TESLA'S RELIANCE ON THE COMMERCE CLAUSE UNDER ARTICLE I OF THE U.S. CONSTITUTION:

Are State Laws Prohibiting Factory Direct Sales Unconstitutional?

By Leonard A. Bellavia

In less than two weeks' time from February into March of this year, Tesla released, and subsequently retracted, significant changes to its sales model. First, Tesla announced in late February 2019 that it would be closing all "brick and mortar" stores and exclusively sell cars online. Under Tesla's proposed February business model, consumers would no longer be able to walk into a retail location to inspect or test drive a Tesla vehicle before completing an online purchase with the assistance of a Tesla representative. Tesla stated that by eliminating its physical locations, it would lower its prices on all vehicles – besides the Model 3 – by six percent. However, late February 2019 seems long ago, as Tesla has already announced in early March a reversal of the "new" business plan.

Under the March "reversal," instead of a complete shutdown of all physical locations, Tesla would be closing approximately ten percent of its stores, singling out those with the least amount of foot traffic. Other locations that had been closed immediately after Tesla's February announcement would be re-opened with smaller staff. There were also stores that would be "under review" and may eventually be shut down by Tesla anyway.

Is Tesla's rapid reversal of its plan to sell vehicles exclusively online a sign of defeat under the franchise laws throughout the country? Or is it more likely that Tesla's change of heart is based upon real property lease obligations at their U.S. locations which reportedly exceed 1.6 billion dollars over the next few years?[1]

Whatever the reason may be for Tesla's reversal, it is likely that Tesla is, at least in some way, still planning to disrupt the automobile franchised dealership model. It is possible that Tesla may have attempted to overhaul its current business model too early and may still plan to later move sales strictly online once the leases they are currently locked into as part of their retail location/showroom network come closer to expiration.

In the early 2010's, Tesla began its aggressive campaign to bypass the traditional means of selling vehicles through franchised dealerships, or as Tesla called them, "middle men." By lobbying to amend, or abolish, states' franchise laws banning the direct sale of vehicles to consumers, Tesla endeavored to change the rules under which factories have sold vehicles to dealers for decades. To the dismay of automakers and franchised dealers alike, Tesla began to gain ground in a number of states.

Beginning in 2013, New Hampshire passed legislation allowing auto manufacturers to sell directly to consumers as long as the manufacturer had no existing dealer franchisees/network. This law allows Tesla to sell vehicles directly to consumers because it never sold vehicles through

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[1] Stumpf, Rob. *Tesla Still Owes $1.6 Billion in Leases for Closing Stores: Report*. The Drive. (March 9, 2019). http://www.thedrive.com/news/26857/tesla-still-owes-1-6-billion-in-leases-for-closing-stores-report

franchised dealerships. The following year, Washington passed legislation banning direct sales by manufacturers, but grandfathered Tesla's right to sell directly to consumers. Later in 2014, after a multi-year litigation in Massachusetts' highest court, Tesla was granted the right to sell to consumers directly.

Since then, Tesla has experienced other smaller victories, sometimes through negotiated settlements, such as the right to open a limited number of stores in a variety of states, such as New York, New Jersey, Ohio and others. However, Tesla has also encountered various legal obstacles on its path to circumventing the traditional franchised dealership network method of selling vehicles.

TESLA VS. THE STATE OF MICHIGAN

In 2016, Tesla sued the state of Michigan in Federal Court. In *Tesla Motors, Inc. vs Ruth Johnson, et. al.*, 16-cv-1158 (U.S.D.C. W.D. Michigan), Tesla challenged the constitutionality of Section 445.1574 of the Michigan Compiled Laws. Section 445.1574 prohibits motor vehicle manufacturers from directly selling their vehicles to consumers within the State. Instead, this Michigan state law requires all manufacturers to contract with independent, franchised dealers to sell their cars.

Tesla alleges that Michigan Compiled Laws Section 445.1574: (a) blocks Tesla from pursuing legitimate business activities and subjects it to arbitrary and unreasonable regulation in violation of the Due Process Clause of the Fourteenth Amendment; and (b) discriminates against interstate commerce and restricts the free flow of goods between states in violation of the dormant Commerce Clause. Tesla alleges that the sole purpose for applying Section 445.1574 to a non-franchising manufacturer like Tesla was to insulate Michigan's entrenched automobile dealers and manufacturers from competition which is not a legitimate government interest under the U.S. Constitution.

Specifically, Section 445.1574 provides that manufacturers "shall not," among other things, "sell any new motor vehicle directly to a retail customer other than through franchised dealers." Mich. Comp. Laws Ann. § 445.1574(1)(i). In other words, Section 445.1574 prevents manufacturers from selling cars directly to consumers in Michigan and even from servicing cars at facilities within the State. Section 445.1574 also prohibits manufacturers from owning, operating, or controlling a new or used motor vehicle dealer. Mich. Comp. Laws Ann. § 445.1574(1)(h). Tesla also argues that it does not propose to own, operate, or control a dealership; it simply wants to sell cars directly to consumers. In this respect, Tesla claims that Section 445.1574 creates a monopoly in favor of Michigan-based franchised dealers and benefits Michigan's local manufacturers (who sell their cars through dealers) by blocking Tesla from operating within the State.

Tesla also contends that:

- Even if the Michigan law could be regarded as a reasonable limitation on the ability of manufacturers employing a traditional dealer network to compete unfairly against their own dealers, it serves no rational purpose as applied to Tesla, which

only sells directly to consumers. Furthermore, the application of Section 445.1574's manufacturer-direct sales and service prohibitions to Tesla has no legitimate rational basis as Tesla has never sold cars through an independent dealership and therefore cannot engage in unfair business practices vis-a-vis a franchised dealer. As applied to Tesla, Tesla contends that the prohibition serves only to deny Michigan consumers access to Tesla's sales.

- Section 445.1574 unquestionably harms consumers as it prevents a non-franchising manufacturer like Tesla from selling cars within the state of Michigan and removes a competitor from the marketplace. It is further alleged that increasing competition enhances consumer choice and reduces prices whereas reducing competition takes choice away from consumers and increases prices.

In sum, the main focus of the Michigan lawsuit is Tesla's contention that the above-referenced Michigan law violates the Commerce Clause. The United States Constitution empowers Congress "[t]o regulate Commerce. . . among the several States." U.S. Const. Art. I, § 8, cl. 3. The Commerce Clause also has a negative aspect, referred to as the dormant Commerce Clause, which restricts state and local governments from impeding the free flow of goods from one state to another. The dormant Commerce Clause prevents states from promulgating protectionist policies, i.e., regulatory measures aimed to protect in-state economic interests by burdening out-of-state competitors. Tesla contends that Section 445.1574 violates the dormant Commerce Clause by prohibiting Tesla from selling and servicing cars in Michigan except through independent franchised dealers, which impermissibly discriminates against interstate commerce by impeding the flow of out-of-state-manufactured vehicles into Michigan and by favoring in-state interests (Michigan franchised dealers and Michigan-based vehicle manufacturers) over out-of-state interests (Tesla). Again, Tesla argues that the Michigan law does not advance any legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives and imposes a burden on interstate commerce that is clearly excessive in relation to any conceivable local benefit.

While the lawsuit is still in the discovery phase, the State of Michigan's Answer to Tesla's Second Amended Complaint asserts the following affirmative defenses:

- Tesla never has sought permission for direct sales but only for dealer licenses
- The State of Michigan has a constitutional, legitimate non-discriminatory reason for its purported non-discriminatory statute which is to prevent vertical integration in the manufacturing and selling of automobiles.
- The statute was not promulgated to discriminate against Tesla because it was enacted before the existence of Tesla.

CAN STATES BAN ONLINE DIRECT SALES BY A MOTOR VEHICLE MANUFACTURER?

While Tesla's move to a strictly online sales model appears to be halted for now, the automaker still poses a threat to the traditional dealer network model. If Tesla's lobbying efforts are

successful and they obtain approval for their online model, it may open the door for new online manufacturers to appear and begin selling cars directly to consumers. Therefore, like Tesla, other new auto manufacturers from India, China and elsewhere may be emboldened and attempt to navigate around the franchised dealer network system.

The case between Tesla and the State of Michigan is still pending, but Tesla has doubled down on its argument that any state attempting to ban Tesla's "online sales only" business model would be an unconstitutional restraint on interstate commerce that violates the Commerce Clause. When asked whether pro-franchise law state regulators would challenge Tesla's online sales model, Musk stated, "I'm sure the franchise dealers will try to oppose [Tesla] in some way, but to do so would be a fundamental restraint on interstate commerce and violate the Constitution. So, good luck with that." Alicandri, Jeremy. *Tesla's Online Model Confuses Industry Experts*. Forbes (March 5, 2019). However, Musk's argument served as an overly simplistic reading of the Commerce Clause.

The Framework of a Dormant Commerce Clause Analysis

Indeed, just some of the questions that a Court must reach to determine whether a state law, such as the one in Michigan that prohibits a manufacturer from selling any new motor vehicle directly to a retail customer other than through franchised dealers, would be stricken as an unconstitutional violation of the Commerce Clause, are (a) whether the law discriminates against out of state competition or has the effect of favoring in-state economic entities; (b) whether the law effectuates a legitimate local purpose and if its burden on commerce is excessive in relation to its benefits; and (c) whether the State has any other reasonable means of advancing a legitimate local (non-economic) state interest.

As just one example, in the case of *Granholm v Heald*, 544 U.S. 460 (2005), many of these same issues were raised. Specifically, the Supreme Court examined two state laws that permitted in-state wineries to directly ship alcohol to consumers but restricted the ability of out-of-state wineries to do so. The Supreme Court consolidated the two state cases and granted certiorari on the following question: "'Does a State's regulatory scheme that permits in-state wineries to ship alcohol directly to consumers but restricts the ability of out-of-state wineries to do so violate the dormant Commerce Clause in light of § 2 of the Twenty-first Amendment?'" 541 U.S. 1062, 158 L. Ed. 2d 962, 124 S. Ct. 2389 (2004).

One of the two consolidated cases originated in New York. In that case, the District Court initially granted summary judgment to the plaintiffs (i.e., out of state wineries) as it held that, under established Commerce Clause principles, the New York direct-shipment scheme discriminated against out-of-state wineries. However, the Court of Appeals for the Second Circuit reversed because it determined that the law effectuated a legitimate local purpose and its burden on commerce was not excessive in relation to its benefits. 358 F.3d 223 (2004). Specifically, the Second Circuit "recognize[d] that the physical presence requirement could create substantial dormant Commerce Clause problems if this licensing scheme regulated a commodity other than alcohol." *Id.*, at 238. The court nevertheless sustained the New York statutory scheme because, in the court's view, "New York's desire to ensure accountability through presence is aimed at the regulatory interests directly tied to the importation and transportation of alcohol for use in New

York," *ibid.* As such, the New York direct shipment laws were "within the ambit of the powers granted to states by the Twenty-first Amendment."

However, the U.S. Supreme Court, based on the Commerce Clause, invalidated both state laws. Simply stated, the Supreme Court held that the differential treatment between in-state and out-of-state wineries constituted explicit discrimination against interstate commerce and this discrimination substantially limited the direct sale of wine to consumers, an otherwise emerging and significant business.

Turning this same analysis to Tesla, the question becomes, can states proffer a strong enough legitimate local purpose for prohibiting manufacturers from selling new motor vehicles directly to retail customers other than through franchised dealers so that such laws would survive a Commerce Clause challenge? As stated above, in reaching its decision, a Court must analyze the following: (a) whether the law discriminates against out-of-state competition or has the effect of favoring in-state economic entities; (b) whether the law effectuates a legitimate local purpose and if its burden on commerce is excessive in relation to its benefits; and (c) whether the State has any other reasonable means of advancing a legitimate local (non-economic) state interest. Further, a Court must consider the evidence presented on a "sensitive, case-by-case" basis to ascertain the purposes and effect of the law being analyzed in order to determine whether the law is unconstitutional. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994). Indeed, the Supreme Court has held that a state law's burden on interstate companies does not, by itself, establish a claim of discrimination against interstate commerce. *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 126 (1978). Further, the Supreme Court has stated that "incidental burdens on interstate may be unavoidable when a State legislates to safeguard the health and safety of its people." *Philadelphia v. New Jersey*, 437 U.S. 617, 625 (1978).

Safety Concerns and Protection Against Fraud are Among
Legitimate State Interests for Banning Online Direct Sales

First, a strong argument could be advanced that Tesla should not be permitted to sell its vehicles online directly to consumers because of the inherent shortcomings regarding the servicing of Tesla vehicles. Specifically, states have a "legitimate" public interest in ensuring that its citizens have reasonably convenient access to a dealer who can service their vehicles or perform warranty services. In this vein, certain state franchise laws also require dealers to meet specifically mandated service facility requirements in order to obtain licensing to operate an auto dealership. If Tesla is intending to increase sales under a direct sales model, that would necessarily require a more robust "brick and mortar" service presence nationwide. While Tesla has stated that it would have service centers located throughout each state, it is unlikely that these service centers would be located such that no consumer would be forced to drive an unreasonable distance or have to wait an unreasonable amount of time to have service or warranty work performed.

A second legitimate local purpose for prohibiting manufacturers from selling new motor vehicles directly to retail customers other than through franchised dealers is that states possess a legitimate interest in requiring financing contracts to be signed by consumers while physically present at a dealership. These "wet ink" requirements are also imposed by numerous finance companies. These laws and finance company requirements are meant to pose an additional layer of protection

to consumers in an area that has been found to be rife with fraud and predatory lending practices. In a 2017 Forbes article by Diane Hembree entitled, *E-Contract Abuse Alert: How Car Dealers Can Fake Your Auto Loan*, David Valdez, a California attorney, discussed the difficulties inherent in executing electronic contracts and how consumers, especially those who speak English as a second language, are more susceptible to fraud and predatory lending. Valdez's observations are especially on point given the actions of Credit Acceptance Corporation, an auto finance company that utilizes electronic contracts, which settled, for over $12 million dollars, a class action suit regarding fraudulent overcharging of consumers. *Fielder v. Credit Acceptance Corp*., 19 F. Supp. 2d 966, 1998 U.S. Dist. LEXIS 14222, 37 U.C.C. Rep. Serv. 2d (Callaghan) 462.

A Similar Direct Sale Issue Previously Decided Against Ford

In F*ord Motor Co. v. Texas Department of Transportation, et. al.*, 264 F.3d 493 (5th Cir. 2001), a case that seemingly mirrors the pending Tesla versus the State of Michigan case, Ford attempted to market pre-owned cars in Texas via its internet site. The Texas Motor Vehicle Division argued that Ford's actions violated a Texas State law – formerly Section 5.02C(c) of the Motor Vehicle Code, currently Section 2301.476(c) – that prohibited a manufacturer or distributor from (a) owning an interest in a dealer or dealership; (b) operating or controlling a dealer or dealership; or (c) acting in the capacity of a dealer. In rejecting Ford's Commerce Clause challenge to the Texas State law, the Fifth Circuit held that (i) the statute was not discriminatory because it dealt with the status of being a manufacturer, no matter where domiciled and (ii) the elimination of the ability to sell used cars from Ford's website was not a constitutional burden on commerce. Most importantly, the Court held that the law did not violate the Commerce Clause because it was a legitimate reason for the State of Texas to require retail car sales through independent dealerships to prevent vertically integrated companies from taking advantage of consumers and to prevent unfair practices and other abuses. The decision in F*ord Motor Co.*, is instructive as the Michigan state law currently challenged by Tesla does not discriminate against out-of-state manufacturers. Specifically, Tesla is held to the same standard as manufacturers such as General Motors or Toyota, which are required sell their vehicles through a franchised dealer network. As such, even though the law may have an incidental effect on interstate commerce, the law regulates the conduct of manufacturers, no matter where domiciled.

As seen in *Ford Motor Co.*, a third legitimate local interest is the prevention of "vertical integration" of dealers and manufacturers. In fact, this was raised as an Affirmative Defense in Tesla's lawsuit against the State of Michigan. In this respect, state laws, such as Section 445.1574 of the Michigan Compiled Laws, that prevent the direct sale of vehicles to consumers by manufacturers, cause franchised dealers within the same geographic area to compete for the sale of their vehicles. Such competition amongst franchised dealers leads to lower vehicle prices for consumers. With an online direct sales model, the same incentive to reduce prices is not present for manufacturers. Indeed, a 2015 study by the Phoenix Center for Advanced Legal & Economic Public Policy Studies showed that intra-brand competition amongst franchised dealers in Texas caused new vehicle prices to drop by Five Hundred Dollars ($500.00) per sale. Beard, T. Randolph, PhD; Ford, George S, PhD; Spiwak, Lawrence, Esq. (2015) *The Price Effects of Intra-Brand Competition in the Automobile Industry: An Econometric Analysis*. *Phoenix Center Policy Paper Number 48*.

In sum, while Tesla continues to push the argument that franchise laws prohibiting direct sales by manufacturers are an unconstitutional violation of the Commerce Clause, it has been demonstrated that there are numerous compelling, legitimate state interests in prohibiting manufacturers from selling new motor vehicles directly to retail customers other than through franchised dealers. As such, rumors of the imminent demise of the automobile franchise dealership model are extremely overblown.