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DEALER LAW REVIEW 16.2
Empowering Iowa's Automobile Dealers

What's New This Issue:

Arenson Law Group, P.C. is excited to bring you DEALER LAW REVIEW, your number one source for legal automotive news and information. We connect your franchise with the legal world and explain how legal changes may impact you and how you do business. Check arensonlaw.com/blog for the latest news and updates!

Arenson Law Group, P.C.
425 2nd Street SE, Suite 900
Cedar Rapids, IA 52401
319-363-8199

GM's RSI: Ruled Unreasonable, Unfair, and Unlawful

In early May, the New York Court of Appeals ruled in *Beck Chevrolet v. General Motors* that GM's Retail Sales Index (RSI) was unlawful according to New York's Motor Vehicle Dealer Act. This ruling is the culmination of a dispute between Beck Chevrolet and GM over the terms of their franchise agreement, which would have resulted in Beck losing his GM franchise if he failed to reach 100 RSI.

New York Statute and Outcome

The language of the New York statute makes it "…unlawful for any franchisor, notwithstanding the terms of any franchise contract… to use an unreasonable, arbitrary or unfair sales or other performance standard in determining a franchised motor vehicle dealer's compliance with a franchise agreement." Motor Vehicle Dealer Act § 463(2)(gg). The Court found that GM's RSI standard was unreasonable and unfair because the standard failed to include local brand popularity or import bias. The Court goes on to say that "at a minimum, [the Act] forbids the use of standards not based in fact or responsive to market forces because performance benchmarks that reflect a market different from the dealer's sales area cannot be reasonable or fair." As a result, GM can no longer terminate Beck's franchise for failure to reach 100 RSI.

Termination Based on RSI in Iowa

In Iowa, the franchisor first initiates a hearing with the Department of Inspections and Appeals by filing an application for permission to terminate. These hearings are no small matter, having similar evidentiary and procedural rules as full-fledged court actions. *(Continued on Page 2)*

Selling Used Vehicles Without Warranty Worries

If you are selling a used vehicle "as is," take steps to ensure that it doesn't come back to haunt you. If you are providing limited warranties or service contracts, you need to be aware of the types of warranties that apply, and how to effectively limit them.

You might be thinking that the whole point of "as is" sales is to avoid any further responsibility or liability. However, problems arise if a 60 or 90 day guarantee or warranty is provided, or if a service contract is entered into at the time of the sale of the "as is" vehicle. The Magnuson-Moss Warranty Act (MMWA) is the Federal law that regulates warranties and disclaimers. *(Continued on Page 2)*

Continued: GM's RSI: Ruled Unreasonable, Unfair, and Unlawful

To succeed at this hearing, the burden is on the franchisor to show good cause for termination. The general rule is that a dealer's failure to meet RSI is not a fact considered by the Department when determining good cause termination. However, under an exception, the franchisor can use a dealer's failure to meet RSI if they also prove that the failure "will be substantially detrimental to the distribution of franchis[o]r's motor vehicles in the community." Although a potential factor, this failure to meet RSI is typically not sufficient, on its own, to result in termination – the franchisor still needs to show additional factors for good cause termination. These factors include the dealer's total transactions, infrastructure investments, adequacy of facilities, honoring of warranties, potential injury to the public, and failure or bad faith by dealer to comply with other reasonable requirements. Iowa Code § 322A.15. Good cause does not include a realignment, relocation, or reduction of dealerships.

Takeaways for Iowa Dealers

At the very least, the *Beck* case provides guidance to Iowa authorities when they determine the reasonableness of a manufacturer's requirements. Further, it would be very difficult for a franchisor to terminate an Iowa dealership by simply pointing to a low RSI. On balance, this decision should assist Iowa dealers and their counsel to argue that GM's standards are arbitrary. GM North America President, Alan Batey, has indicated that GM will be looking at this opinion and how they might make some uniform adjustments to the metric. Whether GM will actually adjust their RSI in response to the *Beck* case remains to be seen. ■ ■ ■

Continued: Selling Used Vehicles Without Warranty Worries

The MMWA is clear that if a dealer offers its own warranty or enters into its own service contract on a used vehicle, the "as is" status is lost and Iowa implied warranties apply to the sale. Because these warranties are implied by statute and do not appear in the contract, it is beneficial to know what they are and how they may apply to the sale of your used vehicles.

Iowa Implied Warranties on the Sale of Used Vehicles:

In Iowa, the applicable implied warranties to avoid are:
1) The Implied Warranty of Merchantability, and
2) The Implied Warranty of Fitness for a Particular Purpose.

Did you receive a letter from the factory? Don't just stick it in a file; it can come back to bite you. Make sure your attorney knows about it and responds.

The Implied Warranty of Merchantability:

A purchaser of a used vehicle can bring a claim under the Implied Warranty of Merchantability so long as 1) the dealer is a merchant, 2) the used vehicle is not merchantable (see below), 3) the purchaser is proximately damaged, and 4) the purchaser gives dealer timely notice of defect. If you are receiving this newsletter, you certainly qualify as a merchant. The purchaser's damages are usually the cost to repair the problems with the used vehicle. Lastly, if the purchaser doesn't tell you about it and keeps driving the car despite the problems, after a reasonable passage of time, the customer likely can't come back later and win a suit under an implied warranty claim. *(Continued on Page 3)*

Continued: Selling Used Vehicles Without Warranty Worries

The real crux of the Implied Warranty of Merchantability is whether the used vehicle is merchantable. So what does it mean for a used vehicle to be merchantable? Iowa courts have not addressed this particular issue at the time of publication, but it is likely they would approach such a case as follows. At the time of sale, a used car must be in reasonably safe condition, substantially free of defects that could render it inoperable, and perform up to the level reasonably expected of a car of the same age, mileage, and price. This means that a vehicle with many miles and sold for a significant discount would not be held to the same standard as a premium used vehicle with fewer miles and a higher price tag.

When the purchaser fails to win their Implied Warranty of Merchantability case, it is typically because they fail to show that the defects existed at the time of sale. However, this is a determination that may be made by a jury, based on circumstantial evidence.

The Implied Warranty of Fitness for a Particular Purpose:

The Implied Warranty of Fitness for a Particular Purpose does just what it sounds like, it warrants that a vehicle is fit for the particular purpose that the purchaser has in mind. Although this varies from purchaser to purchaser, almost all vehicles are purchased with the intent that they be used as transportation. As such, when a used vehicle is defective, both the warranties of Merchantability and Fitness for a Particular Purpose are breached.

This warranty becomes more important when a purchaser comes to the dealership with a specific purpose in mind, like hauling trailers or off-roading, and then relies on the dealership sales person to select a particular vehicle that meets that purpose. As long as the vehicle can do what is promised, this warranty is not a problem. But, if you sell the vehicle knowing that they need to haul up to two tons and the vehicle can only handle one ton, the purchaser may have a claim under the Warranty of Fitness for a Particular Purpose.

Avoiding Warranties Altogether - Selling Vehicles "AS IS":

Now that you have a better idea of the kinds of implied warranties that might apply to your used vehicle sales, you might be wondering how you can avoid such warranties. The key here is two words -- "AS IS". When you sell a used vehicle "as is" the implied warranties are excluded from the transaction. If you are selling the vehicle "as is" then under no circumstances should you add any 60 or 90 day warranties or enter into any service contracts. Adding these warranties or service contracts may negate the "as is" language and reinstate the implied warranties to the transaction.

Properly Limiting Implied Warranties:

Now you might be wondering if you can make a 60 or 90 day warranty or service contract, and then be free from liability after the time period expires. Generally, the implied warranties discussed above still apply to the transaction after the express warranty expires. The MMWA allows the dealer to limit the application of the implied warranties so that they expire at the same time as the express warranty. An example of language upheld by courts in Illinois: **To the extent allowed by law, any implied warranty of merchantability or fitness applicable to this vehicle is limited to the 12-month/12,000 mile duration of this written warranty.** If you are concerned about properly selling your used fleet, contact your auto dealer counsel. ■ ■ ■

(Selling Out of Trust begins on Page 4)

Selling Out of Trust

In Iowa, when a dealership sells vehicles "out of trust" (SoT), it may subject the violator to criminal and/or civil litigation, loss of dealer license, and up to 20 years in federal prison (18 U.S.C. § 1963). Let's follow Dealer X through the following hypothetical:

Perhaps Dealer X has been losing money for months or even longer. Suppose Dealer X has not reduced dealership expenses and/or cannot raise gross profits. Maybe the floor plan financer wants more floor plan reduction or curtailment and there is not sufficient cash flow. Dealer X may either know or later discover that instead of paying off sold vehicles in accordance with the floor plan agreements, the controller has neglected to pay off sold vehicles by using those funds to pay general expenses. Oops, now there are not sufficient funds to make payoff(s). Maybe the dealership is out of trust on one vehicle—maybe ten vehicles. Now what?

Does Selling Out of Trust Lead to Criminal Action?

Well—sometimes. To be found guilty of theft under Iowa Code § 714.1(5), Dealer X must have the specific intent to defraud the floor planner. Here, specific intent means "not only being aware of doing an act and doing it voluntarily, but in addition, doing it with a specific purpose in mind." This is determined by a jury according to the specific facts of the case. If Dealer X is unaware of the circumstances resulting in the vehicles being sold out of trust, or those sales are accidental, then Dealer X might avoid criminal liability. To be found guilty of theft, it is more likely that Dealer X must personally direct or allow that the our of trust sale occurs with the intent to defraud the lender. This intent to defraud may still be present even if Dealer X intends to pay the lender back at a later date.

To be found guilty of ongoing criminal conduct under Iowa Code § 706A.1(5), Dealer X must have knowledge that the affairs of the dealership were conducted through unlawful activity. If Dealer X is unaware of the out of trust sale, then Dealer X does not have knowledge and would not likely be found guilty. In contrast, if Dealer X is directing or is aware of the unlawful activity, then Dealer X clearly has knowledge of that activity and may be found guilty of ongoing criminal conduct.

The Iowa Court of Appeals dealt with these issues in *State v. Friedley*, 669 N.W.2d 262 (Iowa Ct. App. 2003). Herald Friedley was charged and found guilty of first degree theft and ongoing criminal activity for selling out of trust and lying to the lender about the location of those vehicles. In *Friedley*, specific intent for theft was found based on the following findings: 1) Friedley directed that proceeds from the sale of cars not be paid to the bank, 2) Friedley was aware of his obligation to the lender but decided to breach the terms, and 3) Friedley hid this scheme from the lender by telling the lender that the sold vehicles were being "test driven."

Civil Litigation

In addition to the criminal charges discussed above, SoT sales leave Dealer X vulnerable to civil litigation with the floor plan lender, customers, and business partners. The floor plan lender can sue Dealer X, as well as any guarantors, under a breach of contract claim. Customers may also bring a cause of action against Dealer X when they realize they lack title to the vehicle sold out of trust.

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Continued: Selling Out of Trust

Advice – In Case of Emergency – Tell the Truth

How could Dealer X avoid this situation?

First, Dealer X could have anticipated that expenses would exceed revenues, then rapidly reduced expenses accordingly.

Suppose that Dealer X encountered a situation where he/she could not take action quickly enough to pay creditors without selling out of trust? As soon as Dealer X became aware that the dealership was in trouble, he/she should have contacted legal counsel to develop a strategy for informing the floor planner about the situation and seeking, e.g., a temporary credit line or perhaps a fixed loan. If Dealer X presents the floor planner with a business plan for increasing profitability, it is more likely that accommodations would be made.

What if Dealer X does not notify the floor planner? If a floor plan lender conducts an audit and asks Dealer X where an out of trust vehicle is located, it is critical for Dealer X to be honest with the floor planner. The worst thing that Dealer X can do is to create a cover-up story about why the vehicle is not on the lot, by claiming, for example, that the vehicle is in an outside body shop, out on a test drive, or at the dealer's house, etc. If Dealer X lies to its lender, then Dealer X has further opened the door to potential criminal charges.

If you have questions or concerns about out of trust sales, or need help working with your floor plan lender, contact experienced auto dealer counsel today. ■ ■ ■

U.S. Supreme Court Looks at Service Advisor Overtime Pay

The recent Supreme Court decision in *Encino Motorcars, LLC v. Navarro* is a major victory for dealerships in the battle with the Department of Labor on overtime pay to service advisors. For now, the worst-case scenario of enforcing overtime pay for service advisors has been avoided and the legal arguments supporting overtime pay have been weakened. This article will explore 1) the history of the automobile exemption and how the industry has fought for it, 2) the *Encino* case and how it came to the Supreme Court, and 3) what the *Encino* decision means for dealerships moving forward.

The Automobile Exemption from FLSA Overtime Pay:

Under the Fair Labor Standards Act (FLSA), employers are generally responsible for making overtime payments at time-and-a-half to employees working over forty hours a week. Ever since 1966, the automotive industry has benefited from a blanket exemption from this practice for "any salesman, partsman, or mechanic primarily engaged in selling or servicing automobiles." (the Automobile Exemption). The heart of the controversy here is whether the language contemplates a service advisor as a "salesman. . . primarily engaged in. . . servicing automobiles." The opposing interpretation is that "salesman" here only applies to an employee "selling. . . automobiles."

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Continued: U.S. Supreme Court Looks at Service Advisor Overtime Pay

From 1978 until 2011, the Department of Labor (the Department) considered service advisors to be included in the Automobile Exemption and thus exempt from overtime pay. This was determined in an administrative opinion and reflected in the Wage and Hour Field Operations Handbook for over 30 years. However, in 2011, the Department changed its mind and ruled that service advisors were no longer included in the automobile exemption. This 180-degree flip in Department stance resulted in an immediate reaction from the industry. With the NADA leading the charge, Congress placed a provision in the 2012 budget preventing the Department from enforcing its new decision on service advisors until March, 2013.

Background on Encino Case:

Encino Motorcars, LLC is a Mercedez-Benz franchise holder in California. This litigation began in 2012 when a group of five current and former service advisors employed by Encino decided to sue for overtime pay, claiming violations of the FLSA. These service advisors were compensated on a commission basis and required to work from 7 a.m to 6 p.m. at least five days per week. The District Court held that service advisors fall within the Automobile Exemption above and dismissed all claims. The Department appealed to the 9th Circuit Court of Appeals, which reversed course and held that deference should be given to the interpretation in the Department's 2011 ruling. Because this ruling conflicted with decisions by the 4th and 5th circuit courts, the Supreme Court granted certiorari to resolve the conflict.

U.S. Supreme Court's Decision on Encino:

After oral arguments in April, 2016, the U.S. Supreme Court, on June 20, 2016, released their final opinion in *Encino Motorcars, LLC v. Navarro*, No. 15-415, slip. Op. (U.S. 2016).

In a majority opinion written by Justice Kennedy, the Court held that the 9th Circuit should not have given deference to the 2011 Department regulation. This was because the Department failed to give adequate reasons for its change in long-standing policy. However, the Court stopped short of making a definitive interpretation of the Automobile Exemption, choosing instead to send that decision back for the 9th Circuit to determine.

This is a positive result for dealerships because the 9th Circuit may decide that service advisors fall within the Automobile Exemption. This would be in line with similar decision made by the 5th Circuit in the *Deel Motors* case, the 4th Circuit in *Greenbrier Ford*, as well as the dissenting opinion in *Encino*, written by Justice Thomas and joined by Justice Alito. If the 9th Circuit finds that service advisors fall under the Automobile Exemption, that will be the end of this debate unless another U.S. Appellate Court decides a similar case differently or the Department pursues additional regulations.

Although it would be a surprise, it is entirely possible for the 9th Circuit to go the other way and choose to require overtime pay to service advisors. If this happens, we would likely see another round back up to the Supreme Court on this same issue. The end result is that, until the 9th Circuit renders another opinion, the fate of overtime pay to service advisors remains uncertain.

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Have questions or concerns? Buying or selling a franchise? Want to suggest a topic for a future article? Please do not hesitate to reach out to **Arenson Law Group** at arensonlaw.com/contact-us today!

Continued: U.S. Supreme Court Looks at Service Advisor Overtime Pay

What to Expect Now After Encino:

Make no mistake — the Department's interpretation of the Automobile Exemption has been weakened by the *Encino* decision. Because the 2011 Ruling is on the books, the Wage and Hours Division of the Department has had the right, since March 2013, to audit dealership records and assess payment of overtime wages and penalties for service advisors. If and when the Department takes this action against an auto dealer in Iowa, which is governed by the 8th Circuit, it will likely be much easier to win those cases under *Encino* than otherwise. *Encino* basically states that the courts no longer have to give priority to the Department's interpretation of the Automobile Exemption, thus, allowing courts to freely interpret the language. Because almost every court that has evaluated the Automobile Exemption has determined that service advisors should be included, it is likely that courts here in Iowa will decide the same.

Notwithstanding the Automobile Exemption, there are other provisions of the FLSA that may provide exemptions for service advisors who are paid on a commission basis. To meet this exemption, service advisors must meet all of the following criteria:

1. The service advisor must be employed by a retail or service establishment (an auto dealership qualifies); and

2. The service advisor's regular rate of pay must exceed 1.5 times the applicable minimum wage for every hour worked in a workweek; and

3. More than half of the employee's total earnings in a representative period must consist of commissions on goods or services.

But keep in mind, the service advisors in the *Encino* case were under a commission structure and that dealership was still drawn into extended litigation. Dealer Law Review will continue to monitor this issue closely and provide updates as they arise. If you have concerns about your employee compensation structure, your compliance with FLSA regulations, or are currently being audited by the Wage and Hour Division, be sure to contact experienced auto dealer counsel. ■ ■ ■

In our Next Issue:

The Privacy Rule Unraveled - Do you meet Federal guidlines for maintaining proper privacy statements and providing proper privacy notices? Learn how to lower compliance costs.

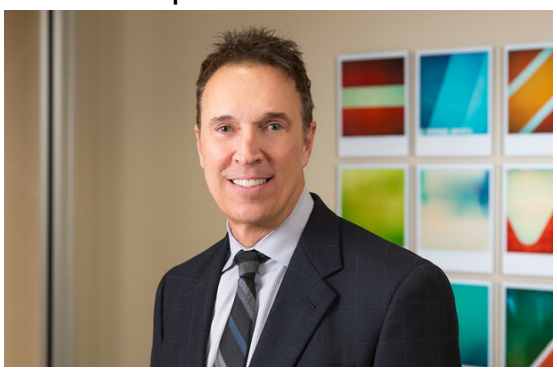
Fair Labor Standards Act - How should you structure your compensation packages for your technicians, sales people, and other employees? Learn what works and how new overtime regulations might impact your operations.

Customer Lists Under Iowa Law - Not all requirements laid out in the Manufacturer's Sales and Service Agreement apply with full force. Is the Manufacturer requesting access to your Customer Lists? Learn about your rights.

Arenson Law Group, P.C.
425 2nd Street SE, Suite 900
Cedar Rapids, IA 52401

The articles in this newsletter are created by **Arenson Law Group, P.C.**, auto dealer and business law attorneys based in Cedar Rapids, Iowa. We provide cradle-to-grave representation for owners, dealers, and senior management of franchised and independent motor vehicle dealerships.

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.



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