Written Testimony of John P. McEleney, Chairman

National Automobile Dealers Association

Submitted to the House Energy and Commerce Committee
Subcommittee on Oversight & Investigations

For Hearing On

GENERAL MOTORS AND CHRYSLER DEALERSHIP CLOSURES AND RESTRUCTURING

June 12, 2009

Mr. Chairman, Ranking Member Walden, my name is John McEleney, and I am the Chairman of the National Automobile Dealers Association (NADA). I am also president of McEleney Autocenter, of Clinton, Iowa., which is actually in Rep. Bruce Braley's district, who is on this subcommittee. We operate General Motors, Toyota and Hyundai franchises and have been in business for 95 years and now provide jobs for 140 people. Additionally, my family held a Chrysler franchise between 1984 and 2007.

NADA's membership consists of over 17,000 new car and truck dealers in the United States, both domestic and international nameplates, whose independently-owned businesses employ upwards of 1 million "Main Street" Americans. NADA truly is the "Voice of the Dealer" because our association represents over 93 percent of all dealers, regardless of make and model. To put this powerful employment model in perspective, the largest private sector employer in America is Wal-Mart, with 1.3 million employees. Moreover, dealership jobs pay well. The typical compensation for a dealership's employee is more than twice the national average of jobs in the retail sector, and our jobs cannot be outsourced. Even more Americans are employed in businesses that supply goods and services to dealerships. Statistics that document the extent of automotive retailers contribute to our economy at the local, state, and national levels may be found at NADA's website.[1]

We need the help of this subcommittee to ask some key questions about the treatment of dealers, their employees, their communities, and the customers that depend upon these local businesses. Why are dealer reductions necessary at this time? How did Chrysler decide which dealers to terminate? How will the announced dealer reductions enhance the viability of GM and Chrysler? To date, we have received no plausible answers to these most basic questions.

At the outset of my testimony, I wish to emphasize that the overall state of auto retailing is dire. No previous economic challenge except for the Great Depression can compare to what confronts franchised dealers today. The automobile retail industry is highly credit-dependent and, as such, was disproportionately hard hit by last year's financial crisis. Floorplan credit, the financing used by dealers to buy new and used vehicle inventory, has contracted dramatically, and even creditworthy dealers are having trouble finding access to floorplan financing. At the same time, we are experiencing the lowest new car sales rate since World War II. Unless and until these larger challenges are resolved, all auto manufacturers and dealers will continue to face problems. In fact, we will not have a meaningful economic recovery in this country without resolving these broader issues, because auto sales historically have constituted 20 percent of all retail spending in the United States. [2]

As the President's Auto Task Force has initiated the restructuring of two of the largest manufacturers in the United States, there has been a significant lack of transparency or justification in this process. As the Chairman of NADA, I have

[1] (http://www.nada.org/Publications/NADADATA/DrivingUSEconomy/)
[2] For more on credit and the auto industry, see the attached Appendix, "Credit and the Auto Industry"

represented dealers in three meetings with the President's Auto Task Force as well as in conference calls, and have provided at their request many documents and data. At our meetings with the Task Force, we have repeatedly explained the fact that dealers are not cost centers for manufacturers but rather externalize the manufactures' costs. Dealers are the largest source of revenue for the manufacturers, and to the extent there is "overdealering" in certain areas, the past 50 years the dealer population has declined every year due to orderly consolidations. I elaborate on these points later in this testimony.

NADA has had regular meetings with the manufacturers on a wide variety of matters related to industry relations. During the past year we have met with Chrysler and GM on numerous occasions to discuss the specific submissions that each company made in conjunction with the bridge loans last year and the viability plans this year. Additionally, we have had numerous conference calls on the same issues.

None of Chrysler's submissions to the government prior to the May 14th announcement could have been interpreted to put Chrysler dealers on notice of the scope of the terminations that followed. Similarly, our discussions with Chrysler officials during the past year did not give any indication of these drastic cuts proposed, much less of the onerous terms and conditions. To the contrary, all indications were that dealer reductions would be achieved in the context of the on-going Genesis program which relies principally upon negotiated transactions based on conditions in the local market.

The potential for such an orderly transition has degenerated into chaos for 789 Chrysler dealers. These dealerships learned on May 14th that they would lose their franchises within 26 days. Moreover, they were told that the factory would not buy back any unsold inventory of vehicles and parts or any of the factory-specific tools that all dealers are required to buy from the manufacturer. No dealer could possibly have anticipated this egregiously short timetable and these unprecedented terms. After all, the franchise agreement requires the manufacturer to buy back vehicles, parts, and tools. No manufacturer has ever imposed such onerous conditions on terminated dealers. Especially troubling is the fact that during the last few years, some of these terminated dealers were pressured by the manufacturer to build large new retail facilities. Moreover, within the past few months, many of the terminated dealers were strongly encouraged by Chrysler to take additional inventory even when local market demand didn't support this decision. In short, many of these 789 Chrysler dealers were team players. They did all that was asked of them by Chrysler and in return were stripped of their franchises on less than three weeks' notice with virtually no recourse. In return for their loyalty, they saw any goodwill in their business evaporate in a matter of days.

Adding insult to injury, *Automotive News* reported just four days after the termination letters arrived that Chrysler was planning to re-enter some of these 789 markets. Since then, we have heard that in some areas prospective new dealers are even touring some of these dealerships targeted for closure. This certainly does not look like a strategy to reduce the dealer count to achieve an efficient rationalization. Rather, this just looks like a strategy to leverage the tremendous unfairness of bankruptcy to force the closure of some dealerships for the benefit of others.

Apparently, at some time during the deliberations of the Administration Auto Task Force, the treatment of GM and Chrysler dealers took a drastic turn for the worse. On March 30, the Task Force rejected GM and Chrysler's own dealer consolidation plans, set forth in their respective "viability submissions" of February 17th, based in part on the fact that task force officials believed their dealer reduction plans did not go far enough or move fast enough. The Auto Task Force's March 30, 2009 Viability Assessment of GM specifically states with respect to brands and dealers that:

> The Company is currently burdened with underperforming brands, nameplates and an excess of dealers. The plan does not act aggressively enough to curb these problems.[3]

Contemporaneous news reports highlighted the same reality:

> New CEO Fritz Henderson says the federal Auto Task Force's rejection of GM's viability plan requires GM to make "deeper and faster" cuts. GM has 60 days to submit a new, more drastic restructuring plan or face bankruptcy. That means GM is pulling forward its plan for dealership consolidation.[4]

Finally this was confirmed in GM's letter on May 14 notifying 1,100 GM dealers of the intention not to renew their franchise agreement beyond October 2010 which read in part "As we have communicated to all dealers, our revised restructuring plan is a result of GM being challenged to move more aggressively and faster in its restructuring efforts".

The Auto Task Force has taken the position that it had not mandated the acceleration of dealer cuts and advised that it was the companies that were initiating the dealer reductions. An Obama administration source told *Politico*," We're happy to listen, but what we will politely say to them is: It's not our job to tell these companies what dealers they should have or, or even how many."[5]

However, in response to a question before the Senate Banking Committee on June 10th, Ron Bloom of the President's Auto Task Force said, "We did not give [the companies] a numerical target, but we certainly did say, regarding plants, regarding dealers, regarding white and blue collar headcount, regarding all these matters, that you need to be more aggressive. . . ."[6]

---

[3] Auto Task Force, March 30, 2009. *GM Viability Assessment – Rejection of GM's February 17, 2009 plan*. "Brands/Dealers: The Company is currently burdened with underperforming brands, nameplates and an excess of dealers. The plan does not act aggressively enough to curb these problems", p. 1.
[4] *Automotive News*, "Henderson's GM speeds up dealer cuts", April 6, 2009
[5] Allen, Mike. "Car dealer cuts coming soon." *Politico,* May 13, 2009
[6] Testimony before Senate Banking Committee, *Congressional Quarterly Transcriptions*, June 10, 2009

While it is recognized that the Auto Task Force did not identify specific dealer reductions, the question remains why did the Auto Task Force mandate these drastic dealer cuts? What is the objective standard for these actions? Where is the public accountability for these decisions? These rapid dealer reductions will adversely affect 789 Chrysler and over 1,100 General Motors dealerships, employing over 100,000 middle-class Americans. These people deserve more. The country, currently facing a national unemployment rate approaching nine percent, deserves more. The state and local governments that depend on the dealerships for revenue deserve more. The Federal taxpayers, footing the bill for the restructuring, deserve more.

These drastic dealer reductions will not increase the viability or competitiveness of GM and Chrysler. Franchised dealerships are independently owned businesses, not the "company owned" stores used by many other industries to distribute their products. The dealer – and not the manufacturer – invests in the land, buildings, facility upgrades, personnel, and equipment necessary to sell and service vehicles. Because of these sizable multi-million dollar dealer investments, manufacturers receive a national retail distribution network at no capital expense and are able to externalize virtually all of the costs associated with the establishment and maintenance of a national retail distribution network for their products.

Absent the franchised dealers, a manufacturer would have to invest billions of dollars to replicate the existing facilities, employees, and retail presence. No manufacturer, much less an automaker in extremis, could possibly assume this burden and hope to remain competitive. No manufacturer would want to assume the risk involved with retailing. For example, if the manufacturers make an unappealing vehicle, the dealers bear the brunt of that mistake and suffer the consequences of unsold inventory. Similarly, the dealers also bear the risk of the deterioration of a prime real estate location and the risk of a local economic downturn.

According to the attached report that we provided to the task force, "The Franchised Automobile Dealer: The Automaker's Lifeline", prepared for NADA by the Casesa Shapiro Group, "far from being a burden to the manufacturer it represents, the automobile dealer supports the manufacturer's efforts by providing a vast distribution channel that allows for efficient flow of the manufacturer's product to the public at virtually no cost to the manufacturer."[7]

Franchised dealers are the largest source of revenue for the manufacturers. In the United States, the dealer body provides 92 percent of GM's revenue. To casual observers this may be a complete surprise, but the explanation is simple. A manufacturer does not sell cars to consumers. A manufacturer sells cars to a dealer, and the dealer sells the car to a consumer. Moreover, because the manufacturers control large streams of payments to the dealer body – all of which are non-interest bearing payments made in arrears for products already delivered or services already performed – the manufacturers can simply use cash management techniques to achieve "cost of money" savings that would easily

[7] "The Franchised Automobile Dealer: The Automaker's Lifeline." Casesa Shapiro Group, November 26, 2008 (Attached)

offset these minimal operational expenses. In the aggregate, the manufacturers can use this "float" to earn millions of dollars. And there are a number of purchases that dealers are required to make – including signs and specialized tools – on which the manufacturers actually make a profit. The "cost of money" savings alone are likely to offset the minimal administrative expenses associated with the direct support of the dealer network.

The rapid and destructive dealer reductions will erode market share. Dealers have deep roots in the community and have helped provide manufacturers with long-term customer relationships that create brand loyalty and maintain customer convenience. Therefore, reductions in dealer numbers will not only cut manufacturer revenue but also market share. Dealer closures must be done carefully to maintain the manufacturer's viability. "We had 13,000 dealers 18 years ago, so we've already cut that in half," Mark LaNeve, GM's North American President, said at this year's North American International Auto Show in Detroit. "We don't want them to close all at once because we figure we lose sales for 18 months after a dealership closes until other dealers pick up the business."[8]

The purported administrative savings from reducing the dealer count will not materialize. Since the principal purpose of the franchised dealer network is to outsource costs, the manufacturers incur very little direct costs related to the dealer network. Therefore, few savings are likely to be generated from dealer reductions.

- <u>Marketing and advertising costs are not likely to be reduced because of a reduction in the dealer network</u>**.** Individual dealers, not the manufacturer, pay for state and local marketing and advertising. Also considering the initial loss in market share resulting from dealer closings, marketing efforts will likely have to be increased in the short run.

- <u>Manufacturer retail incentive costs are determined by the number of vehicles being sold, not the number of dealers in a given market</u>**.** The manufacturers provide various incentives (i.e. rebates) for dealers and consumers to stimulate vehicle sales to clear inventory or increase market share for a particular vehicle. The only way for these costs to be reduced would be a reduction in total vehicle sales.

- <u>Manufacturers require various dealer employees to undergo training, but the dealer pays for these costs, not the manufacturer</u>**.** The dealers will continue to absorb these costs regardless of the number of dealers.

- <u>Destination fees are standardized, so it is highly unlikely that manufacturers' distribution costs will be reduced</u>**.** The manufacturer sets the distribution fee. And unless the manufacturer plans on exiting an entire geographic region, shipping costs will not significantly change. If such a drastic consolidation even did occur,

[8] *Bloomberg News,* "Small cars aren't selling as well, GM official says; Fuel prices send buyers back to SUVs, pickups", January 14, 2009.

the manufacturer would immediately suffer losses in market share, causing the per unit distribution cost to rise.

- Manufacturer's interest expense will not decline, since the expense is related to the number of vehicles financed, not the number of dealers financing the vehicles**.** Most manufacturers provide some financial incentives to offset the initial costs of dealer borrowing (for inventory, parts, etc.). Since fewer dealers would have to finance greater numbers of vehicles to keep sales constant, the remaining dealers would expect to continue to receive the per unit incentive to offset the additional risk of financing a larger inventory.

- The dealer network requires very little incremental costs**.** With modern electronic communications, the costs needed to maintain the dealer network are minimal, as are the potential savings with reducing or even eliminating dealers.

- Simplistic attempts to compare the number of dealerships or the "throughput" of new car sales at GM and Chrysler dealerships to Toyota dealerships are invalid. The task force is only focused on new car sales. Yet, there are 66 million GM vehicles on the road today and 33 million Chrysler vehicles versus 22 million Toyota vehicles. Consumers need to service and repair these vehicles, and domestic brand dealerships serve more cars per location than international nameplate dealerships. Drastically reduced dealers mean consumers will experience higher prices from reduced competition and greater inconvenience from reduced service facilities. Similarly, GM and Chrysler serve far more rural areas than Toyota and – as a direct result – enjoy a higher market share in rural areas.

The inescapable conclusion is clear. Accelerated dealership closings are not necessary for the future viability of either GM or Chrysler. Dealership closings result in loss of revenue for the automakers without any real cost savings.

Now, I will to turn to the status of the GM agreements, both the Participation Agreements for those dealers going forward and the "wind down" agreements for those dealers who will lose their businesses. Last week during my testimony to the Senate Commerce Committee, I voiced NADA's concerns about the extremely one-sided terms of the Participation Agreements delivered to the 4,000 dealers of the new GM. During that hearing Mr. Henderson committed to meet with NADA to discuss our concerns. GM followed through on that commitment. Our leadership met with a team of senior GM officials last Friday, and we had a very frank discussion. As a result, GM has made significant improvements in the Participation Agreement. Additionally, GM has committed to clarify some of the terms of the wind down agreements, and NADA will continue to work with GM to make sure that the wind down agreements will be improved. NADA appreciates GM's efforts to continue to work with NADA on these critically important matters.

An orderly, market-based consolidation of the dealer network has been underway for more than 50 years. For decades the number of dealerships in the U.S. has been shrinking at a consistent pace, dictated by market conditions and accelerating during a recession such as today. In 1949 there were almost 50,000 dealerships and by 1970 that number was 30,800. During that timeframe virtually all of these held domestic franchises. In 1987, there were 25,150 new-car dealerships; by the end of this year, we expect that number to have dropped below 17,000.

The sharp reductions in domestic dealerships have occurred despite the fact that the size of the nation's fleet keeps increasing. The number of vehicles in operation rose from approximately 125 million in 1976 to almost 250 million in 2007. More importantly, the majority of the vehicles in operation today have domestic nameplates. Therefore, the number of domestic vehicles in operation per domestic dealership continues to rise. Even without the drastic reductions that GM and Chrysler seek to impose, the number of GM and Chrysler vehicles on the road today per dealership is at an all time high.

While market forces have operated – and will continue to operate – to reduce the number of dealerships, there are important counterbalancing factors to consider. The foremost of these are the convenience and competition that consumers receive from an extensive dealer network. Intra-brand competition is very important to consumers. Indeed, the most intense competitor for, say, an individual Ford dealer is the nearest Ford dealer. Therefore, any precipitous decline in the size of the dealer network of any manufacturer could dramatically reduce competition for the sale and service of vehicles.

For 100 years, the franchise system has provided a strong auto retail network for consumers, dealers, and vehicle manufacturers alike. All 50 states have enacted motor vehicle franchise laws to inject balance in the inherently one-sided economic relationship between a dealer and the manufacturer and to provide consumers a reliable, convenient, and competitive retail network for automobiles sales and service. The state franchise laws guard against a manufacturer unilaterally terminating a dealership without cause and unilaterally threatening to put the same brand on every corner. A typical state franchise law requires a manufacturer to show good cause in order to terminate a dealer agreement, provides a framework for determining a fair value of the franchise terminated, establishes basic rights of succession from generation to generation, and sets out a definition of relevant market area to preclude unfair proliferation of dealerships. Numerous courts, including the United States Supreme Court, have upheld the constitutionality of various state franchise laws.

The state franchise laws have provided a rational framework for consolidation and reduction of dealerships and have not prevented the termination of brands. Within the past sixty years, the number of dealerships has declined steadily from almost 50,000 in 1949 to 17,000 today. Even with the state franchise laws in full effect, the manufacturers have combined brands under one roof at the dealership level via channeling agreements, eliminated brands altogether, and terminated individual dealers.

The unprecedented evisceration of state franchise laws under the guise of a structured bankruptcy is one of the most disturbing aspects of the treatment of GM and Chrysler dealers. This disregard of state franchise laws is threatening the economic stability of communities and eroding the national infrastructure essential to the recovery of troubled manufacturers. In the case of Chrysler, we have a window to the future unless corrective action is taken: closed businesses, terminated employees, increased foreclosures, and idle real estate, thereby deepening the current recession and threatening even the dealerships that the manufacturers would designate for survival.

The more we learn of the specific facts and circumstances of the Chrysler closures, the more we are concerned that this forced bankruptcy is being used to circumvent long-standing state laws. The fact that the Administration is part of this process is especially surprising, because on May 20, 2009, the Obama Administration released a memorandum that stated as the general policy of the Administration: "preemption of State law by executive departments and agencies should be undertaken only with full consideration of the legitimate prerogatives of the States and with a sufficient legal basis for preemption" Moreover, according to the memorandum, "The Federal Government's role in promoting the general welfare and guarding individual liberties is critical, but State law and national law often operate concurrently to provide independent safeguards for the public."

In addition to protecting broad public interests, the state franchise laws actually provide an economic benefit of the manufacturers as well. Dealer investments in the retail network are premised on the existence of franchise law protections. If the franchise laws were not present to protect those investments, the investments would carry more risk. And that risk, in turn, would command a risk premium. Indeed, publicly-traded auto retailers routinely disclose the possible repeal of state franchise laws as a risk factor in their public filings. If those laws were in fact to be removed, that risk would become a reality and the capital investment markets would respond accordingly. Existing capital would seek safer havens, and the cost of attracting new capital would rise. While this would be very visible in the public capital markets, the same phenomenon would play out in the private capital arena as private dealers make decisions where to place their resources.[9] And these increased costs would have to be paid somewhere in the overall industry value chain. Thus, far from saving manufacturers anything, the removal of the state franchise laws would actually raise their costs of operation.

In conclusion, rapid dealer reductions increase unemployment, threaten communities, and decrease state and local tax revenue without any material corresponding decrease in the automaker's costs. Mr. Chairman, I want to thank you again for convening this hearing, because we still have fundamental concerns. These government-negotiated bankruptcies impose drastic, unjustified dealer cuts, and continue to threaten dealer rights under state motor vehicle franchise laws. These laws inject balance in the inherently one-sided economic relationship between a dealer and the

[9] Similarly, dealers with franchise agreements that have limited durations – e.g., five or six years – could find it difficult (or more expensive) to convince finance sources to loan them money absent the fact that most of the state franchise laws protect non-renewals in the same way they protect against unwarranted terminations.

manufacturer and also provide consumers a reliable, convenient, and competitive auto retail network. Congress must act to ensure that the franchise laws of the 50 states remain intact and apply with full force and effect, especially when the new Chrysler and the new GM are operating outside of bankruptcy. Therefore, we are urging Members of Congress to support H.R. 2743, which would restore fundamental rights to dealers. We stand ready to work with Congress to achieve this goal, because the state franchise laws are the foundation of auto retailing in this country.

Thank you for holding this important hearing, and thank you for the opportunity to testify.