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PERSPECTIVE

Tesla's federal showdown heating up

By Jonathan Michaels

For thousands of automotive dealers across the United States, the dealer franchise system is as sacred as they come. Established at the turn of the 20th century as the mechanism for automakers to distribute their products to the masses, U.S. dealers have served as the blueprint for how cars are sold worldwide. Tesla is now threatening to disrupt it all.

For generations, the model has been the same: A manufacturer enters into a franchise agreement with an entrepreneur to sell the manufacturer's cars; the entrepreneur invests time and capital to build a dealership and service the local community; the automaker sells the cars to the dealer, who in turn, sells the cars to the public, and offers financing, registration, warranty and repair work.

This arrangement resulted in early conflict, which has since been evened with state legislation. Knowing that dealers had a tremendous sunk cost in supporting a brand, early manufacturers were in a position to exert control over the dealer under the threat of a whole host of consequences, such as terminating the franchise, refusing to provide product, or underwriting a competing dealer. So, for instance, if the manufacturer wanted to sell slow moving product to a certain dealer, there was little that could be done.

Recognizing the disparity in bargaining power, in the 1930s states began to enact dealer franchise laws that regulated items such as when a dealer could be terminated, how inventory was to be allocated, when a manufacturer could require the dealer to make (and pay for) a facilities upgrade, and whether a manufacturer could own a dealership.

The franchise law framework proved worthwhile. Dealers and manufacturers had occasional flare-ups, but for the most part the laws kept peace the dealer-manufacturer world. Then came along Tesla.

Founded by the 42-year-old billionaire Elon Musk, the same person who revolutionized online merchant services with his company PayPal, Tesla is disrupting everything familiar in the au-



A Tesla showroom in San Jose, May 25, 2011.

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tomotive world. Its sales are astounding. Consider that in 2013, Tesla sold 18,000 Model S vehicles to 23,000 Chevrolet Volts — and it did so with a car that starts at \$70,000 (the Volt starts at \$34,000). Consumer Reports called the Model S the “best car it has ever tested,” and so it is perhaps not surprising that Tesla's shares are trading at \$207, while Ford is struggling to break \$15.

Then there are the dealers. Taking a page out of Apple's “Think Different” campaign, Tesla has decided to forgo the traditional dealer network route, opting instead to open a series of company-owned stores. Like the Apple stores, the Tesla stores are placed in high-end shopping malls, where they offer an entirely different buying experience. Customers schedule a test drive with a Tesla employee and then are directed to the company's website (called the “Design Studio”) to outfit the car with features and make the purchase. This has franchised dealers and state regulators stirring.

The Tesla business model is deeply criticized for oversimplifying the car buying process and the dealer-consumer relationship. Unlike disposable consumer goods, vehicle purchases are mired in complexity. Substantial disclosures have to be made, the vehicles have to be properly registered and insured, and vehicle financing is an animal all its own.

Then there is the matter of warranty, service and recalls. Unlike traditional dealers, who have service bays to meet the demands of consumers, the Tesla stores offer no such amenities. Tesla addresses the issue by dispatching service vans to consumers' homes, but this solution is short lived, at best. A service van can never match the abilities of a full scale service center, and Tesla's ability to service its customers will necessarily wane as the units in operation age and

become more plentiful. It is one thing to send service vans out when the company has 20,000 new cars in the hands of consumers, and quite another when there are 250,000 aged units on the road.

Pundits also point out that franchised dealers are much more likely to advocate a covered warranty repair than a manufacturer (the repairs are paid for by the manufacturer, resulting in profit to the dealer), leading to fewer warranty repairs being allowed. They also note that the franchised dealer system necessarily drives price down, as same line-make dealers are required to compete against one another for market share. Because Tesla will own all of its stores, price elasticity would be less at play.

All of this had led to a nation divided, and a flurry of legislation throughout the states. So far, five states have banned Tesla from selling cars (New Jersey, Arizona, Texas, Virginia and Maryland), two states allow sales but with significant restrictions (Colorado and Georgia), and two others have pending legislation (New York and Ohio). If the legislation in New York and Ohio go through, Tesla will be prevented from, or significantly restricted from, selling cars to just about 100 million people — or one-third of the U.S.

This rush of activity has caught the attention of the Federal Trade Commission, leading to an inevitable showdown in the federal arena. Last month, three high-ranking FTC officials came out against what they called the “protectionist” network of laws in the U.S. that govern automotive dealers. As they stated: “The legal protections expanded until in many states they included outright bans on the sale of new cars by anyone other than a dealer-specifically, an auto manufacturer. Instead of ‘protecting,’ these state laws became ‘protectionist,’ perpetuating one way of selling cars—the independent car dealer.”

The question raised by the Tesla business model is fundamental to how we see ourselves, how we respond to new and innovative ideas, and ultimately, how we choose to govern a capitalistic market. Is it un-American to disallow an entrepreneur, who builds a better mousetrap, to simply sell its product to qualified consenting adults who are desirous of buying it? Or, are the states within their rights to protect the franchised dealer, and ultimately consumers, from what they believe to be an unacceptable erosion of the long-standing vehicle sales model? To be sure, both are entrenched in their views, and with so much at stake, the debate will not end without federal intervention.



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