the franchise. And dealers are gaining ground.

I. *Wide World* – Incentive Program Changes Are Franchise Modifications

In *Wide World* (and its companion cases), three New York Maserati dealerships challenged Maserati's rollout of its new Commercial Bonus Policy, the first incentive program that Maserati had ever instituted. Until January 2017 Maserati had a traditional relationship with its dealers, in that it wholesaled vehicles to its dealer network, and the dealers sold those cars at retail. Other than some minor housekeeping items to qualify, Maserati dealers would receive for the sale of, by example, the Ghibli, a 9% trading margin and 4% holdback (based on MSRP) that would be paid on a per new car sale basis with no strings attached.

But Maserati recently decided to implement an incentive program that would drastically change the margin structure and put onerous conditions on a substantial portion of Maserati dealers' income. Maserati took 2% away from trading margin and 2% away from holdback, and put these monies into a new incentive program worth up to a total of only 3.5% (with the remaining 0.5% being put into an "advertising fund" controlled entirely by Maserati). The incentive program has many hoops for Maserati dealers to jump through to earn back what they had been receiving (and planning to receive in connection with their business models) for the past twelve years without any costly obligations. These hoops would include, among other things, image and facility requirements, customer service targets, used car sales targets, part sales targets, and more – many requirements that the state dealer acts prohibit Maserati from imposing directly. Under the guise of an "incentive" program, it would be very expensive for the Maserati dealers to comply with the new program, in order to qualify for money that they used to enjoy (and planned to receive) automatically.

Three Maserati dealerships petitioned the New York Department of Motor Vehicles to protest the modification of their franchises by the new Commercial Bonus Policy. The dealers argued that the changes went to the fundamental heart of the relationship between dealer and manufacturer, and would adversely affect them for years to come. In granting the dealers' motion for partial summary judgment, the Administrative Law Judge (ALJ) agreed:

> Do the changes in the "holdback" and the Bonus Program have the potential to significantly impact [Wide World's] franchise agreement? [Wide World's] loss of the present assured 4% "holdback" for the 2% "holdback" and subjective Bonus Program by reducing their present long standing expected margin both as to the amount received from MNA and also due to the increased administrative cost to administer the Bonus Program, effectively and significantly impacts its return on investment and as such is a modification of its present franchise agreement.

8/1/17 Findings and Disposition, at 6.

Importantly, because the new Commercial Bonus Policy is deemed a "modification," the ALJ noted that it is subject to the automatic stay provided under the New York Dealer Act, N.Y. Veh. & Traf. Law § 463(2)(ff)(3). The fairness hearing is set for late October, to determine the remaining issues of whether Maserati had "good faith" and "good cause" in making these modifications.

II. *Beck Chevrolet* – Still Expanding Its Reach Over A Year Later

Wide World was expressly informed, in part, by the New York Court of Appeals' decision in *Beck Chevrolet*,[1] which continues to affect a sea change in the industry for manufacturers, dealers, and legislatures across the country. While the *Beck* decision is most notable for its holding that a manufacturer must use a fair sales metric in assessing its dealers (including the consideration of local market conditions that each dealer faces), the court in *Beck* also separately held in that "a modification is not limited to a change in the franchise contract because other documents may be constituent parts of the parties' written agreement." 27 N.Y.3d at 395. Moreover, under the New York Dealer Act, a manufacturer is expressly forbidden from attempting to contract its way out of those statutory restrictions; otherwise "a franchisor with superior bargaining power could easily circumvent the purpose of the Dealer Act by reserving the right to change franchise terms at will, even where a change results in significant adverse effects on the dealer." *Id*. at 395-96. This rationale underpins a finding that incentive programs fall under the franchise relationship, and, accordingly, unilateral changes to those programs by a manufacturer constitute modifications to the franchise that may be challenged by the dealer, requiring the manufacturer to then prove that the change was implemented in good faith and for good cause.

The RSI portion of the *Beck* decision is also useful in challenging the manufacturers' new incentive programs, to the extent that the new incentive programs are premised upon unfair sales performance standards, such as segment-adjusted state or regional market share. For instance, in *CMS Volkswagen*,[2] the New York federal district court granted Volkswagen's motion to dismiss a price discrimination claim regarding its Variable Bonus Program, which offered bonus payouts to the dealers only if dealers they achieved their sales objectives—objectives that were created by Volkswagen and based upon segment-adjusted regional market share. Citing the *Beck* decision, the Second Circuit vacated and remanded the district court's dismissal, which relied upon the "statutory interpretation and conclusions" of the district court opinion that had been reversed in *Beck*. To the extent that segment-adjusted regional market share continues to be a part of manufacturer sales metrics for its dealers (even in the context of incentive programs), *Beck* will continue to be useful in keeping the manufacturers in check.

III. *Beck* As Statute – State Legislators Expanding Dealers' Rights

The *Beck Chevrolet* holding has also been codified in certain states over the past year.[3] For example, the Florida legislature recently enacted. Florida Statute § 320.64(41),[4] which prohibits manufacturers from establishing, implementing, or enforcing criteria "for measuring sales or service performance of any of its franchised motor vehicle dealers in this state which have a material or adverse effect on any motor vehicle dealer," and which (1) "are unfair, unreasonable, arbitrary, or inequitable," or (2) "do not include all relevant and material local and regional criteria, data, and facts." In essence, this statue codifies the prohibition against the use of segment-adjusted regional market share to measure dealer sales performance, as held in *Beck*—but it also goes further. Florida's *Beck* statute applies to service performance as well, and to any other manner in which either performance is measured—which arguably includes any measures utilized by manufacturers in administering their incentive programs.

Indeed, Maryland likewise codified the holding of *Beck*, and made the application of *Beck* to incentive programs explicit. Earlier this year, the Maryland legislature passed an amendment to its dealer act, taking effect on October 1, 2017,[5] to expand the definition of "coercion" to include the loss of incentives. The Maryland act now also requires that any assigned market area or "performance standard, sales objective, or program for measuring dealership performance that may have a material effect on a dealer, including the dealer's right to a benefit or payment under any incentive or reimbursement program, and the application of that standard" be "fair, reasonable, and equitable." They must also include "considerations of the demographic

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characteristics and consumer preferences of the population in the dealer's assigned market area," including car and truck preferences of consumers, and "geographic characteristics, such as natural boundaries, round conditions, and terrain, that affect car and truck shopping patterns." Maryland's *Beck* statute, therefore, expressly recognizes that manufacturer incentive programs are not "voluntary" for a dealer, and that the threatened loss of the profit margin from incentive programs can constitute "coercion."

IV. Conclusion

The dealer law battle of the 20th century was private coercion, behind closed doors, where a manufacturer would force a dealer to accept unwanted inventory, to acquiesce to an add point next door, or any other abusive aim. The dealer law battle of the 21st century is manufacturer incentive programs, where the manufacturers strong-arm their dealers in broad daylight, under the guise of standards and regulations, in an effort to accomplish what the dealer acts were designed to prohibit. Unless and until manufacturers resume treating their franchised dealers as partners, and not subordinates, these battles will continue for the foreseeable future. Considering the razor thin profit margins that many dealers face, dealers will have no choice but to fight the manufacturers with respect to their coercive incentive programs, just to remain profitable. ■

References

1. *Beck Chevrolet Co., Inc. v. Gen. Motors LLC*, 27 N.Y.3d 379 (2016), *reargument denied*, 27 N.Y.3d 1187 (2016).
2. *CMS Volkswagen Holdings, LLC v. Volkswagen Grp. of Am., Inc.*, 669 Fed. Appx. 602, 603 (2d Cir. 2016).
3. In addition to Florida and Maryland, discussed herein, Illinois, Montana, and Ohio have also enacted statutes codifying *Beck*. *See* Il. St. Ch. 815, § 710/12(d)(9); Mont. Code Ann. § 61-4-207(1)(a); Ohio Rev. Code Ann. § 4517.55(C), § 4517.01(MM), & § 4517.59(d).
4. This refers to the provision added by 2017 Fla. Sess. Law Serv. Ch. 2017-187; it appears that two separate subpart (41)s were added roughly simultaneously (*see* 2017 Fla. Sess. Law Serv. Ch. 2017-141). We believe that the numbering will be rectified in the future.
5. *See* 2017 Maryland Laws Ch. 560 (H.B. 1120).

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President's Message

Andy Weill
Weill & Mazer
NADC President

I will use this space frequently to call attention to some of the ways NADC members have well served the organization and our various practices. This time, I would like to single out the Hudson Cook firm.

There are so many ways that I almost take them for granted. Like all of us, I get *Spot Delivery*® each month. And even though I don't practice in all of the areas discussed, I generally read the whole darn thing. The articles are so clearly written, with practical perspectives, that I always find something to learn. (The August 2017 issue contains indispensable information about the CFPB's new arbitration rule.) Moreover, there is a special art to making a discussion of a legal case interesting and engaging, and *Spot Delivery*® is a role model in that regard. It has become such an expected pleasure that at times, I forget to stop and say a simple "Thanks" for everyone who makes it happen.

As an attorney with a practice focused largely on F&I tax/regulatory matters, I don't always get into the trenches with other areas of law that other dealer counsel see regularly. But these questions come up in my practice, and I often need to have an easy reference to basic concepts in TILA, Fair Credit Reporting, deceptive advertising, etc. Fortunately, within easy reach I have the volumes of CarLaw, which combines the virtue of being interesting without any sacrifice of clarity.

Hudson Cook has provided numerous speakers for our conferences and authors for our articles. They also generously sponsor various events at our conferences. They are role models of a commitment to the notion that the generous sharing of their expertise elevates everyone's practice, to the benefit of all.

It has also been my pleasure to work with Tom Hudson for many years while he was Secretary of NADC and with Patty Covington when she served as President (and other offices prior). Both of them were tireless and meticulous, and consistently gracious under all circumstances.

From time to time, a question would arise and I would think to myself, "I bet someone at Hudson Cook knows this." And not only would I be right – I always found someone willing to give me a hand. Often, they had to give me a brief beginner course to get me up to speed on an unfamiliar concept.

I have been fortunate enough to see these qualities of dedication, professionalism, and generosity of spirit in so many NADC members, and it gives me great pleasure to salute Hudson Cook for all they have done for our organization. I'm a better lawyer for my clients thanks to you, and I'm not alone. ■

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Will the Recent *Avrahami* Tax Court Decision Have an Impact on Auto Dealer F&I Reinsurance Programs?

By Andrew J. Weill and Phyllis E. Simon, *Weill & Mazer, APC*

Tax professionals who work with dealers have been anticipating the Tax Court's decision in *Avrahami v. Commissioner* (149 T.C. No. 7), issued August 21, 2017. The case involves the use of an insurance company under federal tax law that qualifies to elect to be taxed only on investment income under Internal Revenue Code §831(b). These structures have been under increasing IRS scrutiny in recent years. While the adverse taxpayer result in *Avrahami* is specific to facts that are quite distinguishable from the typical car dealer F&I reinsurance structure, the decision holds important lessons for attorneys advising dealers in such programs. As the Court states, the *Avrahami* decision was a case of first impression, because there are no other cases that address microcaptives and the interplay among §§162 [tax deductions], 831(b) [tax on only investment income of non-life insurance companies], and 953(d) [election by foreign controlled corporation to be treated as a domestic corporation].

Summary of the Decision

The Avrahamis owned three shopping centers and three thriving jewelry stores. In earlier tax years, the taxpayers had spent approximately $150,000 insuring these businesses. The taxpayers' CPA suggested that a captive insurance company might be a good fit, so they then formed a company (Feedback) in St. Kitts. Feedback made the elections under §953(d) and §831(b). Feedback issued policies only to Avrahami businesses. Feedback also entered into a cross-insurance program to reinsure terrorism insurance for other small captive insurers through a very limited risk-distribution pool. All of the Avrahami entities made no changes to their existing commercial carrier coverage.

The Tax Court found numerous problems with the pricing of the policies. The actuary was unable to support, using actuarial theory, the pricing of the Avrahami policies. Instead, the actuary was trying to meet a "target" amount each year, which just happened to be the maximum amount allowable under §831(b).

The Tax Court was unimpressed by the terrorism risk pooling arrangement, noting that the policy excluded acts of terrorism "occurring in a city with more than 1.5 million residents" and the term "city" was not defined in the policy. The Tax Court noted that the policies charged all participants the same amount, regardless of location. Moreover, there were too few entities to result in adequate risk pooling. Ultimately, the Tax Court found that exorbitant premiums were being charged for coverage with very low probability of being triggered.

These and other factors resulted in an adverse determination for the taxpayers on virtually all issues.

Implications for the Auto Dealer Advisor

At first, some advisors were worried about the impact of *Avrahami.* After all, dealership F&I reinsurance programs often feature companies that make elections under §§953(d) and 831(b). Those resemblances, however, are superficial. Important distinctions between the *Avrahami* facts and the typical dealership F&I structure include:

- **Different Industry.** As noted, the taxpayers were not automotive dealers; they were in the retail jewelry business.
- **No Insurance of Third Party Risks.** Although the taxpayers tried to argue that their captive insurance company did insure some third party risk, the court ruled against them. Unlike car dealers, the arrangements in the *Avrahami* case did not involve consumer risks, such as vehicle protection risks.
- **Purely Tax Motivated; Premiums Unjustifiable.** The premiums were calculated for the purpose of taking the maximum deduction under 831(b); the actuary could not justify the calculations as proper premiums.
- **Exotic Insurance.** The major premium was for a "terrorism" policy that excluded acts of terrorism in cities with more than 1.5 million residents. The terrorism policy did not appear to be priced like typical insurance, because all policyholders were charged the same premium, regardless of location.
- **No Claims Paid.** The taxpayers' captive insurance company did not pay any claims until after the IRS began its audit of the company.
- **Inadequate Reserves.** The insurance company had insufficient funds to pay claims.
- **Insufficient Risk Pooling.** The insurance policies only insured, at most, five taxpayer-related entities.
- **Other Insurance for the Same Risk.** The taxpayers did not cancel their original commercial insurance policies. There was no business purpose for the additional insurance other than creating a tax deduction.

In the view of these authors, the second factor above, unrelated risk, is probably the most important point to bear in mind. Car dealer F&I programs are **not** true captive arrangements, because they involve the transfer of **unrelated third party risks.** The IRS has recognized that the transfer of the risk of auto purchasers (typically service contracts) is a transfer of unrelated third party risk and that properly structured reinsurance programs are insurance for federal tax purposes. *See* TAMs 2004-53012 and 2004-53013.

The *Avrahami* decision does hold some useful lessons for attorneys and advisors to dealers asked to review proposals on behalf of clients. Any reputable program should be able to explain how its program does **not** raise the *Avrahami* concerns. Unrelated third party risk and justifiable pricing policies should allow auto dealers to demonstrate that their reinsurance programs fit the definition of insurance for federal tax purposes. Additionally, any dealership should be able to readily show that its sale of F&I products and forms of dealer participation are driven primarily by economic motives, not tax incentives. ■

Andrew Weill is a principal at Weill & Mazer, APC, in San Francisco, California and a Certified Specialist in Taxation Law. Phyllis Simon, an attorney with the firm, is a former in-house tax counsel for a Fortune 500 company and has over 20 years of experience in counseling businesses and individuals regarding business transactions and tax. A primary focus of their practice is tax, regulatory, and other legal issues regarding aftermarket financial and insurance products in the automotive industry.

In the Wake of the New Arbitration Rule – Retail Installment Sale Contracts and Consumer Leases

By Terrence J. O'Loughlin, J.D., M.B.A., *Reynolds & Reynolds*

Consumer advocates have, seemingly, achieved one of their major objectives with the apparent promulgation of the CFPB's new Arbitration Rule. It is "seeming' and "apparent" as of this printing, since it is unknown if Congress will override the onerous Arbitration Rule (the Rule) through the application of the Congressional Review Act.

But until such time the applicable dates are:

July 19, 2017	The Rule was published in the Federal Register.
September 18, 2017	Effective Date of the Rule
March 19, 2018	Compliance Date of the Rule

It should be noted that arbitration agreements entered into before the Compliance Date remain enforceable.

The numbers tell much of the tale:

728	Pursuant to the Dodd Frank Act, § 1028, a
728	page arbitration study was produced.
775	The final Rule is 775 pages in length.
113,000	There were 113,00 filed comments from the public regarding the proposed Rule.
Millions of Dollars	Potential damages to defendants if the Rule takes effect.

It was, and remains, a contentious issue with enormous potential liability for the automotive business and underwriting retail installment and sale contracts and consumer lease contracts.

Although the initial CFPB study could have determined that all arbitration provisions in consumer agreements have no value, and could be prohibited, the CFPB did not reach that conclusion. The Rule addresses only pre-dispute arbitration agreements not post-dispute arbitration agreements. Class action waivers can continue to be used with post-dispute arbitration agreements.

In a nutshell, the Rule addresses the storing, the lending, and the moving of money with the onerous stricture that class action waivers are, generally, not permissible in pre-dispute arbitration provisions in commerce regarding various products. The Rule addresses which entities, products, services, and excluded parties are affected.

The CFPB has authority to regulate any person (*i.e.,* provider) who engages in offering or providing a "consumer financial product or service." This definition includes financial products or services that are "offered or provided for use by consumers primarily for personal, family, or household purposes," the extension of credit, and, of course, would include retail installment sale contracts and consumer lease contracts.

However, there is a significant limitation on the CFPB's jurisdiction, which remains a great victory for the automotive industry. Franchise dealers who are engaged in the sale or leasing, and servicing, of motor vehicles, and routinely assign their contracts to an unaffiliated third party finance source, are expressly excluded from the CFPB's jurisdiction. The CFPB may not exercise any rulemaking, supervisory, enforcement, or other authority over such a dealer. Accordingly, the Rule, would not apply to agreements between an excluded dealer and a consumer. This limitation complicates how these new disclosures must be made. In addition, there are non-covered products and services, such as service contracts or vehicle protection products, included in vehicle transactions, which are unaltered by the Rule. The mandated disclosures required by the Rule are further complicated by a franchised dealer selling CFPB regulated (covered) products and non-CFPB regulated (non-covered) products in the same transaction.

Reynolds & Reynolds, among other DMS providers, offers stand-alone arbitration agreements as well as retail installment sale contracts, lease contracts, and other consumer-facing documents which incorporate an arbitration agreement. Each of these documents will accommodate the requirements of the Rule.

The Rule

The Rule prevents providers from invoking class action waivers in pre-dispute arbitration agreements in contracts for "covered financial products and services." In other words, the consumer cannot be prevented from suing providers in a class action by contract.

Disclosures Required by the Rule

Certain disclosures are mandated by the Rule. However, which disclosures are required depends upon which products are being sold. For example, in a relatively complex transaction, where some products are subject to the Rule, and others are not, an alternative disclosure with optional language may be necessary.

The basic required language is:

> We agree that neither we nor anyone else will rely on this agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action filed by someone else.

However, when the Agreement applies to multiple products or services, only some of which are covered by the Rule, the provider may include the following alternative provision in place of the first statement:

> We are providing you with more than one product or service, only some of which are covered by the Arbitration Agreements Rule issued by the Consumer Financial Protection Bureau. The following provision applies only to class action claims concerning the products or services covered by that Rule: We agree that neither we nor anyone else will rely on this agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action filed by someone else.

This second provision appears to apply when a provider is supplying both covered products and services (*e.g.,* the RISC and a GAP waiver) and non-covered products and services (*e.g.,* a service contract or vehicle protection product). For example, service contracts and other non-financial products or services could contain an enforceable class waiver, but claims relating to the financing of such products or services would be subject to the Rule. Conversely, GAP products could not contain a class waiver that is enforceable by a provider. In conjunction with the second provision, optional language may be added to address effective dates, delegation, and excluded parties.

Recommended Changes in Arbitration Documents

Reynolds & Reynolds is mindful of these legal requirements and balances those requirements with preferences in the market place. Consequently, Reynolds will be offering changes in its arbitration language.

There are several options for disclosing the requirements of the Rule. Reynolds balanced the potential for retaining as much flexibility for the dealer with the requirements of the Rule which financing sources must respect.

The basic arbitration language found in the Reynolds & Reynolds documents remains the same, but it accommodates the Rule and its implications. The language will include the following changes:

- Addition of the basic disclosure;
- A clarification indicating that the agreement contains more than one product or service and that only some of them are included in the Rule's application;
- A statement that certain persons are excluded from the Rule;
- The fact that agreements entered into prior to March 19, 2018 are unaffected by the Rule;
- Limitation of the class action waiver to the ambit of the Rule;
- Redrafting of certain clauses to reflect the implication of the Rule;
- Addition of other language for greater clarification; and
- Addition of another arbitrator option.

As it remains unclear whether Congress will override the Rule, Reynolds is fully prepared to meet the dates certain mandated by the Rule. Samples of the new documents will be made available when this uncertainty clears. ■

Terry O'Loughlin is the Director of Compliance for Reynolds & Reynolds and is admitted to both the Pennsylvania and Florida Bars. Prior to joining Reynolds he was employed by the Florida Office of the Attorney General.


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