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Understanding Sales Performance Measurement: How Average Became the New Minimum

Condensed from the white paper created by economist Ted Stockton of the Fontana Group.

This article addresses the familiar topic of sales standards applied to or imposed on dealerships by automotive manufacturers and distributors. The names are different but the concepts are the same. The byzantine arrays of calculations and dense lists of Census tracts determine what is purported to be the number of sales that an average dealership would make selling from your location. Every dealership is "expected" to equal or exceed what an average dealership would sell. Virtually all manufacturers and distributors imply, and some directly assert, that any shortfall to this average level of sales is a breach of franchise obligations.

The Culture of Sales Standards:

Whether it is GM's RSI, Chrysler's MSR, RSE, Sales Effectiveness, Sales Efficiency, or others, the rhetoric is the same:

"We don't want you to be the best dealer, we only want you to be average."

"If you take out the pump-ins, your market is only at 50% of state average. You're going half-speed."

"This is the same system used to measure sales performance of every dealer. It relies only on actual registrations in your market and for the brand. Therefore, it is fair and reasonable."

"It's up to you to sell the cars faster, so you'll earn more product. All dealers are under the same allocation system."

The problem is that the rhetoric collides with our

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CASE UPDATE: Trial Court Limits the Definition of "Oppression" for Minority Shareholders

Last summer, the Iowa Supreme Court decided Baur v. Baur Farms. In that case, the court helped define "oppression" in relation to minority/majority shareholder relationships. Issue 13.4 of the Dealer Law Review pointed out that this case provided lessons for closely-held corporations; it encourages closely-held auto dealerships to evaluate relationships with minority shareholders and take a close look at the requirements of their bylaws. The supreme court emphasized that oppression is defined by the minority shareholder's "reasonable expectations." This expansive definition was worrisome for closely-held corporations as set out by the supreme court. The case was remanded to the trial court for further fact finding.

In this case, the minority shareholder repeatedly attempted to sell his stock to the other shareholders, but the others declined to purchase the stock. The minority shareholder also received no return on his investment in the form of dividends or otherwise. The Iowa Supreme Court saw these two factors as oppressive conduct. However, the trial court looked in depth at the facts of this case to determine that there was, in fact, no oppression involved.

One of the major issues that the trial court faced was to determine whether the minority shareholder's expectations were in fact reasonable in this case. As a minority shareholder, reasonable expectations are limited. Generally,

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a minority shareholder will not participate in business management and the stock value will be less than the majority shares simply because of this lack of control. In addition, dividends are often absent from closely-held corporations—because this case involved a closely-held farm, there would likely never be any dividends.

The trial court pointed out that the minority shareholder's expectations in this case are further limited by the fact that he acquired his shares by gift and inheritance. The inheritance was motivated by the desire for the land to stay in the family, not simply as a gift of monetary value. The trial court concluded that this factor makes the minority shareholder's desire to sell that much more unreasonable. In addition, the minority shareholder in this case was limited by the bylaws of the corporation. The bylaws provided a specific method to value the stocks and included a specified right of first refusal to the corporation. The court also concluded that the minority shareholder should have made its expectations known to the other shareholders in order for those expectations to be reasonable. The minority shareholder here did not do so; he neither expressed a desire to change the bylaws nor requested dividends.

Further, the minority shareholder's expectations differed significantly from the other minority shareholders. Even if the court granted the buy-out price that this minority shareholder calculated, it did not include the required discount for selling a minority share. As such, the buy out, if granted, would have been oppressive to the other shareholders.

In addition to the two lessons articulated in Dealer Law Review 13.4, auto dealers should also be aware that the definition of oppression may be based on the expectations of the minority shareholder, but those expectations are limited. Based on the trial court decision in this case, the court will look extensively into the facts and determine if those expectations are reasonable based on the role of a minority shareholder. If you have questions about this case or the role that minority shareholders play in your auto dealership, contact experienced business and auto dealer counsel today.

***Arenson & Maas would like to thank Roger A. McEowen of the Iowa State University Center for Agricultural Law and Taxation for his valued input on this case update.*

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experience and judgment about automotive markets and our basic logical reasoning. Not every dealership can be above average. If a dealership doesn't get cars, it is not going to sell them. Some markets are tougher than others, and some brands are harder to sell in different markets.

Why, then, does the manufacturer toe the line on its sales standards when common sense and basic arithmetic tell us that the standards are by design impossible to achieve for much of the dealer body? The manufacturers have abundant data with which to analyze markets. They also employ many analysts and consultants to study dealer and market performance. To answer this question, it is necessary to take a step back to the roots of the retail automotive industry and its underlying economic structure.

Relationship of Industry Structure to Sales Performance Standards:

The retail automotive industry operates in a market structure called the "successive monopoly." Within this market structure, two (or three, if a manufacturer sells to an intermediate distributor) stages exist between the manufacture of the vehicle and the ultimate sale to a retail customer. Assuming a two-stage structure, the manufacturer sells to its customer, the dealer, which then sells the vehicles to the end-using consuming public. Both the manufacturer and the dealer have some degree of market power.

Determining Market Price and Output:

To understand the implications of this market structure, it is necessary to step back to more elementary economics. The law of demand is that when price rises, quantity demanded declines or vice versa. Applying this general principle to the retail automotive market means two simple things: if dealers charged less, end-using customers would buy more; if manufacturers charged less, dealers would buy more.

Inherent Tension and the "Influence Region":

Herein lies the inherent tension between dealer and manufacturer. Both parties would be better off if the other would sacrifice the value of its market power and sell its products at lower prices. Another way to understand this concept is to see the successive monopoly structure as one that provides a total amount of available profit that is rooted in retail demand. Logically, the dealer and the manufacturer prefer to capture greater shares of the total retail profit than what they actually capture. However, for either party to do so, the other party must sacrifice its own well-being. This creates the incentive for opportunistic behavior on the parts of both parties.

The manufacturer is the larger party and drafts dealer agreements in a fashion that is largely one-sided and non-negotiable. While the manufacturer's incentive to act opportunistically stems from the same market structure as does the dealer's, its ability to act on that incentive is much more tangible.

In the successive monopoly structure, the behavior that maximizes one firm's profitability generally does not maximize the profit of the other firm.

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It is generally true that any level of sales that the dealership would pick to maximize its own well-being would be lower than the number of retail sales that would maximize the manufacturer's well-being. The difference between the number of retail sales that maximize dealer well-being and the number of dealer sales that maximize manufacturer well-being is the area in which the manufacturer holds the incentive to influence dealer behavior.

The manufacturer has several potential tools to influence dealership behavior in the short run. Some examples include fixed sales quotas, franchise termination threats, and the unchecked ability to appoint intra-brand competitors (encroachment). As you know, state law limits or restricts the use of these tools by manufacturers.

Whether to Observe or Affect Dealership Sales Performance:

The most prominent tool in the manufacturer's kit is the sales performance standard. Across virtually all markets and brands, manufacturers attempt to enforce a standard by which all dealerships must exceed some average level of sales performance to avoid the allegation of a franchise breach. We posed the question earlier of why the manufacturer would wish to require something that is mathematically impossible, and the answer now becomes clear. The purpose of sales performance measurement is much less to measure dealership sales performance and much more to influence it.

As stated earlier, it would be a rare case that a dealership or group of dealerships independently chose a level of sales market-wide that was to the manufacturer's liking. Accordingly, there is little reason for the manufacturer to study or evaluate dealer performance that is not in the manufacturer's influence. Instead, the manufacturer chooses a performance "standard" that generally declares approximately half of the dealer network either deficient or in default, giving the manufacturer discretion to act in those cases that it sees fit. In short, the manufacturer employs a sales measurement system that always keeps the pressure on dealer sales volumes, perpetually influencing dealer behavior towards the manufacturer's optimal level within the successive monopoly.

Understanding the fallout from these measurement systems can be helpful. At the very least, it can arm you for the next dealer contact meeting. The first thing to understand is that the manufacturer's decision to consider *average* performance to be *minimum* performance is a policy decision, not an analytical one. In a sense, these systems assume that half of the dealer body must always be deficient and failing in its sales performance obligations. However, I have encountered no analysis that shows this assumption to be true—or even an investigation that it might be. It is actually pretty strange that manufacturers set operational standards for dealers in terms of facilities, training, capitalization, etc. and even vet new dealer candidates but still seem to believe that half the dealers are deficient!

The second thing to understand is that today's allocation turns into tomorrow's retail sales. If the manufacturer allocates more vehicles to dealers, the sales standard rises, and dealers still fall below the standard. The consequence is that, except under very unusual circumstances, the manufacturer will never allocate enough vehicles for all dealerships to be sales effective.

One check on manufacturer behavior:

A problem facing manufacturers is that while they benefit in the short run from having dealers surrender market power, if too much of dealers' market power is eroded, then dealers would be unwilling to make the specific and illiquid investments in heavily-branded facilities and the extensive uncharged services (car washes, loaner fleets, cafes) that are perceived as necessary to operate high-profile franchised dealerships. Therefore, if manufacturers could set fixed sales quotas, terminate at will, and encroach freely upon territory, dealers would divest and lower the profile of the brand presented to the consuming public. The market power of the brand would eventually suffer. The ideal outcome for manufacturers would be to, first, induce specific investment from the dealers, and given that investment, then influence dealer behavior toward the manufacturer's profit-maximizing level. For close followers of the industry, consider whether facility initiatives have been followed by stepped-up pressure on dealer sales performance!

Summary:

The economic roots of the retail automotive industry result in market behavior whereby dealers and manufacturers maximize profit at different levels and prices of retail sales. Left to their own devices, dealerships would not sell a number of vehicles that was to the manufacturer's liking. This limits the incentive of the manufacturer to evaluate dealership sales performance in an analytical sense. Instead, manufacturers employ measurement systems that declare average sales performance to be minimum performance and hold approximately half of dealers in default. Not all dealers can be above average, and there could never be enough vehicles produced to make every dealer at least average when some dealerships are above average. While the manufacturer clearly knows these things, the traditional sales performance measurements do have the effect of influencing dealer behavior, moving it towards the manufacturer's profit-maximizing level. While the need for dealers to have enough profits to support specific investment does limit manufacturer influence somewhat, the incentive for opportunistic behavior does exist whereby manufacturers would induce or compensate facility investment and follow up with increased pressure on sales performance.

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The articles in this newsletter are created by ARENSON & MAAS, PLC, auto dealer and business law attorneys based in Cedar Rapids, Iowa. Jim Arenson, a 30-year veteran of the car business (including 22 years as a dealer operator and franchise-holder of Chevrolet, Mercedes-Benz, and Volvo), is the senior member of the firm. We provide cradle-to-grave representation for owners, dealers, and senior management of franchised and independent motor vehicle dealerships.

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