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Auto Dealers' Uphill Battle

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By Aaron Jacoby

The auto industry has been consolidating of late, with car dealers pushed along in the process by GM and Chrysler through the court approved mass rejection of 3,200 franchise agreements in the manufacturers' bankruptcy proceedings pending in the U.S. Bankruptcy Court for the Southern District of New York. Industries typically face consolidation and attrition as a natural, evolutionary course in the business cycle. It is unusual, however, for businesses to suffer shutdowns of the magnitude faced by GM and Chrysler dealers.

Thousands of dealers, including many in California, whether or not their business was failing, are now forced to close their doors. Dealers, who are major advertisers, sponsors of Little League, philanthropists and major campaign contributors with political muscle are not going quietly. Main Street U.S.A. is taking notice, feeling the effect of the sudden elimination of so many jobs and the significant reduction in sales tax revenue. The U.S. Congress and the California State Senate are taking notice as well, with newly proposed legislation designed to address dealer termination. The federal law seeks to restore franchise rights taken away in the bankruptcy proceedings while the California law would mandate repurchase obligations in the event of termination, allowing dealers to recoup some of the losses suffered.

While the House bill has good intentions, the ultimate reversal of the bankruptcy process seems impractical, potentially unlawful and, therefore, unlikely. Dealers will need to rely on the passage of California's enhanced protections to recoup losses suffered in termination of their franchise rights.

How did we even get here? As part of the bailout and bankruptcy process, President Obama's Auto Industry Task Force sought the winnowing of the GM and Chrysler dealer bodies as a key element of the restructuring of the two giant manufacturers. The stated goal was that a reduced dealer count, in line with competitors such as Toyota and Honda, would enhance efficiency, save money and allow us to rebuild the American car industry. The task force directive, however, ignores the franchise distribution model, supported by state laws that prohibit manufacturers from direct sales to consumers. In other words, dealers are the only conduits through which manufacturers sell their vehicles. Sudden elimination of dealers erodes market share because dealers are the customers of the manufacturers - producing revenue, not cost.

There is no question that there are more GM and Chrysler dealers than can be supported by current demand. This was not always true. The dealer body grew over time to meet customer demand. State laws inhibited the ability of a manufacturer to terminate its dealer franchisees. Therefore, reduction of the dealer body was typically due to attrition by acquisition, voluntary closure or a dealer's bankruptcy rather than termination.

During this Great Recession, dealer attrition is on the rise as a natural result of weaker vehicle demand. Most accept the fate that a business without customers must fail and those dealers are shutting their doors with heavy hearts but without political protest. But dealers do not accept that GM and Chrysler, companies deemed too large to fail, used the bankruptcy process to override natural economic cycles, shifting dealer attrition into high gear, eliminating more than 3,000 dealers by rejecting their franchise agreements without regard to any of the state laws that would otherwise protect a dealer's significant investment. (See, e.g. California Vehicle Code Section 3061, which sets forth the good cause factors required to support a judicial finding that the termination of a franchise is warranted.)

Cue the U.S. House of Representatives, which is now also shifting into high gear with legislation that would reverse the court-sanctioned rejection of dealership franchise agreements. The measure is an amendment to H.R. 3170, a financial services appropriations bill. The proposed legislation provides that "no automobile manufacturer in which the Federal Government has an ownership interest may deprive an automobile dealer of its economic rights as they existed prior to the commencement of a bankruptcy case by the manufacturer, including its rights to recourse under State law." As one would expect, GM and Chrysler oppose the legislation. The Obama administration said on July 15 that it "strongly opposes" the legislation as well. Despite manufacturer and White House opposition, the bill is gaining momentum and widespread support in the House and Senate. We'll soon see where this uphill road leads.

If the bill somehow passes in the House and the Senate prior to the summer recess and the president signs a bill that is contrary to the goals of his own task force, can Congress actually undo what the bankruptcy court hath wrought? As my bankruptcy partner, Larry Katz is fond of saying, "Section 363 of the Bankruptcy Code [which permits the sale of assets free and clear of all rejected obligations] reigns supreme." Translation: No. The court already approved the asset sales of GM and Chrysler pursuant to Section 363. Fiat already bought Chrysler - we will be driving Fiats before this bill can become law. Rejected dealers will be long gone.

Another steep, uphill litigation battle is in store for the dealers in the unlikely event that the political process is successful. The newly proposed legislation may be unlawful. While there is no blanket prohibition against civil ex post facto laws, the Supreme Court has recognized that retroactive laws do present real problems of fairness. See, e.g. *General Motors Corp. v. Romein*, 503 U.S. 181 (1992). In that case, Justice Sandra Day O'Connor identified the unfairness of retroactive legislation: "Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions." For this reason, "the retroactive aspects of economic legislation must meet the test of due process - a legitimate legislative purpose furthered by rational means." The proposed legislation is not likely to pass the "due process" test in the face of a bankruptcy court's ruling pursuant to well-settled principles of bankruptcy law.

California is taking a different approach, related more broadly to franchise termination and avoiding the concept of reversing the bankruptcy's rejection process. California's S.B. 424, if passed, will confirm by statute what is generally required under dealer franchise agreements upon termination of the franchise relationship. This bill will ensure that dealers are properly indemnified for their significant investment in the millions of dollars for actions of manufacturers or distributors beyond their control. The proposed Senate bill sets out detailed procedures and responsibilities of manufacturers and distributors in repurchasing and reimbursing dealers for their vehicle inventories and other items that are returned when a franchise is terminated. Further, the bill updates California law to be more in line with the statutory requirements of other states. Texas and Colorado, for example, both have statutes in place regarding payment to franchised dealers following the termination of a franchise.

The proposed California Senate bill, the more practical approach, is long overdue and may help to preserve the business investment of many dealers in California. Preserving the dealers' business investment means preserving jobs in our state as well as enormous sales tax revenue for California.

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