BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

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COMMISSION AUTHORIZED

June 12, 1990

The Honorable Earl Goodwin
State Senator
Alabama State Senate
Montgomery, Alabama 36130

Dear Mr. Goodwin:

In response to your request, the staff of the Federal Trade Commission is pleased to provide these comments on Senate Bill 401, a bill to regulate relations between suppliers of agricultural, utility, industrial and outdoor power equipment ("equipment") and their Alabama dealers.[1] Under the Bill's provisions, termination or non-renewal of such dealerships without cause would be prohibited; permissible causes, notice periods, procedures for termination, and rights upon termination would be specified; and particular practices by the supplier would be proscribed.[2] We believe that Senate Bill 401 is likely to raise the costs of distributing the specified equipment in Alabama without providing offsetting benefits. Ultimately, Alabama consumers can be expected to bear the burden of the resulting increases in equipment prices and decreases in the quality of dealership services.

I. Interest and Experience of the Staff of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. In furtherance of this statutory mandate, the staff of the Commission comments, upon request, on governmental measures that

[1] These comments are the views of the staff of the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or of any individual Commissioner.

[2] The Bill contains a wide variety of proposed constraints upon the supplier-dealer relationship, many of which, though somewhat ambiguous, may have broad implications for Alabama law. This comment does not attempt to deal with the potential impact of each of the Bill's provisions, or with an assessment of the grounds for singling out for state regulation this particular category of private contractual relationships. Rather, it attempts to evaluate the implications, for competition and consumer welfare, of what we construe as the principal features of the proposed legislation.

may affect competition and consumers. The staff has provided comments to federal, state, and local legislatures and federal and state administrative agencies on a wide range of matters that raise issues of competition or consumer protection policy, including proposed legislation to limit suppliers' ability to terminate dealers.[3]

II. Brief Description of Senate Bill 401

Section 3 of S.B. 401 includes a list of twelve unlawful acts and practices relating to dealer agreements.[4] Section 4 treats in detail the permissible grounds for termination of a dealership and similar actions, and the procedures to be followed.[5] Section 5 requires that repair parts for equipment be

[3] In 1989, for example, the Commission's staff submitted comments to the Oregon legislature on a Bill dealing with supplier and dealer relationships, and in the same year, in response to your request, submitted views to the Alabama legislature on House Bill 441, entitled "The Construction Equipment Franchise Act." This Bill sought to restrict suppliers' ability to terminate existing dealers for construction equipment or to award new dealerships for such equipment.

[4] Our comments regarding Section 3 are limited to subsections 3(4) (termination of a dealership, and similar actions, without good cause), and 3(6) and 3(7) (supplier price discrimination among dealers). Of the remaining enumerated unlawful acts and practices, subsections (1) and (2) involve coercive dealings, (3) involves refusal to make timely delivery of promised equipment, (5) conditioning renewal on changes in the dealer's place of business, (8) interference with changes in a dealer's capital structure which do not impair capital or change the dealership's control, (9) other unreasonable interference with changes in the dealer's ownership, (10) requiring waivers of liabilities established by the Bill, (11) taking more than 180 days to audit compliance with promotional campaigns, and (12) unreasonably withholding consent to transfer of ownership upon the death of a dealer or principal owner.

[5] Section 2(8) defines "good cause" in general terms, apparently for application in the subsequent prohibition, at Section 3(4), of termination of a dealership "without good cause." However, Section 4(b) subsequently states that "termination by a supplier of a dealer agreement shall be with cause when the dealer has" acted or omitted to act in ten specified ways. The relation of Section 2(8) to Section 4(b) is not entirely clear. For purposes of this comment we have assumed

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made available by the supplier "throughout the reasonable useful life" of the equipment, and mandates in detail allowances for periodic return of surplus parts for credit, and the amount of such credit. Section 6 similarly mandates, and specifies terms for, repurchase of equipment and parts upon termination of a dealership.

Section 7 requires compensation by the supplier for dealership facilities under certain conditions. Section 9 provides for court actions by a dealer against a supplier, for damages and injunctive relief, based upon violations of the Bill's provisions. Section 13 provides for additional civil actions, by "any person who is injured in his business or property by a violation of this act."[6]

III. Restrictions on Termination and Non-Renewal of Contracts with Dealers

Senate Bill 401, if enacted, would significantly restrict the ability of suppliers of equipment to Alabama dealers to terminate or decline to renew[7] relationships with dealers. The

[5] (...continued)
that Section 4(b) is intended as an exhaustive description of valid causes for termination within the scheme of the Bill.

[6] Although the title of the section is "Civil Action by Dealer," its terms may thus confer standing on a larger group. Additionally, the grounds for such actions are extended to "the commission of any unfair and deceptive trade practices," language similar in its generality to that contained in the FTC Act's Section 5 (15 U.S.C. §45). This comparison suggests the possibility of an interpretation extending far beyond the Bill's specific prohibitions, and even beyond the subject matter of supplier-dealer relationships.

The relationship between the remedies provided by Section 13 and Section 9 is not indicated.

[7] The restrictions also extend to actions by the supplier to "change the dealer's competitive circumstances," a concept that the Bill does not define or otherwise elaborate, though it is employed at several key points. It appears in Section 3(4) (prohibition of supplier actions relative to a dealer "without good cause"), in Section 4(a) (requirement of notice of deficiencies and opportunity to cure), in Section 4(c) (requirement of written proof of performance deficiencies), and in Section 9 (provision of an injunctive remedy for dealers).
(continued...)

most severe restrictions would apply to the termination of those dealers the supplier specifically judges deficient in marketing its products and/or providing service to customers.

The Bill specifies ten dealer actions or omissions that would constitute "cause" for termination or non-renewal. Which of the ten specified causes is invoked by the supplier as the basis for ending its relationship with the dealer has very important procedural implications. If the action is supported by any of the six types of "cause" listed in Section 4(b)(1)-(6), including that the dealer entered bankruptcy or was convicted of a crime, the dealer may apparently be terminated summarily. If the supply relationship is severed for one of the four other specified reasons, however, the supplier must give the dealer 90 days written notice of an intent to terminate and provide at least six months to cure the asserted deficiency, and must also meet standards of documentary proof of the deficiency.

The six causes for which summary termination would be permitted clearly represent serious potential problems for a successful supplier-dealer relationship. But the causes that would trigger the notice-and-opportunity-to-correct procedure could lead to the supplier losing sales and consumer good will, if the supplier cannot act readily to remedy deficiencies. Moreover, consumer harm could result if a remedy is delayed. For example, Section 4(b)(7) pertains to a dealer engaging consistently in misleading advertising, failing to provide

[7] (...continued)

In view of its apparent breadth, this phrase may include action by a supplier to authorize a new dealer competing with the existing dealer. Such an interpretation, by preventing the supplier from appointing additional dealers, may grant existing dealers exclusive territories. This would have the potential for anticompetitive effects.

While the courts have come to recognize that the use of exclusive dealer territories or lesser restraints on competition among a given brand's dealers may in some circumstances be pro-competitive, the reasoning of the decisions depends on the proposition that the supplier involved has voluntarily determined that this is the most efficient means of distributing its products (rather than being coerced into adopting it by a dealer cartel). See Continental TV, Inc. v. GTE Sylvania Inc., 433 U.S. 36, 51-59 (1977).

service and replacement parts, and charging "excessive" prices;[8] Section 4(b)(8) to the failure to meet normal standards of sales, service, or warranty performance; and Section 4(b)(9) to the failure to provide adequate sales, service, or parts personnel. Such dealer deficiencies could cause serious harm to consumers as well as suppliers.

Even if the supplier meets the "good cause" standard for dealer termination, his obligations to the dealer under the Bill are not finished. Section 6 of the Bill requires the supplier to repurchase from the terminated dealer any inventory of equipment or repair parts that the latter was required to maintain, and imposes detailed pricing terms on this transaction. Section 6(b) requires that the supplier pay the dealer 100 percent of the current net price[9] of new equipment and of unused repair parts and accessories. Unless the supplier performs the packing and loading of the equipment and parts, it is also required to pay the dealer 6% of the current net price for performing such services.

[8] The Bill would make consistent "excessive pricing" a potential cause for termination. From this brief treatment, not otherwise explained, it is unclear what control over dealers' pricing the Bill intends to confer upon suppliers. Agreements between manufacturers and retailers on resale prices constitute per se violations of the antitrust laws.

[9] Section 2(7) defines "current net price" as the price listed in the supplier's current catalog. Notably, no allowance is made for the possibility that the dealer obtained a discount or other terms more favorable than this list price when it purchased these goods, so the dealer may actually profit on this mandated repurchase.

By contrast, the provisions of Section 5 of the Bill, which impose a detailed obligation on the supplier to repurchase "surplus" parts during the term of a continuing dealership arrangement, requires payment of only 85 percent of the current list price, and requires the dealer to bear the expense of packing and shipping.

Even if the imposition of these repurchase obligations is supportable by a valid legislative purpose, it seems unclear why a dealer terminated for cause should receive more favorable treatment than a dealer in a viable ongoing relationship with the supplier, unless simply to increase the cost to suppliers of carrying out terminations.

A supplier need not repurchase equipment or parts that are not presently resalable,[10] are not demonstrated as having come from the dealer,[11] are not in new condition,[12] or were ordered after receipt of the termination notice.[13] However, any equipment or repair parts not coming within these exceptions must be paid for within 60 days of termination.[14] If a supplier fails to make such payment, it becomes liable for 115% of the current net price of the inventory plus freight charges, court costs, and attorney fees.[15]

Section 7 of the Bill adds further conditions to the supplier's termination of an equipment dealer. This section requires the supplier to pay the dealer "fair and reasonable" compensation for dealership facilities where the dealer has been terminated without good cause.

The cumulative effect of the various restraints on a supplier's actions to end a dealer relationship could apparently override private agreements entered into by dealers and suppliers in two principal ways. First, the requirement that a seller renew a dealer's agreement unless he can establish "good cause" for not doing so[16] could in effect extend the agreement period indefinitely, without regard to the parties' intentions.[17] Second, the Bill could supersede private contractual terms going both to the conduct of ongoing supplier-dealer relationships and to the rights upon termination and upon contract breach. In all of these respects, the Bill would substitute legislative views of appropriate relationships for the particular provisions worked out between private parties.

[10] Section 6(d)(2).

[11] Section 6(d)(3).

[12] Section 6(d)(5),(6).

[13] Section 6(d)(7).

[14] Section 6(e).

[15] Id.

[16] Section 3(4).

[17] The protections for dealers applicable to refusals to renew are identical to those for termination during the contract period, so that at least in this respect the contract is effectively perpetual.

As a general matter, private negotiations between suppliers and dealers in competitive markets can be expected to result in contracts that provide for efficient terms governing duration and termination as well as the other aspects of the relationship. Dealers who value the stability offered by long-term supply relationships may seek long-term contracts that protect their distributorships from termination except upon specified terms. Suppliers who expect their distribution methods to remain unchanged for long periods similarly may choose to encourage dealer enterprise and loyalty by entering into such long-term contracts and offering dealers certain protections against termination.[18] Consequently, regulation should be unnecessary to protect dealers from arbitrary termination or to secure long-term relationships in competitive markets where such arrangements would be the most efficient means of distributing suppliers' goods to consumers.

Such regulations may, however, effectively prevent suppliers from negotiating distribution contracts for shorter terms and retaining the flexibility to modify their distribution systems. Any injury from imposing these conditions on the market would not be confined to suppliers, but, if inefficient distribution relationships result, would likely extend to consumers.

By its tendency to freeze supply relationships, the Bill would tend to deprive equipment suppliers of the flexibility to adapt to changes in market or other conditions. For example, a supplier might wish to withdraw from distributing its product in a particular geographic area because it can no longer profitably operate there. In other cases, a supplier might seek to reorganize its national distribution system to operate more efficiently, and in the process realign its dealership network. In all of these cases, the realignment of the distribution system is likely to produce cost savings that may ultimately be passed on to customers in the course of competition. By impeding such realignments, Senate Bill 401 may increase the cost of selling equipment in Alabama and thus the prices paid by end-users for such equipment.

The rigidity that the Bill would bring to Alabama supplier-dealer relationships can best be appreciated in terms of the increased costs it would likely impose on the adjustment of such relationships. These costs fall into two closely related categories: those imposed directly by the statutory termination process, and those which would derive from the delay in reaching a new equilibrium.

[18] Of course, any dealer whose distributorship is terminated in violation of its contract may sue for redress of this breach.

The direct process costs would consist primarily of the expenses incurred by the supplier in establishing the evidentiary record called for by Section 4(c) as a basis for taking action against the deficiencies described in Section 4(b)(7)-(10). The development of sufficient "written documentation" of sustained poor performance may well be costly and burdensome.

The "delay" costs of termination or non-renewal under the Bill's notice-and-opportunity-to-correct procedures require a little more explanation. A supplier undertaking to use these procedures would apparently have to retain the dealer for not less than nine months[19] after discovering the dealer's shortcomings and reaching its own conclusion that they are unlikely to be remedied, and would have to endure the losses these shortcomings entail during that period. Moreover, termination causes in this category, which includes persistent use of misleading advertising, provision of inadequate service, and failure to perform warranty obligations, may cause serious injury to consumers as well until remedied. Further, the dealer performance deficiencies covered by Section 4(b)(7)-(10) may be frequently occurring reasons for supplier dissatisfaction with dealer relationships.

The costs involved in ending a supply relationship can normally be minimized through a privately negotiated agreement setting forth the duration of the arrangement and appropriate incentives for overall dealer performance.[20] A supplier unhappy with the performance of its dealer may choose not to renew the contract upon its expiration,[21] but has no incentive to discontinue a well-functioning relationship. Under the proposed legislation, however, a supplier may face great difficulty and expense in protecting itself from unsatisfactory dealer performance, and performance incentives for dealers would be correspondingly diminished.

[19] Section 4(a) calls for ninety days written notice of intent to terminate and the provision of "not less than six (6) months in which to cure any claimed deficiency." It is not entirely clear from the terms of this section whether these two time periods are additive or not.

[20] Cf. Klein & Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 J. Law & Econ. 265 (1988) (explicit enforceable contracts requiring dealers to supply a desired level of services are not always economically feasible).

[21] Id.

In view of the costs of establishing grounds for termination and the further costs incurred even when termination has been upheld, we believe suppliers may be hesitant to initiate termination proceedings regardless of the quality of services provided by individual dealers to their customers. The anticipated outcome could well be the provision of lower quality service at higher prices than would occur in the absence of the Bill.

Senate Bill 401 may also produce harmful effects by inhibiting suppliers in appointing new equipment dealers in Alabama. The increased costs the legislation would impose on suppliers when they terminate a distribution relationship may deter suppliers from entering such relationships, and over time reduce the number of equipment dealerships in Alabama. Appointment of "start-up" dealers, who will lack "track records" of performance, could be particularly discouraged, even though some such newcomers might have the potential to become particularly vigorous competitors, and to improve service to underserved communities. A reduction in the number of available alternative dealers would likely harm Alabama consumers.

We understand that many dealers may desire long-term distributorships. Many suppliers will share this preference, since it can enhance their ability to make long-range plans and, if termination of the relationship is not made unduly difficult, maximize incentives for dealer investment in making the distributorship succeed. As noted above, we would expect dealers and suppliers with such common interests to enter into mutually satisfactory relationships. But those dealers and suppliers with shorter time horizons and a different balance of incentives should also be permitted to express those preferences in binding contracts. Enactment of Senate Bill 401 is likely to impede this process.

IV. Other Restrictions on Supplier-Dealer Relationships

Senate Bill 401 contains additional provisions that may impede competition in equipment markets in Alabama. We discuss some of these briefly below.

Sections 3(6) and 3(7) of the Bill both relate to suppliers charging different prices to their dealers within the state. Section 3(6), in brief, forbids a supplier from selling or offering to sell equipment to a dealer at a lower price than that at which it sells or offers to sell the same equipment to another

dealer or to the supplier's retail outlet.[22] Section 3(7) makes it illegal for a supplier "to willfully discriminate" in price or its economic equivalent between dealers where the effect may be to lessen competition or give one dealer an economic advantage. Section 3(6) does not require a party alleging price discrimination to prove either of these effects. These sections appear to be inconsistent both with each other and with federal law dealing with price discrimination. The federal price discrimination law, the Robinson-Patman Act,[23] requires proof of effects to establish a violation, and also provides important defenses, such as meeting in good faith the lower-priced offer of a competing seller or recognizing differences in the costs of serving different dealers. Neither Section 3(6) nor Section 3(7) appears to recognize these defenses.

Section 3(6) apparently would require suppliers to establish a uniform statewide wholesale price for equipment. This requirement would prevent a supplier from giving savings to dealers that were justified by the supplier's lower cost of serving them. It also could inhibit a supplier from assisting an Alabama dealer in meeting competition from nearby out-of-state dealers, since a supplier would have to make any discount given such a dealer uniform throughout Alabama. In addition, mandatory uniform statewide pricing may increase the ability of suppliers to agree on prices by limiting the opportunity for individual suppliers to undercut any agreed-upon price by granting legitimate selective discounts to particular dealers.

Senate Bill 401 also mandates that suppliers provide dealers with an opportunity to return inventory annually during the term of the distributorship.[24] It also provides that the Bill's

[22] The implication that a supplier can place its wholly owned retail outlet at a competitive advantage by attributing a relatively low internal transfer price to the "sale" of an item to that other part of its own enterprise is without apparent support. What the supplier's outlet facility "gains" by the low transfer price is directly offset by what the supplier "loses" from the price at which it could have sold the equipment to an outsider. Of course, real savings may result from efficiencies attending such a vertical integration.

[23] The comparison here is to Section 2(a) and (b) (15 U.S.C. § 13(a) and (b)) of the Robinson-Patman Act, which deal respectively with the basic price discrimination offense and the meeting-competition defense.

[24] Section 5.

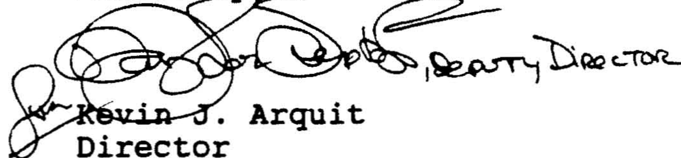
remedy shall be in addition to any contractual rights.[25] This provision, too, raises concerns. To the extent that the statutory requirements are more costly than those afforded privately, such increased costs are likely to be translated into higher prices for equipment sold in Alabama.

V. Conclusion

We believe that, if enacted, Senate Bill 401 could lead to a rigid system for the distribution of the specified equipment in Alabama, by denying suppliers the ability to respond flexibly to changing conditions and to develop lawful efficient incentive structures in their dealer relationships. This rigidity could lead to an increase in costs for suppliers and, in turn, result in higher prices and decreased service for consumers.

We appreciate the opportunity to comment on this Bill. We would be happy to provide additional information if we can be of any further assistance.

Sincerely,



Kevin J. Arquit
Director

[25] Section 5(8).