The Wheels of Justice

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The Monthly Dealer Legal Newsletter compiled by "The Dealer's Law Firm," Myers & Fuller

Factory Horror Stories: How Proactive Responses Can Prevent a Nightmare

Written responses provide a track record that aids your position

Since we began writing *The Wheels of Justice* on a monthly basis, we have been telling all of you about factory initiatives and agendas – the ones they admit to and the ones they don't.

We have tried to weave into every article the need for each of you to do two things – educate and respond. Educate yourselves and your employees as to what your state franchise laws can do for you. And respond (in writing) to each and every action that the factory takes that you feel could or is going to hurt your store. To fail to do either of these can result in disaster for you and your dealership.

Here is a look at recent horror stories that have happened to some dealers—and why it's essential for you to remember our educate and respond mantra:

In a recent termination case, a manufacturer had been sending self-serving written correspondence to a dealer that first warned the dealership that it must increase sales and customer satisfaction numbers. That led to the factory subsequently placing the dealer under a notice of default and eventually threatening the dealer with termination.

Background: The manufacturer had done a massive national network analysis that resulted in the redefining of many, if not most, of its dealers' PMAs. The dealer (not our client) was no exception, and the dealership's PMA was increased. That change should have prompted a letter to the factory and a call to both her state association and a good lawyer. The manufacturer eventually sent a notice of termination and the dealer notified a a law firm and filed a protest of the termination under state law.

The problem: The dealer never responded in writing to any of the manufacturer's letters concerning sales or PMA changes. While there were many reasons (some legitimate and many fabricated) that the dealer's performance did not meet the manufacturer's sales and service goals, the judge focused on the lack of written response from the dealer.

The judge essentially concluded that the

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THIS ISSUE

Protection from Unfair Termination, Part II

Franchise laws should clearly define what constitutes an 'unfair' termination

Editor's note: Last issue, our writers addressed the need for franchise laws to include an "automatic stay" of a termination pending a "final determination" of the dealer's protest and the dealer's "right to sell" while a termination protest is underway. In this second installment, our writers share why franchise laws need clearer definitions of what constitutes an "unfair" termination to provide greater protections for dealers.

Many state franchise laws fall short of clearly defining what constitutes an "unfair" termination. In many cases, the franchise laws leave that determination in the hands of a designated decision-maker who is

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Letters of Intent: Their Role in Buy/sell Deals

Plus tips for buyers and sellers

"Let's write up a letter of intent and get this transaction rolling…"

That phrase is often uttered after discussions and negotiations between a buyer and seller. But are letters of intent—affectionately referred to in the biz as "LOIs"—really a necessity? Are there alternatives for the parties to a transaction?

Every transaction is different from the previous, and not every deal will begin with the negotiation and drafting of a LOI. But it is important for buyers and sellers to understand when an LOI may be useful given their respective and unique circumstances.

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Factory Horror Stories, *continued from page 1*

manufacturer had been trying to help the dealer improve sales and service performance for years and the dealer had just ignored these attempts to help. When faced with silence on the part of the dealer, this particular judge thought the dealer did not care what the factory said and was predisposed to rule in favor of the "Evil Empire." This judge's rationale is not unique.

Another area of concern that we have tried to warn dealers about is the stated plan of many of the factories to reduce or even eliminate small dealers in both single and metro markets. Sometimes they call it consolidation. Sometimes they call it small dealer elimination. Regardless of what they call it, the result is a reduction in the number of dealerships that are individually owned and operated.

It is interesting to note that on the one hand, domestic manufacturers who are losing market share, are attempting to consolidate linemakes in the hands of larger, wealthier dealers in an attempt to increase market share. (It apparently has not occurred to these manufacturers that the products that they offer might play a part in the decreased market share or that larger doesn't always mean better.)

The GM Channel Strategy and Chrysler Plan Alpha seem to be concentrating on the metros, while Kia and Hyundai and some of the other imports are focusing on the small fringe dealers. They either notify the dealers that they are considered to be non-viable or create incentive plans that ensure that they will be non-viable in the future (sort of a self-fulfilling prophecy, don't you think?). If you are a Pontiac dealer, you are going to be forced to become a Pontiac, Buick, GMC dealer or sell to someone who will. If you are a fringe Kia dealer, you better hope Kia's incentive plans are held to be a violation of state law or you will be forced to become some larger dealer's satellite. The list goes on and on.

Providing more allocation to chosen dealers, making available incentive money only at sales levels that are unattainable by smaller dealers, and awarding favored dealers additional points are just some of the tactics we are running up against. It's in your best interest to respond when the effects of these factory moves play out in your market:

- If you notice that your competing dealers seem to be getting the popular models at a much greater rate than your dealership, put it in writing to the manufacturer.
- If you don't think the incentive programs are functionally available to all dealers (code word for anti-trust), then write and tell them so.
- If you think the factories are giving larger dealers a competitive advantage, find out what your state association thinks about the situation and whether or not your state law protects you against that type of behavior.

How to respond to market area changes that can hurt your viability

Some of the more dangerous games the factories are using include the manipulation of their dealer body by jerry-rigging the dealers' primary market areas and then judging them on market share instead of sales (the justification for the terminated dealer in the beginning of this article).

Here's one example of this dynamic: A manufacturer assigned one of our dealer clients census tracts that, due to geography in the area, made it easier for customers in those tracts to visit any one of three other dealers with the same line makes.

To make matters worse, the factory's market area changes also included census tracts that lay closer to a high growth area that included another, newer dealer with the same line make, as well as other inter-brand competitors and many retail stores. Consumers in this area had direct access to the new dealer by interstate and to our dealer only on windy two lane roads.

The result of these newly assigned census tracts is that even though this dealer's sales are up 220 percent from the previous year, the dealer will not be sales effective based on market share in the census tracts his market area. The factory is now talking about adding a point in the market. (If the manufacturer doesn't terminate you, it adds a point and accomplishes the same thing.)

In this instance, the dealer recognized a written response was required and called us. The approach we took: Show the manufacturer that its sales and service agreement requires that it accounts for the general shopping habits of the public in a given market area, as well as any other marketing conditions that would affect our dealer's sales performance differently than other dealers.

In this instance, the factory initially disagreed with our position, which triggered mediation over the changes in the dealer's census tracts.

During mediation, we pointed out that the law would not permit an unreasonable assignment of geography and that we would bring suit if the factory stuck with its position. The factory came to its senses (they saw we could win) and did the right thing. They changed the dealer's PMA back to where it was and the dealer is now a superstar.

The perils of signing addenda to your franchise agreements

Anther horror story is that of a dealer who bought a small dealership that was under threat of termination, out of trust, owed consumers money from trade-ins, etc. Although the dealer was experienced and successful, the manufacturer required the dealer to enter into a term agreement with the *special condition* that the dealership must meet the region's customer satisfaction average.

The additional language also required the dealer to agree that if he did not meet the benchmark that this failure would constitute a *material breach* of the franchise agreement and would constitute good cause for termination of the franchise. The net effect of signing this addendum was that the manufacturer was attempting to force the dealer to wave his rights to protest the termination under state law.

Even though the dealer felt this requirement was unreasonable, he did not write to the factory or ask for help. He signed the agreement and guess what? He did not meet the conditions. He called us and we discovered that he was in a state that prohibited preconditions in approving a buy sell and we were able to get the factory to withdraw the threat of termination.

In good times and bad, the factories have agendas that are not always in the dealer's interest. Stay alert. Know your state law. And always notify your manufacturer in writing if the manufacturer takes actions that are adverse to your interest.

By Daniel E. Myers, Esq.

Article summary

- If it doesn't feel right, challenge it.
- Any factory communication of any importance must be in writing.
- Be active in your state dealer association.
- Know your factory and its dealer network plans
- Know your state law and the protections it affords.
- Don't ever assume the factory will not enforce a term or provision of an agreement it places before you.
- Get help before signing any document from the factory, not after…it's cheaper that way.

Dealer Credit Insurance Practices Withstand Class Action Challenge

A key lesson: Make sure your operation meets state guidelines, norms

Dealers often form separate insurance companies to allow the earning of commissions on the sale of credit insurance and other insurance products. These companies, owned by the dealer principals, have no separate staff or offices, exist only on paper, and use the dealership's sales and finance personnel to sell insurance products. Sometimes, a consumer lawyer finds this arrangement a "sham" and seeks to recover damages for alleged failure to comply with insurance-related federal and state law. A recent case in Michigan demonstrates how this scenario plays out.

A consumer (Webb) who purchased credit insurance in connection with the financing of a new car brought an action on behalf of herself and a class action of others against the dealer (Westborn Chrysler Plymouth Jeep, Inc.).The case alleged that Westborn violated the federal Truth in Lending Act (TILA), the Michigan Credit Reform Act, the Michigan Credit Insurance Act, and the Michigan Motor Vehicle Sales Finance Act.

The court found that the credit insurance transactions at Westborn were standard and representative of the way in which credit insurance is bought and sold in Michigan. Westborn's dealer/operator established and owned the "Susan Agency" solely to sell credit insurance to Westborn's customers. Michigan law requires credit insurance to be sold by a separate entity. The Susan Agency has no employees, does no commission work, solicits no outside business and sells credit insurance exclusively to Westborn customers, through Westborn's finance managers. Westborn retains a 45 percent commission. Michigan's insurance commissioner approved the policy documents and calculation methods, which were performed using a Reynolds & Reynolds computer program to calculate rates. The credit insurance coverage includes the total interest accrued through the entire duration of the retail installment contract.

None of Webb's three alleged TILA claims succeeded. First, the court found that her claim that Westborn violated TILA by disclosing commissions paid to a third party as an "amount financed," rather than as a "finance charge," fell within exceptions in Truth in Lending regulations. Although the TILA disclosure did not identify the Susan Agency on the form, or disclose that Westborn received the commission or the amount of the commission, the court found that Westborn met the exceptions in 12 C.F.R. § 226.4(d)(1). The exceptions allow Westborn to exclude charges for voluntary credit insurance premiums from the finance charge. Although the Susan Agency was the only agency from which Westborn customers could purchase credit insurance, the language in the retail installment contracts did not require Webb or any customer to buy credit insurance from the Susan Agency as a "condition to the extension of credit."

The court found, as to a second TILA claim, that Michigan law permitted Westborn's sale of gross coverage credit life insurance; therefore, Westborn did not violate federal law. The sale of gross coverage insurance has been the prevailing practice in Michigan for decades, a great number of such policies are outstanding, and the Michigan Office of Financial and Insurance Services condoned the practice. Friend of the court briefs filed by the Detroit Auto Dealers Association and the Michigan Automobile Dealers Association supported Westborn's position.

The court also determined Michigan law did not prohibit the dealer/operator from either receiving commissions or owning both Westborn and the Susan Agency. The Michigan Financial Institutions Bureau's December 1996 declaratory ruling, endorsing the operation of dealer-related insurance agencies for the purpose of selling credit life insurance in Michigan, supported the court's determination. Since the commissions paid to Westborn were lawful, Westborn did not violate TILA by disclosing them in the "amount financed."

Webb's claim that Westborn violated Michigan law by charging premiums, disclosed as an "amount financed," at an unlawful rate and included excessive commissions similarly failed. Webb contended that Westborn's use of the gross coverage method resulted in a premium for scheduled amounts, not yet due and payable and, thus, "not yet earned by the creditor." She argued that in effect, the gross coverage method allowed Westborn to impose unearned finance charges at the beginning of the contract.

Although informative, the Westborn case is limited to Michigan law. Dealers who own or operate insurance agencies in conjunction with the financing of vehicle sales should consult experienced legal counsel to better understand their own state law.

Case reference: Webb v. Westborn Chrysler Plymouth Jeep, Inc. Civil Action No. 03-CV-71077-DT (E.D. Mich. May 11, 2005)

By Robert C. Byerts, Esq. and Shawn D. Mercer, Esq.

Article summary

- Review your credit insurance transactions to ensure they are standard and representative of the way credit insurance is bought and sold in your state. This is especially true for dealers who form their own insurance companies for these transactions.
- Make sure the insurance disclosures comply with Truth in Lending Act requirements.
- Check with the agency that regulates insurance sales in your state to confirm state law permits the arrangement you have between the insurance entity and the dealer entity.

Unfair Termination, *continued from page 1*

charged with assessing whether a factory's proposed termination is appropriate and has met any requirements for providing notice to a dealer.

But many judges, unfortunately, fall prey to the factory's deceitful argument that the termination is for a "fair" reason when in fact that reason involves something that is outside of the dealer's obligations under the dealer agreement.

For instance, a judge may believe that a dealer who does not comply with the factory's demands related to new facilities requirements may be in violation of their franchise agreement and should rightly be terminated. This often leads to arguments over whether the facilities requirement—often detailed in a "facilities addendum—is actually a component of the franchise agreement. We recommend that franchise laws short-circuit this dynamic by ensuring franchise laws clearly spell out that a termination is unfair if the factory bases it solely upon the dealer's failure to comply with the latest facilities requirement. Franchise laws and factories should only require dealers to have facilities that enable them to satisfactorily sell and service the manufacturer's line of vehicles.

Another example: Factories send a termination notice for failure to comply with its sales performance requirements. As we have written about many times, the manufacturers' performance calculations involve voodoo science. Unfortunately, judges often side with factories after hearing arguments that a particular performance formula is a standard to which all dealers must comply.

Specifically, we would suggest franchise laws include a list of those items that are considered "unfair" reasons for termination of your franchise:

- Dealer's failure to comply with unreasonable sales standards;
- Dealer's failure to comply with unreasonable service standards;
- Dealer's failure to comply with any specific preowned vehicle sales requirement;
- Dealer's failure to comply with any specific facilities requirement (this provision should constitute "good cause" for termination if a dealer does not provide adequate facilities to properly sell and service the manufacturer's new vehicles);
- Dealer's failure to comply with unreasonable capital standards;
- Dealer's failure to comply with any unreasonable requirement of the franchise.

In addition to specifically defining "unfair" reasons for a termination, a strong franchise law termination provision must include specific timeframes under which factories provide termination notices to dealers. We suggest that the dealer be given up to 180 days written notice of an alleged default under the franchise agreement. This would give dealers the opportunity to cure any deficiency. If the dealer does not cure the alleged default, then the dealer should be given a written notice that provides a 90-day time period to file a protest of a proposed franchise termination.

"Judges often side with factories after hearing arguments that a particular performance formula is a standard to which all dealers must comply. "

Within this provision, the franchise law should also specifically provide that if a termination is based upon a failure to perform in the area of sales or service, the decision-maker "must" consider the dealership's performance up through the time of a final hearing. We have run into several judges that have decided that a dealership's improving performance is not admissible into evidence beyond the date of the termination notice. This, of course, could lead to the absurd result of terminating a dealer that, at the time of the final hearing, is performing at or above the standard set by the factory.

Lastly, within the notice provision, it is critical that franchise laws include language that addresses actions a manufacturer may take that result in the effective termination of a dealer—even if the manufacturer has not given a formal termination notice to the dealer.

We learned in our Oldsmobile termination litigation that the manufacturers will argue that judges have no right to hear a termination case until the manufacturer provides dealers with a formal notice of franchise termination or the non-renewal of a franchise agreement. In the Oldsmobile cases, GM made this argument even though it had told the world that it was "discontinuing" Oldsmobile, which resulted in a rapid and immediate decline in sales for Oldsmobile dealers.

Every judge ruled in our favor, saying that the circumstances surrounding the manufacturer's actions, and not a formal written notice from the manufacturer, will determine if a termination or proposed termination has occurred. Even so, codifying these rulings within your franchise law's termination provision will thwart factory attempts to provide to avoid giving formal notice of a termination when its actions demonstrate the contrary.

By: Richard N. Sox, Jr., Esq. and Loula M. Fuller, Esq.

Article summary

- Strong termination protection must include a specific definition of those reasons which shall be considered "unfair" reasons for a manufacturer's proposed termination.
- Strong termination protection must include specific timeframes in which a dealer receives notice of an alleged default and is allowed time to cure the alleged default.
- Strong termination protection must include specific timeframes in which a dealer has to protest a termination following the opportunity to cure.
- Strong termination protection must include a provision requiring the decision maker to take into consideration the dealership's performance following the date of the notice of termination.
- Strong termination protection must include a provision allowing a dealer to protest actions taken by a manufacturer that have the effect of terminating the franchise.

Letters of Intent, *continued from page 1*

Why sellers may insist on crafting an LOI

Sellers often use LOIs to flesh out prospective buyers. The theory is a buyer is not going to go to the time and expense of negotiating an LOI unless the buyer is serious about working in good faith toward entering into a definitive agreement. In that case, an LOI serves as a screening tool.

Taking the deal off the market prevents a bidding war and is perhaps the number one reason why a buyer would insist on using an LOI..."

Aside from summarizing the economic terms of a transaction, a seller may also use an LOI to provide protection against the improper use of confidential information exchanged between the parties during the due diligence phase prior to execution of a definitive agreement. This is especially useful when the parties have not entered into a confidentiality or non-disclosure agreement. Sellers also can use an LOI to protect their employees. A binding term can be included in the LOI that prevents a buyer from soliciting the seller's employees. Consequently, an LOI can protect a seller from a competitor *posing* as a buyer only to obtain confidential information and poach on the seller's talented employees. It is important that the LOI expressly state that such protections are binding provisions to which the parties are agreeing (see sidebar, this page).

Sellers also use LOIs to set limits on the warranties and representations that will be set forth in the definitive agreement. Non-compete, employment or consulting, and earn-out agreements are often described in detail in an LOI.

Why buyers may insist on using LOIs

Buyers have different reasons for entering into an LOI. Buyers can insist that an LOI contain a binding term providing exclusive rights to negotiate with the seller and prohibiting the seller from continuing to shop the deal to other prospective buyers. Taking the deal off the market prevents a bidding war and is perhaps the No. 1 reason why a buyer would insist on using an LOI instead of a mere term sheet. To add teeth to the "no-shop" provision, a buyer might insist on adding language imposing a break-up fee. Such a term would require the seller to pay to the buyer a pre-determined sum as liquidated damages should the seller violate the no-shop provisions of the LOI.

A buyer might also insist on drafting an LOI and use it as evidence of a prospective transaction to shop for financing. Buyers often use LOIs to set out a structured schedule for obtaining due diligence information and documents.

As a seller and buyer begin discussing and negotiating a transaction, the parties should decide early on how they wish to begin putting the deal into writing. While the parties may choose between a term sheet or a LOI, neither is a requirement.

A buyer will often skip the LOI or term sheet step and communicate an offer by presenting a proposed definitive agreement. Regardless of the approach, it is important to discuss the pros and cons with your experienced franchise lawyer and determine which approach is best given the circumstances.

By Robert Bass, Esq.

Article summary

- Use letters of intent to document the material terms of a proposed transaction.
- Define the terms in an LOI that should be binding and non-binding. Example: Any necessary protections should be made binding and subject to enforcement in court.
- Consider using a "term sheet" instead of an LOI when both parties in a transaction comfortable with each other and want to move rapidly to the drafting of the definitive agreement.
- Discuss the pros and cons of letters of intent with your franchise attorney.

A quick look at the enforceability of an LOI

Generally speaking, an LOI is regarded as an agreement to agree—i.e., neither party can drag the other to the church and force a marriage.

But sloppy drafting of an LOI can create ambiguity over whether the document constitutes a binding or non-binding *agreement*. Care must be taken to ensure that the effect of the LOI is not to bind the parties in a legal contract, if that is the intent of the parties. However, most LOIs will contain binding and non-binding provisions. It is best to separate binding from non-binding terms in an LOI. Binding terms are enforceable in court and should be included in a clear and distinct section of the LOI.

What if both buyer and seller want all terms to be non-binding? In those scenarios, it's best to draft a "term-sheet" or "proposal." Essentially, the parties set down the economic terms in bullet-point fashion with no words of agreement exchanged. The lawyers then use the "bullets" to draft the definitive transaction agreement. This approach is often useful in a transaction where the parties are very familiar with each other and there is a great degree of trust. The use of a term-sheet also saves on transactional costs because it eliminates legal fees for crafting an LOI.

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