

BY LAWRENCE FISHER

**Q:** When are blatantly anticompetitive acts not a violation of antitrust laws?

**A:** When lawmakers say so.

More often than not, state regulation of business practices impedes innovation, raises costs and distorts markets. Most of these rules predate the Internet – indeed, some predate the revolution in commerce that brought us everything from direct marketing to big-box stores. However, they remain on the books, invisible to consumers and protected by the lobbying dollars of the incumbent businesses they protect.

But this sleeping dog may not snooze indefinitely. A light has been shown on these hitherto obscure laws, thanks in part to Tesla Motors' high-profile effort to sell its electric cars through company-owned stores, much as Apple sells iMacs and iPhones. Auto dealers, who once derided electric cars as niche vehicles for tree huggers, now view the Silicon Valley upstart as a threat and have used franchise laws to block Tesla's direct sales in numerous states. The goal is to protect local dealers from competition that would erode their market – and, in the best traditions of modern capitalism, force them to be more cost-effective and service-oriented.

Like the various laws that protect and subsidize the “family farm” – you know, those 2,000-acre grain factories run by mom, pop



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and \$4 million worth of machinery – state economic regulation is rooted in historical circumstances. Indeed, it may have been justifiable in economic terms at one time. For example, a century ago it was arguably a good idea to protect grieving families of the dead from fly-by-night embalmers by licensing funeral directors. It makes no sense today to use such laws to block inexpensive crematoriums or online casket sales. (More about that later.)

By the same token, the small businesses that sprang up to distribute automobiles in the 1920s may have needed protection from manufacturers who demanded big local investments, yet felt free to cancel the relationships or establish other dealers a few miles away. But today's corporate multibrand dealerships can take care of themselves without help from Big Brother. And they certainly can't justify using their legal muscle to prevent Tesla from competing directly in terms of either fairness or efficiency.

Meanwhile, the three-tier distribution system for alcoholic beverages – producers must sell to distributors who sell to retailers – is a states-rights legacy of the repeal of Prohibition and clearly did not anticipate the blossoming of boutique wineries, microbreweries and artisan spirits makers in the last two decades that target national and international markets through the Internet.

But a puzzle lurks. When Borders and Barnes & Noble decimated the ranks of independent bookstores – and when Amazon subsequently ate the chain stores' lunch on the Internet – there was plenty of teeth gnashing, but no legislation. When the specialized dealers in PCs, like CompUSA, MicroAge and Businessland, were undone by big-box consumer electronics stores like Best Buy, Apple's glitzy stores and Dell's direct-to-consumer approach, there was little outcry. How, then, have some incumbent businesses successfully commanded state protection from what the economist Joseph Schumpeter famously called creative destruction?

The short answer is that independent booksellers lacked the deep pockets and organizational strength of the National Automobile Dealers Association. The laws protecting business turf are primarily state, not federal, statutes. And any Johnny-come-lately who seeks to come between state legislators and their benefactors among the car dealers is likely to face a cold reception. Lobbyists for the dealers are quick to note that they are pillars of the community who sponsor Little League and the Kiwanis Club's charity drives. Equally to the point, they are also big donors to political campaigns. Woe betides the politician who crosses them on behalf of some out-of-state competitor spouting the virtues of competition.

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## Your Friendly Neighborhood Automobile Trust

In the first two decades of the 20th century, the auto industry distributed its products every way imaginable. Cars were sold directly through factory stores, mail order and consignment, and indirectly through department stores, traveling salesmen and wholesale dis-

tributors – and even through the Sears catalog. But as supply caught up with demand, the hodgepodge began to rationalize. From 1923 to 1929, “the leveling of demand for new cars logically resulted in a change of emphasis from production to distribution,” wrote Alfred P.



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Sloan Jr., the godfather of General Motors. “On the [retail] sales end, that meant a change from easy selling to hard selling. Dealer problems of an entirely new nature began to arise.”

Manufacturers took over wholesale distribution, while wholesalers morphed into retailers. These franchised dealers took on warranty repair and regular maintenance, and provided a means to trade in used cars for new ones. They were contractually obliged to invest in service facilities and were expected to maintain significant inventories so that buyers could drive home new cars the same day they shopped. Dealers, moreover, became vulnerable to “channel stuffing” – being forced to take on more inventory than they could possibly sell at a profit – a manipulative strategy reportedly pioneered by Henry Ford in the 1920’s.

Dealers sought succor in new laws. “The car dealers went about getting protection after the Great Depression. But it’s in the 1950s that we start seeing regulations like the Automobile Dealers Day in Court Act,” which increases dealers’ leverage to seek damages in federal court for abuses of franchise agreements, explained Francine Lafontaine, a professor of business economics and public policy at the Ross School of Business at the University of Michigan. “Maybe at some specific time there was a benefit, but then these dealers became entrenched. The results are higher prices for consumers at the end of the day.”

Although the act is a federal statute, most of the laws protecting franchise dealers were passed at the state level. Lafontaine says that the state laws have been successfully used to block manufacturers from canceling dealerships because of falling demand, as after the 2008 financial crisis, or in response to customer complaints or shady behavior. All states require auto dealers to be licensed,

which has effectively stymied Internet distribution of cars. Thus, sites like Carsdirect.com and Cartelligent.com (as well as brick-and-mortar enterprises like AAA and Costco) do not sell cars, but rather negotiate discounts with franchise dealers.

The licensing requirement also effectively blocks auto manufacturers from selling directly to consumers because most states will not license them as dealers. As long as there were no new entrants in auto manufacturing, which was the case for many decades, this requirement protected the franchisees’ legal cartel.

When Tesla launched its \$109,000 Roadster in 2008, the conventional wisdom was that the latest coming of electric cars would fail just as earlier iterations had, fatally handicapped by high battery cost and short driving range. Never mind that the speedy two-seater went 200 miles on \$5 worth of electricity. Tesla sold the Roadster direct to customers – at first from the factory, later through a few stores. But the dealers’ lobbies didn’t pay much attention because it was a pricey vehicle that would appeal only to rich greenies.

Perceptions changed a bit with the introduction of the Tesla Model S, a sleek \$70,000 sedan aimed squarely at the Audi/BMW/Mercedes crowd. And alarm bells truly sounded when *Consumer Reports* gave its highest rating ever to the S, and the electric newcomer charted sales exceeding the comparable conventional models from that Teutonic triumvirate. As Tesla stores started opening across the United States and abroad, franchise dealers circled the wagons and called their state legislators.

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tions in multiple states have filed lawsuits against Tesla, trying to kill the infant in its crib – or at least to get Tesla to put the crib under their protection. In states that prohibit direct sales, like Virginia and Texas, Tesla operates “galleries,” which resemble its stores. But they cannot take orders, or even discuss price and financing options.

Texas has the most stringent law, requiring all new cars to be purchased through independent dealers. Texans may still purchase vehicles from Tesla, but the transactions must be handled out of state. This may result in loans with higher interest rates and the inability to finance Texas state sales tax owed as part of the car loan. Also, buyers cannot take advantage of Tesla’s personal delivery service. New owners, moreover, must register the vehicles and pay the sales tax themselves.

Tesla’s effort to persuade the Texas legislature to open the door to direct sales may not prove as futile as one might expect. Indeed, Tesla’s strategy of demanding marketing concessions from states if they are to have any chance of inducing Tesla to build production facilities in their jurisdictions suggests why the dealers’ market power may be vulnerable. Texas is one of five states lobbying to be the site of Tesla’s planned \$5 billion mega-factory, where it will mass-produce lithium-ion batteries in partnership with Panasonic.

New Jersey, which initially licensed Tesla

stores, abruptly switched sides in March. Elon Musk, Tesla’s chairman and chief executive, wrote an open letter to New Jersey citizens, asserting that, after initially promising to put the matter to a vote by the state legislature, Gov. Chris Christie caved to the auto dealers.

Musk did not mince words. “The rationale given for the regulation change that requires auto companies to sell through dealers is that it ensures ‘consumer protection,’” he wrote. “If you believe this, Governor Christie has a bridge closure he wants to sell you! Unless they are referring to the Mafia version of ‘protection,’ this is obviously untrue. As anyone who has been through the conventional auto dealer purchase process knows, consumer protection is pretty much the furthest thing from the typical car dealer’s mind.”

In May, dealers in Missouri took dead aim at Tesla, proposing amendments to another bill that would force consumers to purchase all new vehicles through franchised dealers. The current Missouri statute only bars franchisors from competing against their franchisees. Ford, for example, cannot compete with Ford dealers.

All this activity at the state level has not gone unremarked in Washington, where three members of the FTC’s professional staff weighed in. In a blog post titled “Who decides how consumers should shop?” Andy Gavil, Debbie Feinstein and Marty Gaynor turned a



gimlet eye toward the dealers. “How manufacturers choose to supply their products and services to consumers is just as much a function of competition as what they sell – and competition ultimately provides the best protections for consumers and the best chances for new businesses to develop and succeed,” they wrote. “Our point has not been that new methods of sale are necessarily superior to the traditional methods – just that the determination should be made through the competitive process.”

NADA, the aforementioned dealers’ trade association, begs to disagree. “State franchise laws create fierce competition between local new-car dealerships, which drives down prices both within and across brands,” said Jonathan Collegio, vice president of public affairs for NADA. “When three Ford dealers compete for the same customer, the customer wins, period.”

Not so fast, say economists, some 70 of whom wrote a letter to Christie urging an end to the direct sales ban:

The automotive industry in the United States (and New Jersey is no exception) is competitive; no manufacturer has anything like a monopoly. Tesla in particular, as an upstart

new entrant, has a market share in New Jersey of less than 1 percent. But even if Tesla *did* have a degree of market power sufficient to extract monopoly prices, prohibiting direct distribution would not be likely to introduce more competition or lower average prices.

“The likelihood that Tesla will successfully convince federal courts to invalidate the various state auto dealer franchise laws in their entirety is remote,” opined Roger M. Quinland, a franchise law attorney with Gordon & Rees. “Tesla’s greatest chance for success lies in convincing the courts that narrow exemptions from state regulations should be tailored for the company, based upon its unique status in the automotive marketplace.”

In any case, the very visibility of the battle may prove a win for Tesla, whatever courts and legislatures decide. “As Tesla’s dealer fight rages on, the company gets plenty of press that enables it to explain what’s unique about its approach to selling vehicles,” the online investment site Motley Fool wrote, noting that Tesla does not advertise. Tesla’s vice president of business development, Diarmuid O’Connell, concurs. “I think that it’s been extraordinarily rewarding,” he told *The Wall Street Journal*. “It’s been vastly worth the effort.”

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## The American Way of Funerals?

In 2011, David Harrington, a professor of economics at Kenyon College, testified on behalf of the monks of St. Joseph Abbey who were barred from selling their handmade wooden caskets in their home state of Louisiana because they were not licensed funeral directors. The monks won their case in federal court. But similar laws remain on the books in many states.

“In the states that have the most restrictive

laws,” Harrington said, “they’re primarily aimed at protecting small, mostly family-owned funeral homes from competition. They create barriers to entry for no-frills cremation operations – but also for national chains, which tend to focus at the high end, with more pricey funeral and cemetery combinations.”

State funeral home licensing requirements largely date to the early 20th century. Initially,

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Harrington says, they were motivated by health concerns. Some experts believed that cemeteries caused epidemics and that the spread of disease could be reduced by embalming. In the 19th century, families had typically prepared the dead for burial themselves, making their own caskets or purchasing them from local carpenters, and arranging delivery to the cemetery with whoever owned a suitable carriage. Early regulations were intended to protect the public from poor-quality embalming, but also served to impart professional status to funeral home operators and spare them price competition.

Today, embalming is most associated with the traditional funeral, which calls for the body's display in an open coffin. But 39 states have ready-to-embalm laws that require all firms offering funeral services to maintain an embalming room at each of their facilities, regardless of whether they offer embalming services. Embalming rooms must conform to strict size and material standards. So these laws significantly increase costs to firms specializing in cremations – and also to funeral home chains, which might otherwise realize economies by consolidating their embalming facilities in single locations.

Many states prohibit cemeteries from operating mortuaries, some prohibit anyone

other than licensed funeral directors from selling caskets, while others make it difficult for anyone other than funeral directors to own funeral homes. All of these measures create barriers to competition and increase costs.

That's hardly a new revelation: Jessica Mitford's seminal work, *The American Way of Death* (1963), portrayed funeral directors as predatory salesmen pushing grieving customers into overpriced goods and services, an image that has been reinforced by subsequent analyses. A decade-long study by the FTC resulted in the federal *Funeral Rule of 1984*, which mandated more transparent pricing and no-frills options. But funeral costs have continued to rise.

Harrington blames state regulations. "It's like a spider's web," he said. "The states that are the most anticompetitive have all these strands of regulation, and they weave this web so they have redundancy of regulation. If you remove one strand, the web still holds. The funeral directors' associations in a lot of states are among the most powerful lobbying organizations. Local funeral home operators are very heavily involved in their churches. And if you look at subcommittees or committees in state legislatures, they are headed by representatives who are currently funeral directors. They have pretty much a lock on blocking any reform."

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## Law of Unintended Consequences

In 1933, the 21st Amendment repealed the 18th Amendment to the U.S. Constitution, thus bringing an end to the 14-year socio-biochemical experiment known as Prohibition. It's worth noting that the prohibition of alcoholic beverage sales did reduce consumption, the stated aim of the ungainly coalition

of do-gooders and religious fundamentalists that spurred passage of the law. But it had myriad unintended consequences, including the growth of organized crime, a sharp increase in deaths from tainted booze and the criminalization of broad swaths of society. It also increased social and economic inequality:



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The wealthy could maintain private stocks of imported wine and spirits with impunity while the poor were jailed for making bathtub gin. (Any resemblance to current drug policy must surely be coincidental.)

The authors of the 21st Amendment paid lip service to the temperance movement's goal of reducing alcohol abuse. But they left the details to the states, giving them authority to decide when and how to organize and regulate alcohol sales. All of them enacted regulations in which single ownership of all three tiers (production, distribution and retail) was partly or totally barred. Only Washington, a wine-making state, has since entirely abandoned the three-tier approach (in 2011).

Arguably, the three-tier system worked reasonably well in the first few decades after repeal, which saw the consolidation of countless regional beer, wine and spirits producers into big national brands and the simultaneous proliferation of wholesale distributors. Then the process began to reverse, first in the 1960s with the emergence of boutique wineries, then typified by Robert Mondavi, Ridge Vineyards and Freemark Abbey; later in the 1970s with the first microbrewers like Anchor, New Albion and Sierra Nevada; and in the 1980s with craft distillers like Germain-Robin, St. George Spirits and Clear Creek Distillery. The distribution tier went through consolidation during these decades so that today there are far fewer, but vastly larger, distributors. Small producers say they struggle even to be noticed and get lost in the big distributors' portfolios, all the while surrendering profits they can't spare.

"State laws continue to empower distributors to select brands and manage them however they want – selling those they choose to sell, while letting other brands sit in their warehouses," wrote Steve Hindy, president of

Brooklyn Brewery. "The only recourse is to sue, and many small breweries lack even a fraction of the resources needed to take on a big distributor in court. As a result, they're stuck with the bad distributor, which severely hampers their ability to perform and grow as a business." Freeing his brewery from a particular distributor cost him more than \$300,000 in legal fees and settlement charges.

State laws have also prohibited wineries from shipping their products directly to consumers, which can often be the only way a small operation can survive. Court challenges have chipped away at these laws. Most notably, in 2005, the Supreme Court decided that, while states could prohibit direct shipments of wine, they could not simultaneously allow direct sales by in-state wineries and bar imports from other states.

"As a general matter, the wine producers favored direct shipment," explained Jerry Ellig, a senior research fellow at the Mercatus Center at George Mason University, and a former FTC official. "The big California wine industry was not really worried about competition from Kentucky or Virginia. The two folks who tended to oppose it were states that had these laws, and wine and spirits wholesalers. They generally would oppose anything that would allow people to get around the distribution tier."

Ellig studied wine prices before and after Virginia passed a law permitting direct sales. "We found that the spread between online and off-line prices diminished," he said.

But distributors retain significant clout. "Together, the nation's two largest wholesalers – Southern Wine and Spirits and Republic National Distributing Company – have revenues of about \$13 billion," David White, editor of the wine blog *Terroirist*, wrote in *The New York Times*. "A chunk of that cash is funneled to lawmakers. The National Beer Wholesalers

Association maintains the nation's third-largest political action committee, and since 2000, it has donated \$15.4 million to candidates for federal office. ... In the past decade ... the

Wine and Spirit Wholesalers of America spent \$9.3 million." All told, he estimates that anti-competitive regulation of distribution increases retail prices by as much as 25 percent.

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## The Fill-in-the-Blank Industry Is Different

Regulation, in general, is deeply unfashionable among owners of small to midsize businesses. Except, of course, when it comes to regulation that protects incumbent enterprises. Automobile sales, alcoholic beverage distribution and funeral services share little in common, yet incumbents in each claim they are uniquely deserving of special favor.

Jonathan Collegio of NADA took particular exception to my suggestion that small bookstores or PC dealers ought to have sought sanctuary in state law. "It's a major fallacy to compare buying cars with buying other goods, like books or computers," Collegio said. "Cars are major purchases that require licensing, insurance, complex financing involving trade-ins; contain hazardous materials; and, if operated incorrectly, can cause serious bodily injury."

That still doesn't explain why Tesla shouldn't be allowed to operate its own stores, which by all accounts do a fine job with the minimal service an electric car requires, and can write finance contracts with the best of them.

"When I was at the FTC, we held a series of hearings on these laws," Ellig recalled. "It was almost comical because we had separate panels on wine, autos, legal services, health care and telemedicine, charter schools. ... All these panelists would come and testify and they hadn't listened to the other panels, so the auto guys would say, this isn't like wine and cheese, this is unique. The alcohol dis-

tributors said this isn't like cars, and legal services said they were not like wine or cheese or books. Everyone was saying there was a unique reason that states should protect their industry, and only their industry, from competition."

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By this point, I expect most readers have concluded that it is difficult to be optimistic that competitive market forces will triumph in these jealously guarded fortresses of economic privilege. Difficult, but hardly impossible. American economic history is full of examples of such privilege being eroded or broken, largely by changes in technology, the rise of countervailing business interests and/or growing public awareness of who foots the bill. Thus steel-consuming manufacturers managed to eliminate import protection for high-cost iron and steel makers, aided in no small part by the rise of domestic "mini-mills" that thrived without protection. By the same token, the rail and airline industries were unable to prevent economic deregulation once they lost control of their regulators and passengers tasted the fruits of competitive pricing.

Indeed, one can spot erosive forces at work in the three industries discussed here, as Tesla takes its complaints to a national stage, the funeral industry consolidates and an array of small wineries and craft beer producers take on the giant distributors. In healthy economies, anyway, competition doesn't stay dead for long. 